InteractiveBrokers

SPOTLIGHT ON

Advisory Firm Chief Compliance Officer Responsibility and Liability

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Overview

Rule 206(4)-7 under the Investment Advisers Act of 1940 ("Advisers Act") requires a registered investment adviser to adopt compliance policies and procedures reasonably designed to prevent violations of the Advisers Act by the adviser or its supervised persons. Each adviser is also required to appoint a Chief Compliance Officer ("CCO") to implement these compliance policies and procedures. While the rule does not prescribe specific requirements for being a CCO, such as a legal degree or requisite years of experience in the securities industry, a CCO must be competent and knowledgeable regarding the Advisers Act and other applicable federal or state laws and should be empowered with full responsibility and authority to develop and enforce appropriate compliance policies and procedures.[1] This spotlight offers a brief review of an advisory firm CCO's responsibilities and analyzes specific circumstances where a CCO may face personal liability.

The CCO's Responsibility

First and foremost, the CCO plays a front and center role in creating and administering the advisory firm's internal control system. Generally, the CCO, along with management, should undertake the following:

- **Analyze Operations** — A CCO should analyze the firm's operations to ensure that they comply with applicable federal and state securities laws and regulations, and should use this analysis to create a system of controls or to supplement the firm's existing control system;
- **Implement Program** — A CCO should implement a program to ensure that all firm personnel fully understands the firm's policies and procedures and their responsibility to implement those policies and procedures;
- **Testing and Review** — A CCO should adopt a testing and review program designed to provide reasonable assurance that the firm's policies and procedures are effective and fully implemented.[2]

[1] See "2018 Investment Management Compliance Testing Survey Highlights Trends," available at iaa.om (2018).

[2] See Lemke and Lins, *Regulation of Investment Advisers*, §2:169, (2020 ed).

Rule 206(4)-7 mandates the firm to conduct an annual review to determine their adequacy and the effectiveness of its compliance program. Therefore, the CCO should consider any compliance matters that arose during the previous year, any changes in the adviser's business activities or its affiliates, and any changes in federal or state laws that might suggest a need to revise the policies and procedures.

At a minimum, as part of this annual review, the CCO should address the adequacy of the firm's compliance program in the following areas:

- **Portfolio management processes**, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;
- **Trading practices**, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;
- **Proprietary trading** of the adviser and personal trading activities of supervised persons;
- **The accuracy of disclosures** made to investors, clients, and regulators, including account statements and advertisements;
- **Safeguarding of client assets** from conversion or inappropriate use by advisory personnel;
- **The accurate creation of required records and their maintenance** in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- **Marketing advisory services**, including the use of solicitors;
- **Processes to value client holdings** and assess fees based on those valuations;
- **Safeguards for the privacy protection** of client records and information; and
- **Business continuity plans**.[3]

Additionally, the CCO should also consider conducting interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments, as the SEC expects the CCO to employ various compliance tests. For example, the CCO should consider periodically testing the execution quality portfolio turnover rate, comparative performance of accounts,[4] activities of access persons' personal trading accounts, and the firm's social media contents, etc. in order to detect possible unusual patterns, red flags, or potential violations.

The CCO's Personal Liability

[3] See Dexter B. Johnson, *A Resolution for Advisers and CCOs: The (New Year's) Annual Review,* The Investment Professional Regulations Blog, available at http://theiprblog.com/tag/chief-compliance-officers/ (Jan 4, 2012).

[4] See Panebianco, *The After-Effect if rule 203(b)(3)-2: What it Means to take on the Role of CCO to Comply with a Controversial Measures*, Journal of Investment Compliance 59 (2005).

Section 203(e)(6) of the Advisers Act grants the SEC the authority to sanction advisers if it finds that the adviser has failed reasonably to supervise employees. Sections 15(b)(6)(A)(i) and 15(b)(4)(e) of the Exchange Act establish a similar authority. A violation of this provision requires a showing of three elements:

> (1) a violation of federal securities laws committed by a person, i.e., the primary violator;
> (2) supervision of the primary violator by another, i.e., the supervisor; and
> (3) the supervisor's failure to reasonably supervise the primary violator's compliance with federal securities laws.[5]

Section 203(e)(6) does not explicitly impose personal liability for supervision on the CCO. Generally, a CCO does not automatically become a supervisor solely because of the title he or she holds. Typically, a CCO may not have line authority or responsibility or other direct control over employees' activities.[6] Historically, the SEC has refrained from imposing personal liability upon CCOs except for three specific circumstances:

- **Participating in the wrongdoing;**
- **Hindering the SEC examination or investigation;** and
- **Wholesale failure to adhere to compliance responsibilities and implement a compliance program.[7]**

We will walk through a few cases to discuss specific circumstances where CCOs may be personally sanctioned by the SEC and where they were not despite firms' compliance failures.

The *Gutfreund* Standard[8]

The rise and fall of Solomon Brothers, the then most profitable firm on Wall Street, need not be recited. Rather, we focus on the personal liability of Donald Feuerstein, Salomon Brothers' Chief Legal Officer and Head of Compliance here. In late April 1991, three members of the senior management of Salomon, including "King of Wall Street" John H. Gutfreund, learned that Paul Mozer, head of Solomon's Government Trading Desk, had submitted a false bid in an auction of treasuries. Feuerstein, though not a direct supervisor of Mozrer, advised senior management that Mozer's action was a criminal act and should be reported to the government, and he urged them on several occasions to proceed with disclosure. However, Feuerstein did not direct that an inquiry be undertaken, and he did not recommend that appropriate procedures be instituted, or that other limitations be placed on Mozer's activities. Feuerstein also did not inform the Compliance Department, for which he was responsible as Salomon's chief legal officer, of the false bid.

[5] See Lemke and Lins, *Regulation of Investment Advisers*, §2:170, (2020 ed)
[6] See Inv. Adv. Act Rel. No 26299 (Dec 24, 2003).
[7] Ascent Team, *Is the CCO Liable? Two SEC Cases, Two Wildly Different Rulings*, (Mar 5, 2019), available at https://www.ascentregtech.com/blog/is-the-cco-liable-two-sec-cases-two-wildly-different-rulings/.
[8] Id.

The SEC took the position that persons occupying positions in the legal or compliance departments of broker-dealers could be found to be “supervisors” under certain circumstances where that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.

In this case, Feuerstein was informed of a serious misconduct by senior management in order to obtain his advice and guidance, and to involve him as part of management’s collective response to the issue. Moreover, in other instances of misconduct, Feuerstein had directed Solomon's response and had made recommendations concerning appropriate disciplinary action, and management had relied on him to perform those tasks. Once Feuerstein was involved in formulating management’s response to the issue, he became a “supervisor” and thus was obligated to take appropriate action to address the misconduct. These responsibilities cannot be avoided simply because Feuerstein did not previously supervise Mozer. As a result, he must either discharge those responsibilities or know that others are taking appropriate steps.

BlackRock Advisors, LLC [9]

This case concerned investment adviser BlackRock’s failure to disclose a conflict of interest involving a portfolio manager’s outside business activity. Daniel Rice joined BlackRock in 2005 and managed BlackRock’s energy-focused registered and private funds as well as separate accounts. Rice was one of BlackRock’s most highly compensated portfolio managers. Between 2007 and 2010, Rice formed a number of business entities, including Rice Energy Management LLC, Rice Energy Irrevocable Trust, Rice Energy, LP and Rice Drilling B, LLC, collectively “Rice Energy.” Rice Energy Entities would form joint ventures with companies held in BlackRock funds managed by Rice. For example, Rice Energy entered into a joint venture with a public coal company held in a fund managed by Rice. By June 30, 2011, ANR stock was the largest holding in the $1.7 billion BlackRock Energy & Resources Portfolio. Despite the significant conflict of interest resulting from Rice’s highly profitable outside business activity, BlackRock failed to disclose the conflict to the funds’ boards of directors or to BlackRock advisory clients.

Senior management at BlackRock, including CCO Bart Battista was informed of Rice Energy as early as January 2007. The CCO reviewed and discussed the matter and allowed Rice to form Rice Energy, but the CCO concluded that there was no associated conflict of interest. Senior management later learned that Rice had repeatedly made loans to a Rice Energy entity in violation of BlackRock’s private investment policy, but again failed to take any corrective action. It was not until February 2010 that BlackRock acknowledged the conflict of interest through a memorandum when Rice wanted to serve on the board of the aforementioned joint venture between Rice Energy and ANR. However, BlackRock allowed Rice to continue his financial investment in the joint venture while managing the portfolio but failed to monitor or initiate any

[9] In the Matter of Blackrock Advisor, LLC and Bartholomew A. Battista, IA Rel No. 4065 (April 20, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4065.pdf.

reassessment of Rice's involvement with Rice Energy. BlackRock also failed to inform the boards of directors of the Rice-managed registered funds or advisory clients about Rice's involvement with and in Rice Energy. Rice's connection to Rice Energy and his simultaneous role as an energy-sector portfolio manager were eventually revealed by the Wall Street Journal in 2012.

In this case, the SEC found BlackRock's CCO Battista caused BlackRock's compliance-related failures. As CCO, Battista was responsible for the design and implementation of BlackRock's written policies and procedures. He knew and approved of Rice's outside business activity but failed to promptly identify any relevant conflicts of interest. Battista did not recommend written policies and procedures to assess and monitor Rice's outside activity and failed to disclose conflicts of interest to the funds' boards and advisory clients. As a result, Battista's **wholesale failure** to adhere to his compliance responsibilities caused BlackRock's not to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

Southwind Associates of NJ Inc.[10]

Southwind was examined by the SEC's OCIE in 2003, 2006, and 2013. In each instance, the staff issued a deficiency letter to Southwind. Each letter discussed different deficiencies, but all of them focused on issues relating to the firm's compliance with the Custody Rule, the Compliance Rule, and the recordkeeping requirements under the Advisers Act. Southwind hired an independent consultant to review its compliance program and provide written recommendations for improvements. After the review, the firm implemented a revised compliance manual. The CCO was responsible for administering the policies and procedures set forth in the revised compliance manual.

Specifically, the revised manual provided the client funds and securities Southwind had custody over had to be verified by an annual surprise examination conducted by an independent public accountant. However, the firm did not retain an independent public accountant to conduct a surprise examination between 2010 and 2012. Additionally, the revised manual provided that Southwind would timely—within 120 days of the private fund's fiscal yearend—distribute audited financial statements every year to its private fund investors. In July 2011, the CCO responded to the independent consultant, who was reviewing Southwind's private fund practice, that he would email relevant entities to request that they provide information to allow the timely distribution of the audited financial statements. However, there was no evidence that the CCO ever contacted those relevant entities with such a request. Between 2010 and 2012, audited financial statements were distributed no earlier than 220 days and as late as 334 days after the end of those private funds' respective fiscal years.

[10] In the Matter of Southwind Associates of NJ Inc., William Scott Villafranco, and Anthony LaPeruta, IA Rel No. 4834 (December 22, 2017), available at https://www.sec.gov/litigation/admin/2017/34-82397.pdf.

In this case, the SEC found the CCO willfully aided and abetted and caused Southwind's violations. The CCO knew of the firm's deficiencies, with each deficiency going unremedied for a number of consecutive years. Pursuant to the firm's compliance manual, the CCO was responsible for addressing the deficiencies. The CCO failed to ensure that Southwind complied with the Custody Rule, despite his awareness of the Rule's requirements and his responsibility as CCO to implement the firm's policies and procedures concerning the Custody Rule. As a result, the CCO was barred from acting in a supervisory or compliance capacity in the securities industry due to his willful **participation in the wrongdoing**.

Pennant Management [11]

Pennant Management was a Wisconsin-based investment adviser registered with the SEC from April 1995 until May 2015. In January 2012, Pennant CEO appointed one of Pennant's portfolio managers as interim CCO. This CCO had no compliance experience but accepted the position contingent upon having access to outside counsel and compliance consultants as needed. At that time, the CCO was already working extended hours to keep up with his portfolio manager duties, which he retained after being appointed as CCO.

After educating himself about a registered investment adviser's compliance requirements and reviewing Pennant's compliance manual, the CCO concluded that Pennant's compliance program was deficient and advised the CEO of his concerns in a number of emails. The CEO, however, did not retain additional outside resources at that time. The CEO then made the CCO's interim position permanent in August 2012 and soon afterward gave the CCO additional compliance duties over four registered entities. In December 2012, the CCO gave the CEO a list of high-priority compliance priority compliance projects that needed to be completed and requested more compliance resources. Again, the CEO did not follow through. On multiple occasions during 2013, the CEO denied requests from the CCO for additional resources.

The CCO learned in January 2013 that the employee responsible for Repo—Pennant's most significant line of business—allocation likely was not following the allocation policy and that Pennant was not maintaining records formally documenting Repo client indications of interest and the basis for allocation decisions. Upon a risk assessment of the Repo program, the CCO detected service counterparty risks related to the program, which he escalated to the CEO and the Board of Directors. However, the CEO did not engage in any efforts to amend Pennant's written policies and procedures to include counterparty due diligence and monitoring. By the end of 2013, clients had invested a total of almost $800 million in the program. As a result, Pennant fell victim to a massive fraud involving a fictitious portfolio of loans in its Repo program, and the CEO was duly sanctioned by the SEC.

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[11] In the Matter of Mark A. Elste, IA Rel No. 5062 (November, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-5062.pdf.

In this case, the SEC faulted the CEO for Pennant's failure to establish a compliance program despite numerous red flags, but significantly, **the Commission did not name or pursue action against the CCO**. The SEC instead found that the CCO, who had no prior compliance experience, had done his best by educating himself and proactively conducted compliance reviews and risk assessments. Additionally, the CCO had repeatedly requested resources for Pennant's compliance program and raised red flags to management, all to no avail.

The *Pennant* case is a stark contrast to the Southwind case. In *Southwind*, the CCO, a trained compliance officer, had adequate recourses for his compliance program but failed to execute it over an extended period of time. In *Pennant*, the CCO educated himself, performed his compliance duties diligently and requested resources and support reportedly, and thereby **avoided liability**.

Conclusion

A CCO may not be a frontline warrior in the capital markets, but as a gatekeeper and one of the most important members of a firm's management team, he or she is responsible for overseeing compliance within the firm and providing reasonable assurance to management that the firm's internal control system is effective and efficient. Although no provision of the Advisers Act specifically imposes personal liability for CCOs, he or she should not, at a minimum, participate in the wrongdoing of the firm and its supervised persons, hinder an examination or investigation or fail to perform his or her compliance duties completely.

A CCO should continue to study applicable securities laws and regulations. And the firm should delegate sufficient seniority and authority to the CCO in order to compel supervised persons to adhere to the compliance policies and procedures.[12]

[12] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Rel no. IA-2204 (Feb 5, 2004).