SUPERVISORY OBLIGATIONS OF BROKER-DEALER LEGAL AND COMPLIANCE PERSONNEL AFTER THE URBAN CASE

The U.S. Securities and Exchange Commission recently issued an order dismissing an administrative proceeding against Theodore Urban, the former general counsel of a U.S.-registered broker-dealer ("Broker"), relating to his purported failure to supervise Stephen Glantz, a Broker registered representative. The dismissal of the proceeding against Mr. Urban in its entirety was required under the SEC’s Rules of Practice because the SEC Commissioners split 1-1 in a vote on the appeal from the SEC’s Division of Enforcement (the “Division”) of an SEC administrative law judge’s order dismissing the proceeding. The SEC’s dismissal of the proceeding leaves unresolved questions of when and if a broker-dealer’s in-house legal counsel and compliance personnel have supervisory responsibilities with respect to registered representatives and other personnel, and what constitutes reasonable supervision of such persons by in-house counsel and compliance personnel.

Broker discovered that Mr. Glantz had engaged in misconduct with respect to his customer-account and other activities at the firm on numerous occasions. Mr. Urban recommended in a memorandum to Louis Akers, the vice chairman of the board of Broker, that Mr. Glantz be fired. Mr. Akers, who had hired Mr. Glantz, chose instead to place Mr. Glantz under special supervision, a decision in which Mr. Urban acquiesced. Mr. Glantz continued to engage in wrongdoing, was prosecuted criminally, ultimately pleaded guilty to securities fraud, served one year of a 33-month sentence, and was released from prison in March 2010.

Pursuant to the Division’s investigation of Broker and certain of its personnel relating to Mr. Glantz’s misconduct, the SEC issued an order instituting administrative proceedings (“OIP”) against Mr. Urban on October 19, 2009. Among other things, the OIP alleged that Mr. Urban was a supervisor of Mr. Glantz and that Mr. Urban failed to exercise his supervisory responsibilities reasonably, within the meaning of Section 15(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Section 203(f) of the Investment Advisers Act of 1940. Mr. Urban asserted that he was not Mr. Glantz’s supervisor and that he could not terminate Mr. Glantz without the authorization of Mr. Akers, for whom Mr. Glantz ultimately worked. The Division argued in the proceeding before the administrative law judge on the merits of the allegations set out in the OIP that Mr. Urban was required to report Mr. Glantz’s misconduct to

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2 It is unclear why Chairman Schapiro and Commissioners Walter and Gallagher recused themselves from participating in the appeal from the OIP. The SEC’s order dismissing the proceeding does not indicate which of the two voting Commissioners, Commissioner Aguilar and Commissioner Paredes, voted to affirm that the allegations in the OIP had been established, and which voted against.
the board of Broker or its executive committee and, in the absence of action by the board or executive committee (although it is not clear what action on the part of the board or executive committee would have been acceptable to the Division), was required to resign and report the matter to regulatory authorities.

In a decision issued on September 8, 2010, the administrative law judge found that Mr. Urban was Mr. Glantz’s supervisor, but dismissed the proceeding because she found that Mr. Urban acted reasonably in exercising his supervisory responsibility. In finding that Mr. Urban was a “supervisor” within the meaning of Section 15(b) of the Exchange Act, the judge relied on John H. Gutfreund, a prior SEC action involving the former head of Salomon Brothers. The judge noted that under Gutfreund, whether a person is a “supervisor” is a facts and circumstances determination that hinges upon whether the “person has the requisite degree of control to affect the conduct of the employee whose behavior is at issue.” Although Mr. Urban was not Mr. Glantz’s direct supervisor, the judge found that Mr. Urban nevertheless was his supervisor because Mr. Urban’s “opinions on legal and compliance issues were viewed as authoritative and his recommendations were generally followed by people in [Broker’s] business units,” although not by the business unit in which Mr. Glantz worked. Mr. Urban also dealt directly with Mr. Glantz on margin-related issues because Mr. Urban was a member of the firm’s credit committee. The administrative law judge’s findings were surprising because Mr. Urban was the general counsel of the firm, not the head of compliance or a business unit head. Many in the brokerage industry were concerned that a chief legal officer could be found to have supervisory responsibility over a registered representative of the firm. This concern was heightened by the administrative law judge’s devoting only a single, conclusory paragraph in her 57-page decision as to why Mr. Urban was a supervisor.

Applying a negligence standard, the judge found that Mr. Urban’s supervision of Mr. Glantz was reasonable under the circumstances. According to the judge, it was reasonable for Mr. Urban to believe that adequate supervisory policies and procedures were in place and that the applicable personnel, who were experienced and well regarded, were supervising Mr. Glantz consistent with such policies and procedures. Mr. Urban also reasonably believed that special supervision would prevent the type of behavior by Mr. Glantz that caused Mr. Urban to recommend terminating him. Mr. Urban also reviewed Mr. Glantz’s customer account activity and, upon learning that Mr. Glantz had engaged in unauthorized trading, reported such trading to regulators, in addition to recommending that Mr. Glantz be fired. Finally, the judge determined that reporting Mr. Glantz’s activities to the CEO of Broker and to the board or the executive committee was not a reasonable alternative for Mr. Urban. The evidence was that the CEO and board would defer to Mr. Akers, who had hired Mr. Glantz and was a powerful individual at Broker.

The judge found that no remedial action against Mr. Urban was appropriate. Under subsections (b)(4)(E)(i) and (ii) of Section 15 of the Exchange Act, a person shall not be deemed to have failed reasonably to supervise another person if there are supervisory procedures in place and being applied that reasonably could have been expected to have detected and prevented the conduct at issue, and the person discharging his or her duty under the supervisory procedures had no reasonable cause to believe that the policies and procedures were not being complied with.

The Division filed an appeal of the administrative law judge’s decision with the SEC. Mr. Urban then filed a motion with the SEC requesting the SEC’s summary affirmance of the administrative law judge’s decision. The SEC issued an order denying Mr. Urban’s motion. In doing so, the SEC stated that the administrative proceeding raised not only the issue of whether Mr. Urban acted reasonably in supervising Mr. Glantz, but also of whether securities professionals are or should be required to “report up” and whether attorneys’ roles within a broker-dealer should affect their liability for failure to supervise. The SEC then split 1-1 on the Division’s appeal.

Because the SEC was evenly divided on the Division’s appeal from the administrative law judge as to whether the allegations in the OIP were established, the proceeding against Mr. Urban was dismissed, as required under the SEC’s Rules of Practice. This “non-decision” decision essentially leaves compliance and legal personnel with no clear guidance as to when they may have supervisory responsibilities with respect to broker-dealer personnel. The administrative law judge, based on Gutfreund, determined that Mr. Urban had “the requisite degree of control to affect the conduct of” Mr. Glantz, but did not state in detail the factors that she considered in making her finding. The SEC also has not explained whether compliance personnel have different and/or additional compliance responsibilities as compared to legal personnel. It appears, therefore, that broker-dealer legal and compliance personnel, who are not the direct supervisors of registered representatives and most other broker-dealer personnel, are left to determine for themselves when they are undertaking supervisory responsibilities and the scope of such responsibilities.

As the SEC effectively acknowledged in its order denying summary affirmance of the administrative law judge’s decision, it is unclear what constitutes reasonable supervision on the part of legal personnel who are determined to have such responsibility. The dismissal of the proceeding in its entirety leaves this issue unsettled. As discussed, Mr. Urban investigated certain of Mr. Glantz’s activities and recommended that Mr. Glantz be terminated, but he did so as part of his responsibilities as a legal officer of his firm, not as a “supervisor” of Mr. Glantz. The Division nevertheless argued that Mr. Urban failed in his supervisory duties. The Division’s view would substantially expand the potential regulatory liability of a large firm’s general

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7 Order Denying Motion for Summary Affirmance, Exchange Act Release No. 63456 (Dec. 7, 2010). The Division’s argument before the administrative law judge seemed to be that Mr. Urban assumed supervisory responsibilities with respect to Mr. Glantz because he became involved in reviewing and addressing Mr. Glantz’s misconduct. By doing so, he purportedly had “the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.”

counsel, yet the administrative law judge’s inclination to accept the Division’s argument that Mr. Urban might be a supervisor and the SEC’s split vote leaves undecided whether the Division’s view is legally justifiable.

It is likewise unclear what constitutes reasonable supervision on the part of compliance personnel. Must legal and compliance personnel report to the board misconduct that is not resolved to their satisfaction at a lower level? Mr. Urban had reported Mr. Glantz’s conduct to the vice chairman of his firm. Why should this not be sufficient? Must such conduct be reported to the CEO? What are legal and compliance personnel required to do if the board or the CEO, upon receiving reports of misconduct, refuses to act or disagrees with recommendations that legal and compliance personnel make with respect to addressing such misconduct? In such circumstances, what, if anything, should be reported to regulators? If the board of directors fails to act upon reports of misconduct, must the legal and compliance personnel charged with supervision of the persons engaging in such conduct be required to quit their employment with the broker-dealer? The expectation that a general counsel resign in such circumstances seems like a draconian action to impose.

The SEC has not indicated whether it intends to address any of these issues. This has to be unsettling for in-house attorneys at broker-dealers. It is in any event clear that this SEC and this Division are likely to pursue and penalize compliance and legal officers notwithstanding their efforts to alert senior management to wrongdoing by employees they do not actually supervise. Whether courts would uphold the SEC in taking such a course of action is uncertain.

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