New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
WEDNESDAY, JULY 9, 2014

Outside Counsel

Expert Analysis

Broker-Dealer Compliance in Era of Regulatory Pressures

BY ROBERT C. GOTTLIEB AND DERRELL M. JANEY

The ever escalating cost to financial market participants from increased regulatory reporting and supervisory examinations stemming from the Dodd-Frank Wall Street Reform and Consumer Protection Act to enhanced regulatory regimes from the Federal Reserve, the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) is a major factor in current market consolidation and the closure of firms across the country. In particular, the nation's broker-dealers have experienced the overwhelming impact of these pressures.

FINRA reports that the number of registered broker-dealers has dropped by 11 percent over the past five years, from 5,005 in 2007 to 4,140 in April 2014.[1] For lawyers counseling broker-dealers, however, advising them on whether to remain independent or merge with a larger player to gain critical mass in the wake of enhanced regulatory regimes is only part of the issue.

In a widening number of instances broker-dealer executives and compliance professionals are held personally responsible for compliance failures. This "trend" substantially increases the risk of the business, especially for small to medium size firms, and effective strategies for avoiding sanctions are more critical than ever.

ROBERT C. GOTTLIEB *is the founder and managing partner of Gottlieb & Gordon.* DERRELLE M. JANEY *is counsel at the firm.*

Rick Kopstein

Robert C. Gottlieb and Derrell M. Janey

Brown Brothers Harriman

On Feb. 5, 2014, FINRA announced that it fined Brown Brothers Harriman (BBH)—the oldest and largest private bank in the United States—a record $8 million for anti-money laundering (AML) compliance failures. This is the highest fine ever levied by FINRA for AML-related violations. Importantly, FINRA also fined the AML compliance officer, Harold Crawford, $25,000 personally and imposed a one-month suspension from association with any FINRA member in any capacity.[2] Even though the size of the fine relative to the scale of BBH's business might appear de minimus, broker-dealers cannot afford the reputational damage associated with anti-money laundering compliance failures because, at minimum, such labels become a competitive advantage for their peers. For compliance professionals within those firms the risk is a potential "death penalty" for their careers.

In the case of BBH, FINRA based the fine on the broker-dealer's "substantial anti-money laundering compliance failures, including, among other related violations, its failure to have an adequate anti-money laundering program in place to monitor and detect suspicious penny stock transactions."[3] Allegedly, BBH failed to sufficiently investigate potentially suspicious penny stock activity brought to the firm's attention and did not fulfill its Suspicious Activity Report (SAR) filing requirements. In addition, BBH did not have an adequate supervisory system to prevent the distribution of unregistered securities.

Penny stock transactions pose heightened risks because low-priced securities may be manipulated by those who distribute false information about the issuer company in order to create demand for the stock. As trading in the stock increases and the stock price rises, the fraudster sells its own shares at inflated prices. After they have realized a profit and discontinued their stock promotion, the stock price falls and investors lose their investment. From Jan. 1, 2009 to June 30, 2013, FINRA found that BBH executed transactions or delivered securities involving at least six billion

shares of penny stocks, many on behalf of undisclosed customers of foreign banks in known bank secrecy havens, such as Switzerland, Guernsey and Jersey. According to FINRA, BBH lacked such basic information as the identity of the stock's beneficial owner, the circumstances under which the stock was obtained, and the seller's relationship to the issuer.[4]

BBH and Crawford were aware (e.g., through internal AML investigations) that certain clients were depositing, and shortly thereafter selling, large blocks of low-priced securities. FINRA also specifically alleged that BBH and Crawford knew that the firm's brokerage activity had expanded when its Swiss bank clients "realized they could offer their underlying clients anonymous access to U.S. securities markets."[5]

FINRA acknowledged that BBH had an AML compliance program that included suspicious activity surveillance; however, FINRA's findings about that program are instructive:

- The system failed to adequately monitor brokerage execution and custodial banking activity involving penny stock transactions;
- The AML program failed to adequately monitor and detect potentially suspicious penny stock activity and sufficiently investigate potentially suspicious penny stock transactions that were raised to the firm's attention; and
- The AML program failed to ensure that suspicious activity was reported in instances where the firm had already responded to regulatory requests regarding information deemed to be suspicious and failed to update prior SAR filings when activity continued through the firm more than 90 days after a previous SAR was filed.

Designing AML programs for broker-dealers must be unique to the risks inherent in the products managed by the firm. On the other hand, the key points from the BBH case are compelling: compliance programs must be intensely active, living organisms that constantly "monitor," continuously "investigate," "ensure" that issues are reported and, once reported, have an adequate protocol for "updating" on the activity at issue. BBH and Crawford were not deemed to have done these things.

There did come a time when Crawford made recommendations to business line management to address the risks of the penny stock business. However, the firm did not pursue those steps on a timely basis. Ultimately, Crawford, as the person responsible for managing the AML staff, was viewed personally (or through his designee) as "responsible for making determinations as to whether to file SARs on behalf of the Firm and was ultimately responsible for establishing and implementing a program reasonably expected to detect and cause the reporting of suspicious activity when appropriate."[6]

The BBH case clearly is not the end of aggressive regulatory action. In the wake of continued pressure from the investing public and politicians to restore investor confidence in the markets generally, broker-dealers and compliance professionals at those firms will not find reprieve any time in the near future. At FINRA's annual conference in late May, the FINRA Chairman and Chief Executive Officer, Rick Ketchum, in his welcome remarks, emphasized that FINRA is endorsing "strong regulation." Whatever that means, in the context of the current environment, it is assured that the approach broker-dealers have historically taken to compliance must change.

The greatest danger is that firms can be shuttered practically overnight where the regulatory violations, in the extreme case, raise a specter of criminal wrongdoing on the part of the organization and its executives. Even in instances where broker-dealer executives and their compliance professionals believe they are being proactive to avoid problems, their conduct to avoid devastating consequences might expose them to further liability.

Chief Compliance Officer

The chief compliance officer (CCO) performs a vital role in helping to shape the compliance culture within any broker-dealer. However, under certain facts and circumstances, the effectiveness of the compliance role can be impeded, and the compliance professional can face liability for failure to supervise, where the CCO performs an operating role or has supervisory authority over business units or other personnel outside of the compliance department.

The practice of shared roles (e.g., CEO/CCO, COO/CCO) is often the case in small to medium broker-dealers where personnel cost is a factor. However, this approach is no longer an acceptable practice. Increased regulatory and supervisory demands require significant focused attention, and where the compliance manager has dual supervisory and compliance responsibilities, the role of compliance within the institution can be blurred. A broker should know clearly whether he or she is being given guidance by compliance or direction on a business issue from line management. The current regulatory environment demands as much.

Furthermore, where those lines are blurred, there is a likely risk that a compliance failure of a business unit, or even with respect to an individual broker within the firm, can result in a sanction for failure to supervise by FINRA or the SEC. Compliance must be, in both form and substance, an independent internal control function, albeit one that has a trust relationship with the firm's business units.

Section 15(b)(6) of the Securities Exchange Act of 1934 authorizes the SEC to institute proceedings against a "natural person" associated with a broker-dealer if someone under that person's supervision violates the provisions of the securities laws and the supervisor failed "reasonably" to supervise that person with a view to preventing the particular

violation. The SEC's Division of Trading and Markets has indicated that most enforcement actions against individuals for failure to supervise have involved business line personnel. However, the SEC has brought failure-to-supervise actions against broker-dealer legal or compliance personnel where the individuals have been delegated or have assumed supervisory responsibility for particular activities or situations, or where they can be viewed to have "the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue."[7]

For example, in *In the Matter of Manuel Lopez-Tarre*, the SEC found that Manuel Lopez-Tarre, the chief compliance officer of a registered broker-dealer, was liable for failing to supervise the owner of the firm and a separate employee who engaged in millions of dollars of unauthorized trading in the brokerage account of two customers. Lopez-Tarre allegedly failed to establish procedures for reviewing the owner's customer accounts and email correspondence. Under the firm's written supervisory procedures, Lopez-Tarre had "sole responsibility for all supervisory reviews of customer account activity."[8] Given his role as compliance officer, Lopez-Tarre was deemed to have been in a reasonable position to have prevented and detected the employees' violations of the federal securities laws.[9] In this case, the compliance officer was barred from the industry.

Even though the facts and circumstances of any particular enforcement action can be unique, the broader implication of *Lopez-Tarre* is that the basis for deeming a compliance officer to be a "supervisor" is murky and there is tension with a long-held view that executive line management is ultimately responsible for supervising broker-dealer employees. Sanctioning compliance for failure to supervise might hinge simply on whether the SEC's Enforcement Division believes the situation warrants that the compliance manager had the "ability or authority to affect the conduct of the employee whose behavior is at issue." In other words, it is a highly subjective test.

The SEC Division of Trading and Markets has provided guidance that emphasizes compliance and in-house legal personnel at broker-dealers do not become "supervisors" solely because they have provided advice or counsel concerning compliance or legal issues to business line personnel, or assisted in the remediation of an issue.[10] On the other hand, insofar as the compliance professional has an ability to alter the conduct of an employee, especially relevant in a small to medium firm where the interaction between the professional and the employee is more intimate, the degree to which the compliance professional can be said to have the "requisite degree of responsibility, ability or authority to affect" employee conduct can be intensely debated in practically every fact situation and raises critical questions about how broker-dealers should view the compliance function in the first instance.

If compliance managers do not have the authority to actually terminate an employee for misconduct but can only make observations about bad acts or improper practices by line management, there can be no meaningful sense in which compliance can be said to have authority to affect employee conduct, except in extreme instances.

At a minimum, in order to avoid even the appearance that compliance is acting in a supervisory capacity, the duties and responsibilities of compliance, even in a small to medium firm, must be clearly defined and the degree of involvement in non-compliance functions should be carefully articulated.

The Future for Compliance

The way forward is an incredible minefield, especially where compliance professionals can be deemed to be supervisors and held to account for employee wrongdoing, including where compliance escalates its observations. Under regulatory reporting regimes that require "prompt" self-reporting, such as under FINRA Rule 4530, legal advisers to broker-dealers will be challenged with navigating privilege issues, ensuring effective approaches for conducting internal investigations under these circumstances, discerning corporate liability from the individual liability of compliance professionals and other executives, and shaping an effective defense where the broker-dealer itself might have criminal liability. The situation certainly is extremely cumbersome and effective regulatory guidance is sparse. Nevertheless, the lesson from recent cases is clear: Beware and take action now before it is too late.

1. Undoubtedly, weakening commission revenue caused by falling equity commission rates and the evolution of electronic trading has also been a factor in broker-dealer closings.
2. FINRA, News Release, "FINRA Fines Brown Brothers Harriman a Record $8 million for Substantial Anti-Money Laundering Compliance Failures," Feb. 5, 2014.
3. See FINRA Letter of Acceptance, Waiver and Consent No. 2013035821401, Re: Brown Brothers Harriman & Co., Respondent; Harold A. Crawford, Respondent.
4. Id.
5. Id. at 3.
6. Id. at 5.
7. See SEC Division of Trading and Markets, FAQs about Liability of Compliance and Legal Personnel at Broker-Dealers Under Section 15(b)(4) and 15(b)(6) of the Exchange Act (Sept. 30 2013).
8. *In re Manuel Lopez-Tarre*, Exchange Act Release No. 65391, Admin. Proc. File No. 3-14562 (Sept. 30, 2011).
9. Lopez-Tarre submitted an offer of settlement to the SEC in which he also supplied a sworn financial statement attesting to his inability to pay a fine.
10. See SEC Division of Trading and Markets, FAQs about Liability of Compliance and Legal Personnel at Broker-Dealers Under Section 15(b)(4) and 15(b)(6) of the Exchange Act (Sept. 30 2013).

Reprinted with permission from the July 9, 2014 edition of the NEW YORK LAW JOURNAL © 2014 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-07-14-16

Gottlieb & Gordon