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As Chief Compliance Officer, Could You Be the Target of an Enforcement Action?

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With the Securities and Exchange Commission's increasing focus on individual accountability for the federal securities laws, there is a growing risk that chief compliance officers (''CCO'') of broker-dealers and investment advisers will find themselves in the Enforcement Division's cross-hairs. As Commissioner Kara M. Stein noted recently, ''[W]e need to be bringing the tough cases against those who could have prevented misconduct. Chief Compliance Officers [among others] who help individuals or firms violate the law need to be sanctioned. . . . We need to send a strong message of instilling personal responsibility and accountability.''[1] Unsurprisingly, the SEC and other regulators have been pursuing aggressive theories of personal liability against CCOs and expanding their potential exposure for violations of the securities laws by their firms. And the increasingly frequent collaboration between examiners from the SEC's Office of Compliance Inspections and Examinations and attorneys from the Enforcement Division is likely to intensify scrutiny of CCOs.

CCOs need to understand the real risk that they could be the targets of enforcement actions and keep that risk in mind as they devise and implement their firm's compliance programs. This article provides an overview of the potential theories of CCO liability under relevant provisions of the U.S. federal securities laws; reviews certain disciplinary actions against CCOs; suggests strategies for minimizing the likelihood of regulators bringing a disciplinary action against a CCO; and discusses issues CCOs should consider if they find their firm or themselves the target of an enforcement action.

[1] Kara M. Stein, Comm'r, Sec. & Exch. Comm'n, Remarks at the American Bar Association Business Law Section's Federal Regulation of Securities Committee Fall Meeting (Nov. 22, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540403898#.UzwWUPldV8E.

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I. Understanding the Risks—Theories of Personal Liability Against CCOs

Enforcement actions involving CCOs are generally based on one of three theories: (i) acting as a primary or direct violator of the U.S. federal securities laws; (ii) aiding and abetting or causing a violation of U.S. federal securities laws; or (iii) failing to reasonably supervise.[2] Because of the different contours of these theories—and the current uncertainty surrounding the third category of supervisory liability for CCOs—it is vital that CCOs understand their potential exposure under all three theories.

[2] *See* Section 15(b)(4)(E) of the Securities Exchange Act of 1934 (''Exchange Act'') and Section 203(e)(6) of the Investment Advisers Act of 1940 (''Advisers Act'').

A. Primary Violator Liability. The most straightforward instance of a disciplinary action brought against a CCO occurs when the CCO is directly involved in a violation of the securities laws. For example, the Commission found that the CCO of a registered broker-dealer violated the anti-fraud provisions of the Exchange Act when he participated in a scheme with a salesperson he supervised to provide kickbacks to a trader in exchange for compensation.[3] In addition, the SEC has charged CCOs with primary violations of the securities laws for creating false compliance documents. For example, the SEC charged Peter Madoff, who served as CCO at Bernard L. Madoff Investment Securities LLC, for creating ''compliance manuals, written supervisory procedures, reports of annual compliance reviews, and compliance certifications to merely paper the file'' when in fact no policies or procedures were ever implemented, and no reviews were actually performed.[4] When a CCO is directly involved in the wrongdoing, the Commission or the Financial Industry Regulatory Authority (''FINRA'') will likely charge the CCO with violating the applicable securities laws. In most cases, these enforcement actions are not really about the CCO's activities and role as a compliance officer. Rather, such cases show that where CCOs themselves are active participants in bad acts, they will be charged just like any other securities law violator.

B. Aiding and Abetting or Causing Liability. To target the conduct of CCOs when they are acting in their compliance capacity, and not as primary violators, regulators can rely on aiding and abetting or causing theories. In general, aiding and abetting liability requires an underlying violation, substantial assistance in connection with the primary violation, and scienter (which can be satisfied by recklessness). CCOs may also be found liable for ''causing'' violations, which similarly involves a primary violation and an act or omission by the CCO that causes the violation. For CCOs, the greatest risk of liability comes from aiding and abetting or causing their firms' violations of compliance program rules.[5] In fact, the SEC has begun a Compliance Program Initiative that specifically targets firms with prior compliance deficiencies, and the Enforcement Division is actively coordinating with examiners in the field to bring cases.[6]

1. Aiding and Abetting Liability

Both the Exchange Act and the Advisers Act authorize the Commission to bring an enforcement action against any person who aids and abets another in violating the securities laws.[7] To be held liable for aiding and abetting a primary violation of the securities laws committed by another person, the Commission must demonstrate: (i) the existence of a primary securities law violation; (ii) knowledge or recklessness on the part of the CCO; and (iii) the ''substantial assistance'' of the CCO in the commission of the primary violation.[8] In a recent case, the U.S. Court of Appeals for the Second Circuit held that the SEC is not required to plead or prove that the alleged aider and abettor ''proximately caused'' a primary securities law violation.[9] The court clarified that the appropriate standard for determining the substantial assistance component of aider and abettor liability in an SEC civil enforcement action is that the defendant ''associated himself with the venture, that the defendant participated in it as something that he wished to bring about, and that he sought by his action to make it succeed.''[10]

Applying aiding and abetting liability, the Commission has charged CCOs for deficiencies in the design and implementation of compliance policies and procedures—that is, the programs that are the peculiar responsibility of a CCO.[11] In one case, for example, the Commission brought an enforcement action against a CCO for aiding and abetting a firm's failure to establish, maintain, and enforce policies and procedures designed to prevent the misuse of material, non-public information.[12] The Commission found that the CCO was responsible for establishing and administering the firm's compliance programs, including policies and procedures designed to comply with Section 15(f) of the Exchange Act (now Section 15(g) of the Exchange Act). The CCO was aware of compliance weaknesses and failures, which the SEC examination staff had identified in a deficiency letter. Nevertheless, the CCO failed to correct them. As a result, the Commission found that the CCO aided and abetted the firm's primary violation. In another example, the Commission brought an enforcement action against a CCO of an investment adviser for, among other things, aiding and abetting the firm's failure to: (i) adopt and implement written policies and procedures to prevent violations of the Advisers Act; (ii) conduct annual reviews of such policies and

[3] *See In re Zwick*, Initial Decision Release No. 336 (Oct. 25, 2007) (SEC determined that David Zwick, as principal and CCO of Suncoast Capital Group, Ltd., a registered broker-dealer violated Section 17(a) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Exchange Act. *See also, In re Application of Dennis Todd Lloyd Gordon and Sterling Scott Lee for Review of Disciplinary Actions Taken by NASD*, Exchange Act Release No. 57655 (April 11, 2008).

[4] *See* Complaint, *SEC v. Peter Madoff*, No. 12-cv-5100 ¶ 38 (June 29, 2012 S.D.N.Y.) (On October 15, 2013, the S.D.N.Y. entered a default judgment against Peter Madoff after he failed to answer, move or otherwise respond to the Commission's complaint. However, the default judgment ordered no monetary relief in light of Madoff's criminal conviction and the $143 billion in restitution ordered in the parallel criminal proceeding.)

[5] *See, e.g., Equitas Capital Advisors, LLC, Equitas Partners, LLC, David S. Thomas Jr. and Susan Christina*, Exchange Act Release No. 70743 (Oct. 23, 2013) (charging CCO with aiding and abetting and causing the firm's violation of Advisers Act Section 206(4) and Rule 206(4)-7).

[6] *See* Press Release, Sec. & Exch. Comm'n, SEC Sanctions Three Firms Under Compliance Program Initiative (Oct. 23, 2013) *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540008287#.U0auW_ldV8E.

[7] Exchange Act Section 20(e), Advisers Act Section 209(f).

[8] Section 20(e) of the Exchange Act and Section 209(f) of the Advisers Act provide the SEC with authority to bring an action against ''any person that knowingly or recklessly provides substantial assistance to another person in violation of [securities laws]'' and such person ''shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.'' *See, e.g., SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009) (setting forth elements of aiding and abetting liability under Section 20(e) of the Exchange Act).

[9] *See SEC v. Apuzzo*, 689 F.3d 204 (2nd Cir. 2012).

[10] *Id.* at 214.

[11] *See White Paper: The Evolving Role of Compliance*, SIFMA (Mar. 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589942363.

[12] *See, e.g., In re Buckingham Research Grp., Inc.*, Exchange Act Release No. 63323 (November 17, 2010).

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procedures; and (iii) establish and maintain a written code of ethics to monitor the personal trading of supervised persons with access to non-public information.[13] There, the Commission found that the CCO failed to take reasonable steps to determine whether the firm had procedures in place to prevent violations of the Advisers Act when engaging in principal trades with the firm's clients and failed to implement such policies on behalf of the firm. The CCO had purchased an ''off the shelf'' investment adviser compliance manual containing sample written policies and procedures for investment advisers (''IA Manual'').[14] The CCO was responsible for revising the draft IA Manual so that the written compliance policies and procedures in the IA Manual reflected the firm's actual advisory business. But more than nine months after becoming CCO, the firm still did not have in place written policies and procedures or a written code of ethics that complied with the mandatory regulatory requirements for investment advisers. As a result, the Commission found that the CCO aided and abetted the firm's violation of Section 206(4) and Section 204(A) of the Advisers Act. Where CCOs default on their principal duties to oversee a compliance program, the Commission may take action against the CCO for aiding and abetting the firm's primary violation of compliance-related rules.

In addition, the SEC no longer needs to demonstrate actual knowledge or scienter as the requisite *mens rea* for aiding and abetting liability. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended the standard of liability to include ''reckless'' behavior.[15] Thus, it is clear that the standard for liability as an aider and abettor now requires something less than actual knowledge.[16] Courts have found the recklessness standard satisfied where ''the alleged aider and abettor encountered red flags or suspicious events creating reasons for doubt that should have alerted him to the improper conduct of the primary violator . . . or if there was a danger . . . so obvious that the actor must have been aware of the danger.''[17]

2. Causing Liability

Separate from aiding and abetting liability, Section 21C of the Exchange Act and Section 203(k) of the Advisers Act authorize the Commission to enter a cease-and-desist order against ''any person that is, was, or would be a cause of'' another's violation of the Exchange Act or Advisers Act or the rules thereunder, if such person ''knew or should have known'' that his act or omission would contribute to such violation. To establish causing liability, the Commission must demonstrate: (i) the existence of a primary violation of the securities laws; (ii) that the person to be held secondarily liable was, through an action or omission, a cause of the primary violation; and (iii) that the person to be held secondarily liable knew or should have known that his conduct would contribute to the primary violation.[18] Unlike aiding and abetting liability, causing liability can attach to merely negligent behavior on the part of the CCO.[19]

For example, the Commission brought an enforcement case against a CCO of a broker-dealer for causing the firm's violations of the reporting, recordkeeping, and record retention requirements under Rule 17a-8 of the Exchange Act.[20] The CCO directed all of the firm's actions with respect to its customer identification program procedures and the verification of its customers, but the Commission found that the CCO failed to meet her obligation to comply with the anti-money laundering obligations of the Rule, including the obligation to maintain an accurate customer identification program. As a result, the CCO was found liable for causing the firm's Exchange Act violation.

C. Failure to Supervise Liability. The ''failure to supervise'' standard traditionally has been applied where the respondent has either direct supervision of the ''line personnel'' who violated the law or possessed some ability to control, discipline, or otherwise alter the conduct of line personnel.[21] Supervisory power can generally include the ability to hire, fire, reward, or punish employees.[22] In describing the role and responsibilities of a CCO of an investment adviser, the Commission has stated: ''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 of the Advisers Act would not necessarily be subject to a sanction by us for failure to supervise other advisory personnel.''[23] Where a CCO clearly has these powers and thus acts in a supervisory

[13] *See Wunderlich Sec. Inc., Tracy L. Wiswall, and Gary K. Wunderlich, Jr.*, Exchange Act Release No. 64558 (May 27, 2011); *see also In re Foxhall Capital Mgmt, Inc.*, Admin. Proc. File No. 3-15293, 2013 SEC LEXIS 1222 (April 19, 2013) (SEC disciplined a CCO for his firm's failure to conduct a timely annual review of the firm's compliance policies and procedures).

[14] The use of off the shelf or pre-packaged compliance policies and procedures can be dangerous for CCOs of brokerage and investment adviser firms. *See, e.g. In re Consulting Servs. Grp., LLC*, Exchange Act Release No. 56612 (Oct. 4, 2007). The SEC found that the CCO was responsible for adopting and implementing the pre-packaged manual and template for use as his firm's written policies and procedures, and that he failed to undertake adequate efforts to identify the risk factors of specific conflicts that may have been applicable to his firm's operations as a pension consultant. As a result, the SEC found that the CCO willfully aided and abetted and caused his firm to violate Section 206(4) and Rule 206(4)-7 of the Advisers Act.

[15] 15 U.S.C. §§ 78t(e), 80b-9(f). *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, Pub. L. 111-203, §§ 929M- 929O (July 21, 2010).

[16] *See Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (''A secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct.'').

[17] *Id.* (internal quotation marks and citations omitted).

[18] Exchange Act Section 21C; Advisers Act Section 203(i)(B).

[19] *See KPMG, LLP v. SEC*, 289 F.3d 109, 120 (D.C. Cir. 2002) (noting that a negligence standard is ''virtually compelled'' by Congress's choice of language in enacting Section 21C). A negligence standard, however, may not apply to causing scienter-based primary violations. *See, e.g. Howard v. SEC*, 376 F.3d 1136, 1141 (D.C. Cir. 2004).

[20] *In re Pinnacle Capital Mkts. LLC*, Exchange Act Release No. 62811 (September 1, 2010).

[21] *See In re Huff*, 50 S.E.C. 524, Release No. 29017, Release No. 34-29017, 48 SEC Docket 767, 1991 WL 296561, at *7 (Mar. 28, 1991) (Comm'rs Lochner & Schapiro, concurring) (noting that an individual with direct responsibility for an employee is presumptively the employee's supervisor).

[22] *See, e.g., Vance v. Ball State Univ.*, 133 S.Ct. 2434 (June 24, 2013).

[23] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Adviser Release No. 2204 at fn. 73 (Dec. 24, 2003).

capacity, there is an obvious risk that supervisory liability could attach. But the degree of control a CCO must have before supervisory liability will apply is somewhat uncertain, and there is a risk that a CCO can drift into the role of supervisor while carrying out what seem to be ordinary, non-supervisory compliance functions.

It is fairly clear that compliance officers may be found liable for failure to adequately perform and fulfill compliance or supervisory functions that they have been delegated.[24] For example, in April 2013, FINRA disciplined a CCO in connection with his firm's sale of non-exempt unregistered securities.[25] FINRA determined that the firm failed to have adequate WSPs in place designed to prevent the sale of non-exempt unregistered securities. In the absence of such WSPs, FINRA concluded that the CCO, who was responsible for the firm's WSPs, violated Rule 3010 which requires member firms to establish, maintain, and enforce a system of WSPs.

Outside of cases involving the ordinary supervision of compliance responsibilities delegated to the CCO, a leading precedent involving supervisory liability is the *Gutfreund* Section 21(a) Report. John H. Gutfreund, the chief legal officer (''CLO'') of a broker dealer, learned that a senior person in the firm's trading desk submitted a false bid in an auction of U.S. Treasury securities and informed management of that fact. The matter was not further investigated, the trader who engaged in such activities was not disciplined, and the trader continued to submit false bids for some time. Gutfreund, as CLO, did not have direct supervisory responsibility over the relevant personnel in the ordinary course of his duties, but the SEC treated him as a functional supervisor when he participated in the firm's response to a compliance issue. The Commission stated that a firm's CLO could be disciplined for a failure to supervise based on the misconduct of employees for whom he was not the direct supervisor but where he had knowledge of possible misconduct and the authority to intervene to prevent it.

> Once a person . . . becomes involved in formulating management's response to the problem, he or she is obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct . . . If such a person takes appropriate steps but management fails to act and that person knows or has reason to know of that failure, he or she should consider what additional steps are appropriate to address the matter. These steps may include disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities.[26]

Although the SEC concluded that Gutfreund had acted reasonably under the circumstances in his capacity as CLO, the SEC's view that Gutfreund had the ''requisite degree of responsibility, ability or authority to affect'' the trader's conduct to qualify as a supervisor represented an expansion of traditional failure-to-supervise claims to non-line supervisors.

The SEC staff has recently begun to push the boundaries of supervisory liability, as seen in the controversial *Urban* case. Even though the *Urban* decision no longer has any legal effect, it does signal the possibility of increasingly aggressive use of supervisory liability. In that case, the Commission charged a firm's general counsel, who was responsible for all legal and compliance matters of a brokerage and investment advisory firm, with failing to supervise the activities of a rogue broker and financial advisor.[27] The Commission's Enforcement staff alleged, among other things, that the general counsel was the broker's supervisor because he had a role in monitoring the broker's actions. The ALJ found the general counsel to be a supervisor of the broker, even though he lacked ''any of the traditional powers associated with a person supervising brokers,'' such as the power to hire, fire, or discipline the broker who was the primary violator. Instead, the ALJ found that the general counsel was the broker's supervisor because he generally had the ''requisite degree of responsibility, ability, or authority to affect'' the broker's conduct. The ALJ based this conclusion on the fact that ''[the General Counsel's] opinions on legal and compliance issues were viewed as authoritative . . . he was a member of the Credit Committee, and dealt with [the broker] on behalf of the committee.''[28] The ALJ did not impose a sanction, however, finding that Urban reasonably discharged his supervisory duties by seeking to have the rogue trader terminated. In particular, the ALJ found that Theodore W. Urban reasonably relied on the firm's director of retail sales to exercise heightened supervision over the trader once indications of his misconduct were made known. After refusing to grant summary affirmance of the ALJ's decision and agreeing to hear the case on appeal,[29] the Commission thereafter summarily dismissed the case.[30]

One problem with the ALJ's decision is that it fails to understand the distinction between the roles of legal and compliance on the one hand, and the business managers of a regulated entity on the other. Generally speaking, business line supervisors are the ones primarily responsible for reviewing, monitoring and supervising the activities within their control and complying with applicable securities laws related to those activities. While legal and compliance staff may be responsible for developing policies and procedures for the firm, they traditionally advise the business on compli-

[24] *See Brady Casille*, FINRA AWC No. 2011025843302 (March 15, 2013)(finding CCO violated NASD Rule 3010 by failing to supervise the firm's owner (and producing manager) who excessively traded in at least five customer accounts, and the firm's written supervisory procedures (''WSPs'') required the CCO to review the producing manager's trading activity, and the CCO failed to identify and follow up on red flags indicating excessive trading).

[25] *Michael A. Zurita*, FINRA AWC No. 2009019534203 (April 4, 2013)(finding CCO violated NASD Rule 3010 by failing to supervise a registered representative in connection with the sale of non-exempt unregistered securities, and instead relied on the registered representative to determine whether the shares were either registered or properly exempt); *see also Richard Borgner*, FINRA AWC No. 20120328624 (March 13, 2013)(finding that a CCO, who was responsible for the firm's Forms U4 and U5, failed to maintain and implement an adequate supervisory system for filing and amending Forms U4).

[26] *See In re Gutfreund*, Exchange Act Release No. 31554, 1992 SEC LEXIS 2939 (Dec. 3, 1992).

[27] *See In re Urban*, Initial Decision No. 402, Admin. Proc. File No. 3-13655, at 56 (Sept. 8, 2010) (''*Urban*'').

[28] *See Urban* at 52.

[29] *In re Urban,* Exchange Act Release No. 63456 (Dec. 7, 2010).

[30] *In re Urban*, Exchange Act Release No. 66259 (Jan. 26, 2012) (Chairman Schapiro and Commissioner Walter recused themselves).

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ance and regulatory issues. But as a result of the SEC's lack of clarifying guidance, compliance officers should be concerned about the potential for personal liability as they provide advice to management and carry out their responsibilities of preventing and, if necessary, addressing violations of laws or regulations by firm employees.

Following *Urban*, there is substantial risk that the standard for supervisory liability is so amorphous that any CCO is at potential risk. As SEC Commissioner Daniel M. Gallagher has put it, ''the question of what makes a legal or compliance officer a supervisor. . .remains disturbingly murky.''[31] Commissioner Gallagher stressed that compliance and legal personnel are ''by default, not supervisors but rather providers of support for the firm's other employees.'' To this end, he warned, ''[a]n overbroad interpretation of 'supervision' risks tacitly deputizing as a supervisor, with concomitant liability, anyone who becomes actively involved in assisting management in dealing with problems. Deterring such active involvement will erode investor confidence in firms, to the detriment of all.''[32]

On Sept. 30, 2013, the SEC's Division of Markets and Trading provided some guidance on the potential liability of compliance and legal personnel at registered broker-dealers through a series of answers to frequently asked questions (''Compliance FAQs'').[33] Overall, the Compliance FAQs should provide some limited comfort to compliance and legal officers who may be wary of their own potential liability for violations of federal securities laws by employees of the firm over whom they have no direct, ''in-line'' supervisory power. But the release is non-binding and explicitly states that the Commission itself has neither approved nor disapproved of these Compliance FAQs. Nevertheless, in clarifying that the ALJ's initial *Urban* decision is of no-effect,[34] and in seeking to relieve some of the concerns that CCOs have expressed, the release provides some encouraging signs that the SEC staff recognizes the concerns of CCOs about their own personal liability and is working to try and allay some of those fears.[35]

[31] Daniel Gallagher, Comm'r, Sec. & Exch. Comm'n, Remarks at The SEC Speaks in 2012, *available at* http://www.sec.gov/news/speech/2012/spch022412dmg.htm.

[32] *Id.*

[33] Div. Mkts. & Trading, Sec. & Exch. Comm'n, Frequently Asked Questions About Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act (Sept. 30, 3013) (''Compliance FAQs''), *available at* http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm. *See also* http://www.sidley.com/SEC-Releases-Guidance-on-Supervisory-Liability-of-Compliance-and-Legal-Personnel-11-12-2013.

[34] In response to one question as to the status of the initial decision in *Urban*, the Compliance FAQs states that under the Commission's rules of practice, if a majority of the Commissioners do not agree on the merits (as was the case in *Urban*), the initial decision ''shall be of no effect.'' Compliance FAQs at 7 (citing Commission Rule of Practice 411(f), 17 C.F.R. § 201.411(f)).

[35] Although the Compliance FAQs specifically addresses the concerns of compliance and legal personnel at broker-dealers about their potential liability under the Exchange Act, CCOs at investment advisory firms should also consider the Compliance FAQs instructive of their own potential liability for failure to supervise under Section 203(e) of the Advisers Act.

II. What CCOs Can Do to Protect Against Disciplinary Action

In carrying out their routine compliance functions, CCOs can mitigate their risks of becoming a target of an enforcement action. But many of these measures must be implemented in advance, before the CCO is in the regulators' cross-hairs.

A. Confirm Supervisory Responsibilities Under Current Compliance Policies and Procedures; Monitor and Test Compliance Program. As basic as it seems, to help avoid liability, the CCO should not have supervisory responsibilities over business line activities. To that end, the CCO should undertake a review of the firm's compliance policies and procedures to designate the appropriate person to have supervisory responsibilities over the relevant business functions of the firm. The firm's procedures should be assessed to ensure that the CCO is not designated as a supervisor of, or has been inadvertently delegated supervisory review over, business activities for which business personnel are or should be responsible. In addition, the firm's procedures should be reviewed and, as necessary, modified to clearly differentiate between compliance monitoring functions and supervisory responsibilities, to help prevent the CCO from inadvertently assuming supervisory responsibilities. The CCO should periodically discuss with the business side their supervisory responsibilities and review whether the proper persons are designated for supervisory functions. And the firm's manual should state that any supervisory authority of legal and compliance personnel is solely for activities within the legal and compliance departments. Finally, compliance officers should ensure that the firm's policies and procedures reflect the firm's business activities and are not ''off the shelf'' procedures that include references unrelated to the actual business.

B. Implement a System for Addressing 'Red Flags.' In the event red flags or potential misconduct are identified, the firm should have a process in place to review, investigate, track, and document the matter. When red flags are identified, it should be documented which business supervisor is handling the issue and how the matter is being handled. Once the CCO is involved in the matter, the CCO should take reasonable action to review how the matter is being addressed so that it is adequately resolved. Firm management should be alerted to potential misconduct, communications with management should be documented, and the CCO should follow-up with management on any corrective action taken. In the event that the CCO is aware that potential misconduct is not being adequately addressed, he or she should report this to senior management and document their discussions with senior management to help avoid being accused of not adequately taking additional steps once the misconduct has been identified.

C. Evaluate Committee Membership. Compliance officers should carefully consider whether serving on a firm's committee may increase the risk that regulators will think they act as a supervisor outside of the compliance department. There can be instances where the CCO should be a voting member of a committee, and the mere fact that the CCO serves on a firm committee by itself should not transform the CCO into a supervisor. But a firm and CCO should consider whether full,

voting membership on a committee is necessary or whether the CCO should participate on a committee as a non-voting or *ex officio* member.

D. Communicate With Supervisors. The CCO should periodically meet with designated supervisors to inquire whether the supervisor is conducting the proper supervisory review of the business he or she is responsible for overseeing.[36] These meetings should be documented. In addition, the firm may consider obtaining certifications from supervisors stating that the supervisor understands his or her role as the supervisor of a specific business and is carrying out his or her supervisory obligations. In the event that a compliance officer assumes supervisory responsibilities on behalf of a business line supervisor, the compliance officer should document the reason for assuming supervisory responsibility and when such responsibility reverts back to the business supervisor.

III. Enforcement Considerations for CCOs

In the current enforcement environment, there is a risk that even the most diligent CCO will become entangled in an enforcement investigation and face possible personal liability. In those circumstances, there are several considerations that CCOs should keep in mind.

First, CCOs should be aware of signs that they are becoming an investigatory target or a potential respondent in an enforcement proceeding. Unlike a U.S. Attorney's Office, the SEC Enforcement Division does not formally designate individuals as targets or subjects of investigations,[37] so there may be no express warning the regulators are starting to focus their attention on a CCO. The one clear indicator is the receipt of a Wells notice directed to the CCO, but that comes only relatively late in the investigative process. At a much earlier stage, a CCO should be alert for signs that the investigation has begun to focus specifically on her role, responsibilities and conduct.

Second, in any investigation, privilege issues need to be considered—and considered carefully in the case of a CCO who is also an attorney. A threshold question is whether the CCO is an attorney that is licensed to practice law; in some cases, an active bar membership may be a prerequisite for asserting the privilege over a CCO's communications.[38] Assuming the CCO is an active member of the bar, the next issue is distinguishing when a CCO is providing legal advice instead of simply monitoring the firm's compliance program. Documents created as part of a firm's routine compliance program are unlikely to qualify as legally privileged. But other communications with the CCO may well be privileged and can be withheld from production. Generally speaking, where an attorney-CCO is providing advice on how to comply with the federal securities laws, that advice should be protected by the attorney-client privilege.[39] It can be challenging, however, to distinguish on a case-by-basis when the CCO is providing legal advice and when he or she is simply fulfilling her responsibilities as a compliance officer. Firms may elect to clearly differentiate the roles of the legal and compliance departments and make it clear that the CCO is generally not within the privilege. There are strategic considerations as well. The CCO may need documentary evidence to demonstrate that he or she was appropriately fulfilling her compliance responsibilities, and asserting privilege over some documents may undercut those efforts. At the same time, there may be issues about which the CCO provided legal advice that the firm would prefer to shield from the view of the regulators. Ultimately, the privilege is held by the firm, and the firm must make a final decision to assert or not assert the privilege, based on all the legal and strategic factors in play at the time.

Third, in many routine examinations, the firm's principal point of contact with the regulators may be the CCO, but if attention starts to focus on the CCO and Enforcement personnel begin to take a more active role, it is time for the CCO to take a back seat in interactions with the regulators. For firms with separate legal functions or a general counsel, it may be a simple matter to have another lawyer step into that role. Alternatively, the firm should consider engaging outside counsel to handle the examination or investigation and insulate the CCO from interfacing with regulators. Where outside counsel has already been engaged, the CCO may have been functioning as the firm's principal point of contact for the outside lawyers. It may be advisable to transfer that responsibility to some other in-house lawyer with no direct involvement in the matter under investigation.

Fourth, once the CCO has become a clear target of the investigation, serious consideration should be given to engaging separate defense counsel to represent the CCO individually. Even if there is no immediate conflict between the interests of the CCO individually and the firm, there may be an advantage to having counsel whose sole responsibility is to the CCO. Depending on the state of play in the investigation, it may be advisable for the CCO's separate counsel not to surface with the regulators and play the role of ''shadow counsel.'' Whatever arrangement the particular circumstances call for, CCOs may want their own lawyer to protect their individual interests.

IV. Conclusion

With the Commission's continuing focus on liability of individuals, CCOs will undoubtedly be under increas-

[36] These meetings are in addition to annual meetings with the CEO and senior management, and detailed report on the firm's compliance program and system of supervisory controls, that is required of broker-dealers and investment advisers. *See* FINRA Rule 3130, Advisers Act Rule 206(4)-7.

[37] According to the U.S Attorneys' Manual, a ''target'' is linked to the commission of a crime and is a putative defendant, while a ''subject'' is a person whose conduct is within the scope of the investigation. *See* U.S. Attorneys' Manual § 9-11.151. While the SEC Enforcement Division does not employ these categories, the SEC staff will sometimes acknowledge that an individual is a mere witness and is not the focus of the investigation.

[38] Typically, the party wishing to assert attorney-client privilege must show that the person to whom the communication was made ''is a member of the bar of a court.'' *See United States v. United Shoe Mach. Corp.*, 89 F. Supp. 357, 358-359 (D. Mass. 1950).

[39] *See, e.g.*, *In re Sealed Case*, 737 F.2d 94, 99 (D.C. Cir. 1984) (party asserting attorney-client privilege for communications by in-house attorney who had duties outside the ''lawyer's sphere'' must make a ''clear showing'' that attorney was acting in a ''professional legal capacity'').

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ing scrutiny. With recent clarifications in the standards of secondary liability and uncertainty about possible expansion of supervisory liability, there is substantial risk that CCOs will find themselves potential targets of enforcement actions. CCOs are well advised to plan ahead and take appropriate steps to minimize those risks.