Catching Fire During Regulatory Hunger Games: SEC and FINRA Disciplinary Actions Against Chief Compliance Officers and In-House Counsel (January-June 2014)

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Introduction

... I notice something is rising up around me. Smoke. From fire... I begin to panic as the smoke thickens. Charred bits of black silk swirl into the air, and pearls clatter to the stage. Somehow I’m afraid to stop because my flesh doesn’t seem to be burning and I know Cinna must be behind whatever is happening. So I keep spinning and spinning. For a split second I’m gasping, completely engulfed in strange flames.  

In Catching Fire, the second installment in the Hunger Games trilogy, Katniss Everdeen embarks on a victory tour to celebrate winning the fight-to-the-death Hunger Games chronicled in the first book of the series. She then finds herself having to quell the rebellion her victory inspired in the Districts (or risk the wrath of President Snow) and having to compete in a special edition of the Hunger Games where she once again has to defend her own life without taking the lives of any other tributes.

Being a chief compliance officer (CCO) or in-house counsel for a broker-dealer (BD) or an investment adviser (IA) is generally not quite so dangerous (or exciting). But it does pose some challenges and risks. CCOs and in-house counsel are in the difficult position of advising their colleagues and helping their firms comply with securities rules and regulations, without necessarily having the power to enforce their advice or decisions. They don’t even get crossbows. Moreover, their conduct is carefully scrutinized by the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA). While there’s no danger of CCOs or in-house counsel perishing in a whirl of flames, they are nonetheless potential targets of SEC and FINRA disciplinary “flames.”

This article, like its predecessors, analyzes many recent SEC and FINRA actions against CCOs and in-house counsel (who shouldn’t be confused with tributes) to gain insight on conduct that is likely to attract...
the attention of regulators. From January through June 2014, the SEC and FINRA brought disciplinary actions for a range of conduct, including failure to supervise, anti-money laundering (AML) deficiencies, falsifying books and records, aiding and abetting primary violations, and reporting violations.

Supervisory Systems and Written Supervisory Procedures

Could there be surveillance cameras? I’ve wondered about this before. Is this the way President Snow knows about the kiss?

Supervisory Systems and Written Supervisory Procedures

BDs and IAs are obligated to have reasonable supervisory systems, including surveillance for conduct such as sales practice violations. Surveillance cameras are probably going above and beyond what is considered reasonable. And surveilling for secret trysts is not required. Instead, FINRA requires broker-dealers to establish and maintain supervisory systems “reasonably designed to achieve compliance with applicable securities laws and regulations,” including written procedures to supervise the types of business in which the firms engage. The Securities Exchange Act of 1934 (Exchange Act) similarly provides a safe harbor from supervisory liability where there are “established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect” violations. Investment advisers are likewise required to adopt and implement policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 (the Advisers Act) and the rules promulgated thereunder. CCOs are sometimes responsible for their firms’ supervisory systems and therefore may be subject to disciplinary actions if they are deficient.

To prevent liability, firms should have procedures reasonably tailored to the business in which they engage. In January 2014, through a settled Letter of Acceptance, Waiver and Consent (AWC), FINRA disciplined a CCO for his firm’s failure to establish and maintain supervisory systems and procedures “reasonably designed to comply with Section 5” of the Securities Act of 1933, which prohibits the offer or sale of any security without registration. The firm and a registered representative participated in the unlawful distribution of four issuers, whose securities were not registered or subject to a registration exemption. When a customer of the firm purported to have converted debt of the issuers into equity of the issuers, the firm participated in the distribution of $10 million of unregistered securities without conducting an adequate inquiry to determine whether the securities could properly be sold under any exemption. The AWC stated that the CCO was responsible for the firm’s written supervisory procedures (WSPs) and that as the “designated supervisor for sales and trading at the firm,” the CCO was “responsible for establishing and maintaining compliance with Section 5.” The firm’s written procedures, however, only “generally addressed the sale of control or restricted stock under SEC Rules 144 and 145,” but “provided little or no supervisory structure to ensure overall compliance with Section 5, particularly given the nature of the firm’s business, which included liquidating large volumes of speculative, thinly traded stock on behalf of its customers.” The firm later revised its WSPs to list certain red flags indicative of the distribution of unregistered securities, which the AWC said the firm missed in connection with the securities at issue. The red flags included the following:

- “A customer opens a new account and delivers physical certificates representing a large block of thinly traded or low priced securities.”
- “The customer has a pattern of depositing physical certificates, immediately selling shares, then wiring out the proceeds.”
- “A customer deposits share certificates that are recently issued or represent a large percentage of the float for the security.”
- “There is a sudden spike in investor demand for, coupled with a rising price in, a thinly trade or low-priced security.”

Accordingly, FINRA found that the firm and the CCO violated NASD Rule 3010(a) (requiring a reasonable supervisory system) and (b) (requiring reasonable written procedures), and FINRA Rule 2010 (mandating that members “observe high standards of commercial honor and just and equitable principles of trade”). For these and other violations, the
CCO was suspended in a principal capacity for two months and fined $15,000. Takeaway: Firms should have procedures relating to the business in which they are engaged; generic descriptions are generally not sufficient.

In another settlement, a CCO was disciplined for her firm’s failure to have written procedures related to business lines in which the firm engaged. The CCO, who was also president, was responsible for creating and updating the firm’s written supervisory procedures. FINRA found that the firm failed to have written procedures related to direct market access business or master/subaccount arrangements. Direct market access accounts comprised nearly 40% of all accounts held at the firm and the firm held two omnibus accounts and approximately 10 master/subaccount arrangements. Accordingly, FINRA found that the firm’s procedures were not sufficiently tailored to the firm’s business and therefore not reasonably designed to achieve compliance with the securities laws in accordance with FINRA Rule 3010. The CCO was suspended for 60 days, fined $10,000, and ordered to re-qualify by examination before acting in a principal capacity again. Takeaway: Firms should have procedures relating to, and appropriately tailored to, the business in which they are engaged.

**Supervision of Individuals**

“Very well. Get your cousin out of here, then, girl. And if he comes to, remind him that next time he poaches off the Capitol’s land, I’ll assemble that firing squad personally.”

The Head Peacekeeper wipes his hand along the length of the whip, spattering blood. Then he coils it into quick, neat loops and walks off.

Whips and firing squads are probably pretty effective (if messy) ways to supervise individuals and to get people to do what you want them to do. CCOs or in-house counsel are not so-equipped, but may nonetheless be considered supervisors when they have been delegated specific supervisory responsibility over another individual or have sufficient “responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue.” Affecting compensation, hiring and firing (from jobs—not literally “fire”) are typical hallmarks of such supervisory authority. When CCOs or in-house counsel are deemed to be supervisors, and do not carry out that responsibility adequately, they may find themselves liable for failing to supervise individuals.

For example, in April 2014, a CCO was disciplined for his failure to supervise an investment adviser representative (IAR) who misappropriated more than $490,000 from approximately 50 clients via fraudulent management fees and redemption requests. In the settlement order, the SEC noted that the CCO, who was also the sole owner and principal of the investment adviser, had supervisory responsibility for the IAR. Starting in approximately 2007, the CCO became aware of instances of fraudulent management fees and funds stolen from clients, but took no action for years. Specifically, neither the firm nor the CCO took action to (1) remove the IAR and deny him access to the firm’s offices; (2) remove the IAR’s access to client accounts; (3) remove the IAR as the broker of record on client accounts; (4) inform securities custodians for client accounts to not accept instruction from the IAR on behalf of client accounts; or (5) adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act specific to the IAR’s means of committing fraud. For these and other violations, the CCO was barred and required, jointly and severally with the firm, to pay disgorgement and a civil penalty of $675,000. Takeways: Generally, CCOs and in-house counsel should play advisory roles (and that should be documented). But when they do explicitly engage in supervisory roles, they must follow through and take steps to address problematic representatives.

**Anti-Money Laundering**

And here I am with buckets of money, far more than enough to feed both our families now, and he won’t take a single coin.

Buckets of money might constitute a red flag in connection with money laundering (although that’s the apparent market value of successfully fighting for your life). BDs often have to look out for subtler signs. FINRA Rule 3310 requires BDs to implement an effective AML program designed to achieve compliance with the Bank Secrecy Act, 31 U.S.C. § 5311 et seq. In addition, Rule 17a-8 of the Exchange Act also requires BDs to comply with reporting obligations under the Bank Secrecy Act. Generally, BDs have an obligation to monitor for and report suspicious activity that may indicate money laundering.

In a May 2014 settlement, FINRA disciplined an AML compliance officer (AMLCO), who was also the firm’s
president and CCO, in connection with the firm's AML supervisory system.\textsuperscript{13} FINRA found that the firm, “through” the AMLCO, “demonstrated an ongoing pattern of noncompliance with the anti-money laundering rules” and that the firm and the AMLCO “failed to establish and implement an adequate AML supervisory system, reasonably designed to ensure compliance with the Bank Secrecy Act.” The settlement order enumerated a number of examples in which the firm and the AMLCO failed to follow their AML procedures, including the following:

- The firm’s procedures set forth red flags that should have prompted investigation by the firm and potentially the filing of a suspicious activity report (SAR); however, despite the occurrence of such red flags, neither the AMLCO nor anyone else at the firm took steps to investigate the red flags, which included:
  - High volume trading of low-priced securities;
  - Wire activity associated with liquidation of low-priced securities transactions;
  - Customer accounts associated with individuals who have securities-related disciplinary histories; and
  - Accounts either domiciled or maintained offshore.

- The firm’s procedures stated that the firm would utilize exception reports to monitor for “unusual size, volume, pattern of type of transactions, geographic factors and any of the red flags listed in the procedures.” FINRA found that the firm did not use exception reports, but instead relied on a daily review of customer trades, which the settlement order characterized as “inadequate as it does not allow the Firm to identify suspicious patterns of trading activity or other AML issues.”

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The settlement order also noted that the firm failed to implement other components of a reasonably designed AML system, including “failing to properly respond to requests under Section 314(a) of the USA PATRIOT Act of 2001, which authorizes law enforcement to communicate with broker-dealers to request information regarding persons or entities of interest to an investigation so that any accounts or transactions involving these individuals or entities can be promptly located.” FINRA found that the AMLCO was the firm’s “AML officer and [ha[d] managed day-to-day operations of the firm as its President, Chief Compliance Officer, and Registered Options Principal since 2006” who was “responsible for the creation and failed implementation of the policies that led to the AML violations by the firm.” Accordingly, by failing to “adequately identify, investigate or report suspicious activity,” the AMLCO was found to have violated NASD Rules 3011(a) and 2110 and FINRA Rules 3310(a) and 2010. He was fined $25,000, jointly and severally with the firm, and suspended for three months in a principal capacity.

In another settlement, FINRA disciplined another AMLCO in February 2014 in connection with his firm’s AML system.\textsuperscript{14} FINRA found that the firm and the AMLCO “failed to establish and implement an AML program reasonably designed to detect and cause the reporting of potentially suspicious activity.” The CCO was specifically responsible for “ensuring that the AML program was adequately tailored to the Firm’s business and appropriately monitoring, detecting and importing suspicious activity.” The AMLCO also “managed the Firm’s AML whole staff, was personally or through his designee responsible for making determinations as to whether to file SARs on behalf of the Firm and was responsible for establishing and implementing a program recently expected to detect and cause the reporting of suspicious activity when appropriate.”

FINRA found that while the firm had an AML compliance program that included suspicious activity monitoring, the firm failed to adequately monitor penny stock activity. FINRA noted that “[r]ading in penny stocks typically poses a higher than average risk because of the possibility of low trading volumes and relative lack of information regarding issuers” and that the SEC “has warned investors that, while many penny stocks are issued by legitimate business with real products and services, such stocks may be easily manipulated by fraudsters who distribute false information about the issuer company in order to create demand for the stock.” Despite the heightened risk, the firm allegedly conducted penny stock transactions “on behalf of bank customers in known bank secrecy havens, such as Switzerland, Guernsey and Jersey” and “allowed these omnibus accounts to conduct penny stock transactions for undisclosed underlying customers.
of foreign banks, even though the Firm could not generally obtain critical information such as the identity of the stock's beneficial owner, how the stock was obtained, or the beneficial owner's relationship with the issuer.” Moreover, FINRA noted that the firm and the AMLCO were aware that certain clients were “depositing, and shortly thereafter selling, large blocks of low-priced securities” but they “failed to tailor the Firm’s AML procedures to adequately detect, investigate and report suspicious activity, particularly patterns of suspicious penny stock activity, or red flags related to penny stock transactions.”

In addition, FINRA found that the firm:

- 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”;
- Failed to update prior SARs filings when activity continued for more than 90 days after the prior SAR was filed;
- Failed to adequately conduct due diligence on correspondent accounts for its foreign institutional customers; and
- Failed to conduct adequate AML independent testing.

For these failures, the AMLCO was suspended for one month in any capacity and fined $25,000. Takeaway: Penny stocks generally require special AML scrutiny, and firms must ensure they are monitoring for red flags set forth in their procedures.

Lying to Regulators

“I think we’ll make this whole situation a whole lot simpler by agreeing not to lie to each other.”

CCOs (and others) can make life (and examinations) a whole lot simpler by not lying to regulators by producing false books and records. BDs and IAs are required to maintain certain books and records under Securities Exchange Act Rules 17a-3 and 17a-4, Advisers Act Rules 204-2, and related FINRA Rules, including NASD Rule 3110. Where they fall short in maintaining truthful books and records, or tamper with them in some fashion, CCOs may face liability if they played some role in the violation.

In a May 2014 settlement, FINRA disciplined a CCO for submitting to FINRA backdated documents related to customer complaints. During the course of a routine examination, the CCO’s firm produced to FINRA Excel spreadsheets showing customer complaints received during a defined time period. The spreadsheets included a notation showing a false date on which the firm’s compliance department had supposedly reviewed the complaints, with the CCO’s initials near the notation. The AWC alleged that “[a]ccording to [the CCO], the date approximated the date on which he had reviewed the spreadsheets.” FINRA noted that the CCO “knew the spreadsheets he marked would be provided to FINRA staff.” FINRA found that the CCO violated NASD Rule 3110(a), which provides that firms have to keep books and records in accordance with applicable laws, rules, regulations, and statements of policy as prescribed in SEC Rule 17a-3 and FINRA Rule 2010. The CCO was suspended in any principal capacity for 20 business days and fined $7,500.

Through another settlement, FINRA disciplined another CCO in June 2014 for submitting backdated outside business activity (OBA) forms to FINRA staff. FINRA found that the CCO, who signed the backdated OBA form, knew or should have known that the forms had been backdated and failed to inform FINRA staff of that fact. Accordingly, the CCO violated FINRA Rule 3270 (governing outside business activities), NASD Rule 3010, and FINRA Rule 2010. For these and other violations, he was suspended from associating in a principal capacity for six months and fined $5,000. Takeaways: Deficient books and records are generally bad, but lying to regulators to make them appear satisfactory is even worse.

Aiding and Abetting

An uprising requires breaking the law, thwarting authority. We’ve done that our whole lives, or our families have. Poaching, trading on the black market, mocking the Capitol in the woods.

While Catching Fire, didn’t discuss the nuances of when someone is the primary or secondary lawbreaker, the federal securities laws do draw such distinctions. Aiding and abetting liability requires an underlying violation, substantial assistance in connection with the primary violation, and scienter, which is satisfied by recklessness. Similarly “causing” violations involve a primary violation and an act or omission by the person or entity that causes the violation. Causing liability, however, requires only negligence in some cases.
In June 2014, the SEC filed a complaint in the United States District Court for the Southern District of Florida, alleging that a CCO/general counsel of an IA aided and abetted fraud committed by his firm and one of its principals.\textsuperscript{21} The complaint alleged that the firm and its principal “[u]nder a purported swap transaction with a consulting and investment firm,” drained nearly all of the assets of two hedge funds managed by the IA and allowed investors in the hedge funds to receive account statements falsely reflecting that their investments were doing well. With respect to the CCO/general counsel, the complaint alleged that he “assisted” with the fraudulent activities because the transactions were done with his “knowledge and consent,” and he knew the transactions were contrary to the investment strategy laid out in the “Explanatory Memorandum” of the one of the funds and contrary to the firm’s “Management Agreement.” The case is pending. **Takeaway:** This case illustrates the perils of failing to report wrongful conduct. If one encounters such behavior, it may be appropriate to report the activity to the board of directors, resign, or disclose to regulators.\textsuperscript{22}

### Reporting Violations

> The day of the reaping’s hot and sultry. The population of District 12 waits, swearing and silent, in the square with machine guns trained on them. ... The reaping takes only a minute.... She has to claw around the girls’ reaping ball for quite a while to snag the one piece of paper that everyone already knows has my name on it.\textsuperscript{23}

Sometimes papers (or reports) determine whether someone should (theoretically) live or die. And sometimes they contain information (pursuant to FINRA Rule 4530) about customer complaints, litigation, and non-FINRA arbitrations, as well as amendments to Forms U4, U5, and BD to reflect events such as arbitration settlements. If CCOs are responsible for reporting obligations, and fail in their responsibilities, they could be liable (but they will not be killed). For example, a CCO was disciplined in January 2014, through a settlement, not for failing to amend a Form BD or someone else’s Form U4, but for failing to disclose his own reportable events.\textsuperscript{24} The CCO failed to disclose his own tax liens totaling $531,082.74. Accordingly, FINRA concluded that he had violated FINRA rules and bylaws.\textsuperscript{25} FINRA suspended the CCO for three months in any capacity and fined him $5,000. Similarly, FINRA disciplined another CCO in June 2014, through a settlement, for failing to disclose his own tax liens totaling $655,772.61.\textsuperscript{26} The CCO was suspended for three months in any capacity and fined $10,000. **Takeaway:** Don’t forget to report your own reportable events.

### Conclusion

**Not even the strongest of the strong will triumph. Perhaps never intended to have a victor in these Games at all.**\textsuperscript{27}

Unlike the “real” fictitious Hunger Games, the “disciplinary proceedings games” have many victors — those who avoid disciplinary actions. To achieve such a victory, it may help to review disciplinary actions like those discussed above (and to continue to read articles like this one) concerning CCOs and in-house counsel who have received attention from regulators in the past. Analyzing these cases could help CCOs and in-house counsel avoid catching fire and going down in flames.
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3 Catching Fire at 160-61.
4 NASD Rule 3010.
6 Section 203(e)(6) of the Advisers Act.
7 Glenn Matthew Chaleff, FINRA AWC No. 2010022017301 (January 2014).
9 Catching Fire at 117.
12 Catching Fire at 14.
14 Brown Brothers Harriman & Co. and Harold A. Crawford, FINRA AWC No. 2013035821401 (Feb. 4, 2014).
15 Catching Fire at 28.
17 Safeguard Securities, Inc. and Peter L. Mooney, FINRA AWC No. 2012030734501 (June 10, 2014).
18 Catching Fire at 130.
19 Section 15 of the Securities Act of 1933 (Securities Act), Section 20(e) of the Exchange Act, and Section 209(f) of the Advisers Act provide for aiding and abetting liability for reckless, as well as knowing, conduct. See In the Matter of MidSouth Capital, Inc. and Mark D. Hill, Admin. Prof. File No. 3-14852, 2012 SEC LEXIS 1254 (finding aiding and abetting liability premised on recklessness).
22 John H. Gutfreund, 51 S.E.C. 93, 114, 1992 SEC LEXIS 2939, *49 (Dec. 3, 1992) (“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.”).
23 Catching Fire at 186.
25 He specifically violated NASD Rule 2110 (for conduct before December 15, 2008) and FINRA Rule 2010 (for conduct after December 14, 2008), along with IM-1000-1 (which concerns filing incomplete or inaccurate information with respect to membership or registration, for conduct before August 17, 2009) and Article V, Section 2 of FINRA’s By-Laws (which concerns obligations to update Forms U4).
26 Douglas McGregor, FINRA AWC No. 2013035123701 (June 13, 2014).
27 Catching Fire at 389.