Someone Should Have Done Something! A Critical Examination of Liability for Failure to Supervise Under Federal Securities Laws

*By Benjamin J. Catalano**

There are few legal concepts as misunderstood or fraught with uncertainty as liability for failure to supervise to prevent misconduct by others. After careful study, Congress amended the Securities Exchange Act of 1934 to enhance the system of self-regulation to provide clear, affirmative supervisory duties for broker-dealers, with corresponding liability for them and their associates, as a necessary component to securities law enforcement. Almost immediately, the scheme was abandoned and replaced by an ersatz duty to supervise applied to individuals with regrettable results for institutional oversight. This Article examines the nature of responsibility for supervision at common law, the sophisticated regime Congress created to impose specific supervisory obligations on broker-dealers and investment advisers, the misbegotten theory that replaced it, and the conditions for return to the original design.

> *[A] duty omitted must be one which the party is bound to perform by law or contract, and not one the performance of which depends simply upon his humanity, or his sense of justice or propriety. In the absence of such obligations, it is undoubtedly the moral duty of every person to extend to others assistance when in danger; . . . and if such efforts should be omitted by any one . . . he would, by his conduct, draw upon himself the just censure and reproach of good men; but this would be the only punishment to which he would be subjected by society.*[1]

Companies are responsible for their employees' misconduct; but that does not mean they are required to do anything to prevent it.

In 1964, Congress amended the Securities Exchange Act of 1934 to cause companies in the securities industry to do just that: Broker-dealers were relieved of administrative liability for violations of federal securities laws by their

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1. United States v. Knowles, 26 Fed. Cas. 800, 801 (N.D. Cal. 1864) (Field, J.).

associates where they established and enforced programs reasonably designed to prevent and detect them. The perpetrators and their accomplices were subjected to discipline by the Securities and Exchange Commission.[2] So were supervisors who failed to carry out their duties.

Initially, the SEC could not proceed directly against principals or employees of broker-dealers who committed or facilitated violations. A convoluted theory in administrative proceedings and settlements with the broker-dealers forced their ouster while enabling the companies themselves to avoid the severest discipline for isolated misconduct. The amendments authorized proceedings against individuals and provided them with hearing rights and other protections that were missing. They also created a sophisticated regime to prevent violations by incorporating oversight for compliance into the administrative operations of broker-dealers grounded in state law and self-regulation. Later, the scheme was applied to investment advisers.

The Commission abandoned the framework: first to overcome jurisdictional limits in cases that arose before the amendments; then to momentum in the theory it reinstated to deal with them. Its maxim reversed the extra incentive to supervise afforded by the revisions, transferred primary responsibility for oversight from companies to employees less capable of performing it effectively, and credited their reactions to wrongdoing over preventative measures. It was inherently arbitrary. Arguably, the approach has impeded development of systemic oversight envisioned by the law.

The need for effective supervision in a continuously growing, increasingly complex industry so crucial to the public welfare is unquestionable. It is an opportune time to reexamine statutory liability for failure to supervise in light of its objectives.

The Duty to Supervise at Common Law and Liability for It Under Federal Securities Laws

In order to understand the basis of liability for failure to supervise one has to keep in mind the nature of supervision relative to its consequences. It consists of action taken and not taken by someone to prevent harm inflicted by someone else on another person. In the securities industry, that might include a branch manager's review of customer account activity to ensure securities recommended by a salesperson are not unsuitable. The manager is liable for it only if there is a duty to perform the function and it is not done or done improperly. The performance itself harms no one: If done properly, it benefits the customer who might have been harmed by the salesperson's misconduct; if not, it merely withholds the benefit of that protection.[3]

2. Hereinafter, the "SEC" or the "Commission."

3. Assuming the manager's action does not itself cause harm—for example, by calling the customer to ascertain suitability and wrongfully endorsing the investment—in which case the harm results from the act, not the failure in oversight.

The Common Law Obligation to Prevent Misconduct

While the common law is replete with obligations to refrain from harming others, traditionally it does not compel action for someone else's benefit.[4] The latter, for the most part, is the province of morals and ethics. Courts, therefore, usually do not recognize a duty to protect, including intervention to prevent harm caused by someone else, unless it is imposed by statute.[5] One can assume the obligation voluntarily in contract, but performance is not legally required and recourse for its omission typically is limited to an action by the beneficiary for the value of the benefit withheld.[6] The quality of the loss distinguishes the

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4. Professor Francis Bohlen, the eminent legal scholar and reporter for the first Restatement of Torts, *see* William Draper Lewis, *Francis Hermann Bohlen*, 91 U. Pa. L. Rev. 377, 381 (1943), wrote:

> There is no distinction more deeply rooted in the common law and more fundamental than that between misfeasance and non-feasance, between active misconduct working positive injury to others and passive inaction, a failure to take positive steps to benefit others, or to protect them from harm not created by any wrongful act of the defendant.
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> [W]hile there is a general liability recognized in common law courts for the natural consequences of all actions whose probable result will be a positive injury to others, duties of positive action for the benefit of others are not general to the common law . . . requiring some other basis than the mere probability that such action is necessary to protect others from an injurious situation not caused by any antecedent misconduct by the defendant.

Francis H. Bohlen, *The Moral Duty to Aid Others as a Basis of Tort Liability*, 56 U. Pa. L. Rev. 217, 219–21 (1905) [hereinafter Bohlen, *Moral Duty*]; *see also* Francis H. Bohlen, *Misrepresentation as Deceit, Negligence or Warranty*, 42 Harv. L. Rev. 733 (1929) (applying the concept to deception and misrepresentation). The principle is attributed to early-American ideas of "independence" and "self-reliance." *See* Bohlen, *Moral Duty*, *supra*, at 221. A leading proponent of those ideals, however, challenged the notion of benefit without consent:

> When Phaëton, wishing to prove his heavenly birth by his beneficence, had the sun's chariot but one day . . . he burned several blocks of houses in the lower streets of heaven, and scorched the surface of the earth, and dried up every spring, and made the great desert of Sahara . . . .
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> If I knew certainly that a man was coming to my house with the conscious design of doing me good, I should run for my life . . . for fear that I should get some of his good done to me[.]

Henry David Thoreau, *Economy*, *in* Walden 69–70 (Fall River Press 2008) (1854). The principle is firmly ensconced in the law of torts. *See* H.R. Moch Co. v. Rensselaer Water Co., 247 N.Y. 160, 167 (1928) ("The hand once set to a task may not always be withdrawn with impunity though liability would fail if it had never been applied at all.") (Cardozo, C.J.); Glanzer v. Shepard, 233 N.Y. 236, 239–40 (1922) (Cardozo, J.).

5. *See* Bohlen, *Moral Duty*, *supra* note 4, at 227. Exceptions involved defendant's possession of the exclusive means of protection and the plaintiff's defenselessness under the circumstances, including innkeeper and guest, carrier and passenger. *See* Harold F. McNiece & John V. Thornton, *Affirmative Duties in Tort*, 58 Yale L.J. 1272 (1949); Bohlen, *Moral Duty*, *supra* note 4, at 226–44.

6. Chief Justice John Marshall explained that the duty in contract stems not from society but from the parties themselves:

> [O]bligation is not conferred on contracts by positive law, but is intrinsic, and is conferred by the act of the parties. This results from the right which every man retains to acquire property, to dispose of that property according to his own judgement, and to pledge himself for a future act. These rights are not given by society but are brought into it. The right of coercion is necessarily surrendered to government, and this surrender imposes on government the correlative duty of furnishing a remedy.

duty from one at law.[7] Thus, a person ordinarily is not legally responsible for failing to prevent a co-worker from performing an illegal act;[8] although the person may be answerable to his or her employer or someone else on a promise to police the other's conduct.[9]

The same is true for the employer—natural person or entity.[10] Regardless, an employer is responsible for an employee's misconduct under the principle of

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Ogden v. Saunders, 25 U.S. 213, 346–47 (1827). *Compare* Restatement (Second) of Contracts § 1 (Am. L. Inst. 1981) (defining "contract" as "a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty"), *and id.* § 2 cmt. a (stating that a "promise" includes "any *moral* or legal duty which arises to make good the assurance by performance" (emphasis added)), *with* Restatement of Contracts § 1 (Am. L. Inst. 1932) (defining "contract" the same), *and id.* § 2 cmt. a (defining a "promise" to mean "both physical manifestations by words or acts of assurance and the *moral duty* to make good the assurance by performance" (emphasis added)). *See* Restatement (Second) of Contracts § 344 cmt. a (describing expectation damages as putting the aggrieved party "in as good a position as he would have been in had the contract been performed"); *id.* § 302 (contract extends to intended beneficiaries). In special cases, a court may order specific performance in equity, *see id.* § 357, but the essence of the relief is the absence of a right to it at law, *see* Willard v. Tayloe, 75 U.S. (8 Wall.) 557, 565 (1869); Schank v. Schuchman, 206 N.E. 127, 128 (N.Y. 1914).

7. Professor Bohlen again:

> Here, then, is the point of separation of tort and contract. . . . The public has an interest that no man shall act so as to injure another, it has no concern that he shall benefit anyone.
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> An obligation to do an act which will confer a benefit and whose breach will cause no other injury than the loss of such expected benefit is purely contractual. And since the law is highly general in its imposition of duties, if precautions not generally required by the relation of the parties are bargained for, though their omission will deprive the party of the expected protection and so may cause actual injury, the obligation being one not usually required to be imposed, is an additional safeguard, a benefit contractual in its essence.

Francis H. Bohlen, *The Basis of Affirmative Obligations in the Law of Tort*, *reprinted in* Francis H. Bohlen, Studies in the Law of Torts 33, 40–41, 87 (1926).

8. *See* Chester-Cambridge B. & T. Co. v. Rhodes, 31 A.2d 128, 432–33 (Pa. 1943); Arthur v. Griswold, 55 N.Y. 400, 405–06 (1874). A person may be liable for the wrongful conduct of another person where he or she participates in it with the same design, *see* Restatement (Second) of Torts § 876(a) (Am. L. Inst. 1979); Williams v. Sheldon, 10 Wend. 654, 656 (N.Y. 1833), or knowingly assists, encourages, or induces it, *see* Restatement (Second) of Torts §§ 876(b), 877(a); Judson v. Cook, 11 Barb. 642, 644 (N.Y. 1852); William L. Prosser, *Joint Torts and Several Liability*, 25 Calif. L. Rev. 413, 429–30 (1937). Absent involvement, however, there is no duty to prevent harm caused by someone else. *See* Restatement (Second) of Torts § 314 (Am. L. Inst. 1965); Murray v. Usher, 117 N.Y. 542, 546–47 (1889); *Chester-Cambridge B. & T. Co.*, 31 A.2d at 432 ("It is true that a director or officer of a corporation may have personal liability for damages suffered by third persons when he knowingly participates in a wrongful act. But where, as in this case, directors or officers are charged with nonfeasance, no individual liability attaches. This has always been the rule in this jurisdiction." (citations omitted)).

9. *See, e.g.*, Pecke v. Hydraulic Constr. Co., 23 A.D. 393, 397 (N.Y. Sup. Ct. 1897) (employee liable to employer in contract for supervisory omissions that resulted in misappropriation by other employees).

10. An employment relationship does not contemplate wrongdoing: "The fundamental idea . . . of agency, has its conception in something lawful that a person may do, and a delegation by such person to another of the power lawfully to do that thing." Brutinel v. Nygren, 154 P. 1042, 1045 (Ariz. 1916); *see also* Warren A. Seavey, *The Rationale of Agency*, 29 Yale L.J. 859, 871 (1920). An agency or contract for an unlawful purpose does not exist. *See* Stone v. Freeman, 82 N.E.2d 571, 572 (N.Y. 1948); Leonard v. Poole, 114 N.Y. 371, 378–80 (1889); *see also* Restatement of Contracts §§ 7, 512 (Am. L. Inst. 1932) (The effect of an "illegal bargain," including an agreement to commit a crime or a

respondeat superior at common law or similarly by statute.[11] The liability is without fault: It does not require proof of causation or a wrongful state of mind by the principal.[12] It is based on control.[13] The policies behind it are twofold: (1) to induce the employer to supervise its employees and other agents to prevent their misconduct in connection with the enterprise;[14] and (2) to reallocate the risk of loss associated with that misconduct.[15] Each being a benefit, however, there is no legal obligation to do either that is enforceable separately. The employer simply is liable for the offense,[16] whether it did everything in its power to prevent it

tort, is that there is no contract.). Likewise, a corporation is "an association of individuals united for a lawful purpose." Kan. Pac. Ry. Co. v. Atchison T. & S.F.R. Co., 112 U.S. 414, 415 (1884); *see also* People v. N. River Sugar Refinery Co., 24 N.E. 834, 839 (N.Y. 1890) (The idea of a corporation "serves very well to designate in our minds the collective action and agency of many individuals as permitted by the law."); Brooks v. State *ex rel*. Richards, 79 A. 790, 796 (Del. 1911). Its attributes are conferred by the state. *See* Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819) (A corporation "[b]eing the mere creature of law, it possesses only those properties which the charter of its creation confers upon it.") (Marshall, C.J.). "Among the most important are . . . individuality." *Id.* The ability to sue or to be sued in the company's name exists only to the extent it behaves lawfully. *See* N.Y. Bus. Corp. Law §§ 201(a), 202(a)(2) (McKinney 2022); Del. Code Ann. tit. 8, §§ 101(b), 102 (a)(3), 121(b), 122(2) (West 2022). If one or more of its agents act unlawfully, their identification with the company is lost. *See* Sternaman v. Metro. Life Ins. Co., 170 N.Y. 13, 21 (1902). Where substantially all of them behave unlawfully, the legal entity does not exist. *See* Adolf A. Berle, Jr., *The Theory of Enterprise Entity*, 47 Colum. L. Rev. 343, 352–54 (1947). Each has to be sued separately or joined in a single proceeding and found liable separately for his or her part in any civil misconduct. *See* Prosser, *supra* note 8, at 414–18.

11. *Respondeat superior*, or "vicarious liability," stems from the law of master and servant. Stated succinctly:

> [T]he duties assigned to a servant give him the power to bind his master in such contracts as come within the scope of his employment. But the law goes further, and makes the master generally liable for his servant's torts so long as they are fairly and reasonably to be traced to his service . . . .

Harold J. Laski, *The Basis of Vicarious Liability*, 26 Yale L.J. 105, 108 (1916). The employer is liable for an employee's offense without identification in agency or common involvement and state of mind, *see* Lake Shore & Mich. Southern R.R. v. Prentice, 147 U.S. 101, 109 (1893) (recognizing vicarious liability in tort), and may be joined to the action as a responsible party, *see* Prosser, *supra* note 8, at 430–31. The same responsibility—civil or criminal—can be imposed by statute. *See, e.g.*, N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481, 492 (1909) (recognizing criminal responsibility of a corporation by statute).

12. *See* Laski, *supra* note 11, at 116, 119 (dismissing the idea of vicarious liability based on implied authority or negligence: "[I]n no case of vicarious liability is moral blame attached to the master.").

13. *See* Restatement (Third) of Agency § 2.04 cmt. b (Am. L. Inst. 2006). Control relevant to liability does not stem from the legal relationship between the employer and the employee, which the latter has repudiated by his or her conduct, so much as the surrounding legal relations that enable the employer to know and to affect the employee's conduct. *See* Laski, *supra* note 11, at 107, 113–14, 115–16.

14. *See* Warren A. Seavey, *Speculations as to* "Respondeat Superior," *in* Harvard Legal Essays 433, 447 (Roscoe Pound ed., Harvard Univ. Press 1934); Laski, *supra* note 11, at 113–14, 116 (attributing the basis to public policy encouraging "masters to keep continual watch over the conduct of their servants").

15. *See* Seavey, *supra* note 14, at 450; William O. Douglas, *Vicarious Liability and Administration of Risk*, 38 Yale L.J. 720, 722 (1929).

16. *See* Lothrop v. Adams, 133 Mass. 471 (1882).

> The logical difficulty of imputing the actual malice or fraud of an agent to his principal is perhaps less when the principal is a person than when it is a corporation; still the foundation of the imputation is not that it is inferred that the principal actually participated in the malice or fraud . . . it is just that he should be held responsible for it in damages.

Id. at 480–81.

or nothing at all. Its partners, shareholders, directors, officers, and other employees are not responsible on the same basis because normally they do not have the ability to accomplish the objectives by themselves.[17] Nevertheless, because there are economic consequences to a company from an employee's misconduct, its managing partners or directors may be obliged to protect against it as part of their fiduciary duties of care;[18] while other partners, officers, and employees assigned to take precautions may be responsible for performing them properly.[19] However, the duties are in contract or equity—not law. There is no legal obligation to do so.

Primary Obligations, Derivative Liability, and Failure to Supervise Under Federal Securities Laws

The federal securities laws[20] impose certain duties on all or various categories of persons (individuals and entities)[21] concerning securities activities in interstate commerce. Sections 5 of the Securities Act forbids anyone from offering or selling securities unless they are registered or the transaction is exempt.[22] Section 17(a) makes it unlawful to do so by fraud or deception.[23] Section 9(a) of the Exchange Act bans manipulative trading practices,[24] while Section 10(b) and Rule 10b-5 outlaw all manner of conduct intended to defraud or deceive.[25] Section 206 of the Advisers Act prohibits fraud, deception, manipulation, and other specified acts by an investment adviser.[26] Other provisions impose reporting requirements on companies;[27] compel filings by

17. *See, e.g.*, Briggs v. Spaulding, 141 U.S. 132, 147 (1891) ("[Directors] are not insurers of the fidelity of the agents whom they have appointed, who are not their agents, but the agents of the corporation . . . ."); *Arthur*, 55 N.Y. at 406 ("The mere fact of being a director and stockholder is not *per se* sufficient to hold a party liable for the frauds and misrepresentations of the active managers of a corporation."); Malloy v. Fong, 37 Cal. 2d 356, 378 (1951) ("The doctrine of *respondeat superior* is not applicable to the relationship between a supervisor and his subordinate employees. The supervisor occupies an economic and legal position quite different from that of the employer.") (Traynor, J.).

18. *See generally* Bowerman v. Hamner, 250 U.S. 504, 513 (1919); *Briggs*, 141 U.S. at 165–66.

19. In addition, partners, officers, and employees may have fiduciary or equitable duties of loyalty and care that supplement their contractual obligations. *See* Restatement (Third) of Agency §§ 8.01–8.08 (Am. L. Inst. 2006).

20. For purposes of this article the "federal securities laws" refer primarily to the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a *et seq.*) [hereinafter Securities Act], the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a *et seq.*) [hereinafter Exchange Act], the Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. § 80a-1 *et seq.*) [hereinafter Investment Company Act], and the Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. § 80b-1 *et seq.*) [hereinafter Advisers Act].

21. *See, e.g.*, 15 U.S.C. § 77b(a)(2) (2018) (defining the term "person" to mean "an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof); *id.* § 78c(a)(9) (defining "person" to mean "a natural person, company, government, or political subdivision, agency, or instrumentality of a government").

22. *See id.* § 77e(a), (c).

23. *See id.* § 77q(a).

24. *See id.* § 78i(a).

25. *See id.* § 78j(b); 17 C.F.R. § 240.10b-5 (2022).

26. *See* 15 U.S.C. § 80b–6 (2018).

27. *See id.* §§ 78*l*(e), 78m(a), (e).

investors;[28] regulate persons soliciting proxies or making tender offers;[29] and require directors, officers, and large shareholders to report ownership and to disgorge short-swing profits in company shares.[30]

Under Section 20(a) of the Exchange Act, any person who "controls" another person liable under any provision of the statute is liable to the same extent subject to an affirmative defense.[31] The section is akin to *respondeat superior*.[32] It provides a similar impetus—but no obligation—for principals to supervise their agents to prevent Exchange Act violations.[33]

A broker-dealer is subject to comprehensive regulation under the Exchange Act.[34] Among other things, it must register with the SEC,[35] join an industry

28. *See, e.g.*, *id.* §§ 78m(d), (g), 78m(f), 78m(h).

29. *See id.* § 78n.

30. *See id.* § 78p.

31. Section 20(a) provides, in pertinent part:

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Id. § 78t(a).

32. Like *respondeat superior*, liability under Section 20(a) does not require proof of causation or knowledge of the underlying offense. *See* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1573–74 (9th Cir.) (en banc), *cert. denied*, 111 S. Ct. 1621 (1990); Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.), *cert. denied sub nom.* Wood Walker & Co. v. Marbury Mgmt., Inc., 449 U.S. 1011 (1980). Unlike the principle at common law, it extends to persons exercising control over the company. *See* G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 957–58 (5th Cir. 1981); Testimony of Sen. Thomas Corcoran, *Hearings Before the S. Comm. on Banking & Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.)*, 73d Cong., 1st Sess. 6571 (1934) ("The purpose [of Section 20(a)] is to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section."). *Compare* H.R. REP. No. 73-1383, at 26 (1934) ("In [Section 20(a)] . . . when reference is made to 'control,' the term is intended to include actual control as well as what has been called legally enforceable control."), *with* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 70 (1932) (identifying five types of legal and actual control, including "majority stock ownership" and "management control"). The prevailing view is that the affirmative defense is intended to protect individuals—not the company. *See* 9 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 617 (5th ed. 2018). For a discussion of the control person liability provisions of the Exchange Act and the Securities Act (limited to liability under Sections 11 and 12), see Loftus C. Carson II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263 (1997); Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability,* Respondeat Superior *and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007 (1983).

33. Some courts have seized on this aspect to require companies to demonstrate they implemented and enforced systems of supervision to satisfy the "good faith" or "non-inducement" prongs of the affirmative defense. *See Marbury Mgmt. Co.*, 629 F.2d at 716; Sanders v. John Nuveen & Co., 524 F.2d 1064, 1072 (7th Cir. 1975), *vacated on other grounds*, 425 U.S. 929 (1976).

34. Section 3(a)(4)(A) of the Exchange Act defines a "broker" in general to mean "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4)(A) (2018). Section 3(a)(5)(A) of the Exchange Act defines a "dealer" in general to mean "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." *Id.* § 78c(a)(5)(A). A person that alternately acts as a broker or dealer commonly is referred to as a "broker-dealer." A broker-dealer most often is a corporation, limited liability company, or partnership, but can be a sole proprietor (or even an employee).

35. *See id.* § 78o(a).

organization for regulating its professional behavior,[36] maintain sufficient capital,[37] protect customer assets,[38] limit the extension of credit to customers,[39] make and preserve books and records,[40] and file financial and other reports.[41] Section 15(c)(1) prohibits a broker-dealer from effecting, inducing, or attempting to induce the purchase or sale of a security "by means of any manipulative, deceptive, or other fraudulent device or contrivance" in contravention of SEC rules.[42] It is responsible for the misconduct of persons under its

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36. Under Section 15(b)(1) of the Exchange Act, *id.* § 78o(b)(1), a broker-dealer's registration is not effective until it becomes a member of a national securities association registered under Section 15A of the Exchange Act, *id.* § 78(o)-1, or, if it effects transactions solely on an exchange, an exchange registered under Section 6 of the Exchange Act, *id.* § 78f, each of which is a self-regulatory organization ("SRO") regulated by the SEC under Section 19 of the Exchange Act, *id.* § 78(s). One of the purposes of an SRO is to regulate the professional and ethical conduct of members by rules "designed to prevent fraudulent and manipulative acts and practices [and] promote just and equitable principles of trade." *See id.* §§ 78o-3(b)(6), 78f(b)(5). The current system is the product of four legislative initiatives: the Exchange Act, *supra* note 20, which required exchanges to register and gave the SEC some authority over their rulemaking and enforcement, the 1938 amendments to the Securities Exchange Act of 1934, Pub. L. No. 75-719, 52 Stat. 1070 (1938) [hereinafter Maloney Act], which extended the system to the over-the-counter ("OTC") market through securities associations, the Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 [hereinafter 1964 Amendments], which expanded the Commission's powers over exchanges and securities associations, and the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 [hereinafter 1975 Amendments], which expanded them further and extended the system to the municipal securities market with the authorization of the Municipal Securities Rulemaking Board ("MSRB"). SEC Chairman (later U.S. Supreme Court Justice) William O. Douglas remarked on its purpose:

> By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone, can effectively reach.

Comments before the Bond Club of Hartford, Connecticut (Jan. 7, 1938).

Historically, the leading SROs were the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD"). *See generally* Richard W. Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROBS. 663 (1964); Howard C. Westwood & Edward G. Howard, *Self-Government in the Securities Industry*, 17 LAW & CONTEMP. PROBS. 518 (1952). Currently, the leading SRO is the Financial Industry Regulatory Authority ("FINRA"), which succeeded the NASD as the only registered securities association, *see* Order Approving Proposed Rule Change to Amend the By-Laws of NASD, Exchange Act Release No. 56145, 72 Fed. Reg. 42169, 42169 (July 26, 2007), with more than two dozen exchanges governing conduct on their facilities, *see National Securities Exchanges*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/fast-answers/divisionsmarketregmrexchangesshtml.html (last modified July 14, 2021). Although sometimes referred to as quasi-government authorities, fundamentally they are private organizations and the rules governing them and their members are contractual. *See* Brown v. Gilligan, Will & Co., 287 F. Supp. 766, 769–70 (S.D.N.Y. 1968).

37. See 15 U.S.C. § 78o(c)(1) (2018); SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2022).

38. *See* 15 U.S.C. § 78o(c)(3) (2018); SEC Rule 15c3-3, 17 C.F.R. § 240.15c3-3 (2022).

39. *See* 15 U.S.C. § 78g(c)(1) (2018); Regulation T, 12 C.F.R. pt. 220 (2022).

40. *See* 15 U.S.C. § 78q(a)(1) (2018); SEC Rules 17a-3, 17a-4, 17 C.F.R. §§ 240.17a-3, 240.17a-4 (2022).

41. *See* 15 U.S.C. § 78q(a)(1) (2018); SEC Rule 17a-5 *et seq.*, 17 C.F.R. § 240.17a-5 *et seq.* (2022).

42. *See* 15 U.S.C. § 78o(c)(1)(A) (2018). Section 15(c)(2) authorizes the Commission to define "such acts and practices as are fraudulent, deceptive, or manipulative." *See id.* § 78o(c)(2)(D). Rule 15c1-2 defines the term "manipulative, deceptive, or other fraudulent device or contrivance" to include "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" and "any untrue statement of a material fact and any omission to state a

control.[43] An individual acting on behalf of a broker-dealer is an "associated person."[44] He or she is not required to register with the Commission,[45] but must adhere to the anti-fraud and other provisions of general application under the federal securities laws and those specific to the person's situation.[46] Ordinarily, an associated person is not responsible for a violation by the broker-dealer or another associated person or required to prevent an offense by anyone.[47] The Advisers Act provides for the registration of investment advisers and subjects them and their associates to disclosure and other substantive requirements.[48] The only statutory provisions compelling oversight by broker-dealers and investment advisers require registrants to implement policies and procedures to protect against insider trading and other misuses of material, nonpublic information.[49]

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material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading." 17 C.F.R. § 240.15c1-2 (2022).

43. *See* Martin v. Shearson Lehman Hutton, Inc., 986 F.2d 242, 244 (8th Cir.), *cert. denied*, 510 U.S. 861 (1993); Christoffel v. E. F. Hutton & Co., 588 F.2d 665, 668–69 (9th Cir. 1978).

44. Section 3(a)(18) of the Exchange Act defines the term "person associated with a broker or dealer" or "associated person of a broker or dealer" to include "any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer." 15 U.S.C. § 78c(a)(18) (2018).

45. *See id.* § 78o(a)(1).

46. *See, e.g.*, SEC Rule 15*l*-1, 17 C.F.R. § 240.15*l*-1 (2022) (requiring "a natural person associated with a broker-dealer" to act in the best interest of a retail customer when making a recommendation); SEC Rule 501(a), 17 C.F.R. § 242.501(a) (2022) (requiring a "research analyst" to certify that his or her opinion in a research report is genuine).

47. *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1291–93 (2d Cir. 1973) (en banc) (A director not involved in preparing false statements distributed by a broker-dealer was not liable for them: "He has done nothing. And he is not to be held vicariously for the fraud or negligence of others . . . unless he has constituted them his 'agents.'"). An associated person may be liable as a "control person" under Section 20(a) of the Exchange Act. *See supra* note 31. There is no private right of action for aiding or abetting a violation of the federal securities laws. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994). Although, under Section 20(e), the SEC can sue "any person that knowingly or recklessly provides substantial assistance to another person" violating the Exchange Act, its rules or regulations, in which case the person is "deemed" to have committed the same violation. *See* 15 U.S.C. § 78t(e) (2018).

48. An "investment adviser" is "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities[.]" 15 U.S.C. § 80b-2(a)(11) (2018). For an overview of the regulation of investment advisers, see Thomas P. Lemke & Gerald T. Lins, Regulation of Investment Advisers (Thomson Reuters 2020 ed.); Robert E. Plaze, Regulation of Investment Advisers by the U.S. Securities and Exchange Commission (2018).

49. Section 15(g) of the Exchange Act provides:

> Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this chapter (or the rules or regulations thereunder) of material, nonpublic information.

15 U.S.C. § 78o(g) (2018). Section 204A of the Advisers Act, *id.* § 80b-4a, requires the same of registered investment advisers.

The SEC, however, has broad administrative authority. Under Section 15(b)(4) of the Exchange Act, it can institute disciplinary proceedings against a broker-dealer if the broker-dealer or any person associated with it "willfully violated any provision of [the federal securities laws]"[50] or "willfully aided, abetted, counseled, commanded, induced, or procured [such a] violation by any other person" or "failed reasonably to supervise, with a view to preventing violations of such provisions . . . another person who commits such a violation, if such other person is subject to his supervision."[51] Section 15(b)(6)(A) authorizes proceedings against associated persons for the same offenses.[52] Section 203(e) and (f) of the Advisers Act provide for similar actions against investment advisers and their

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The SEC has issued rules imposing supervisory requirements on broker-dealers in various areas. *See, e.g.*, Rule 15c3-5, 17 C.F.R. § 240.15c3-5 (2022) (requiring broker-dealers providing market access to other broker-dealers and customers to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage financial, regulatory, and other risks). In 2003, the Commission adopted Rule 206(4)-7 under the Advisers Act, 17 C.F.R. § 275.206(4)-7, which requires registered investment advisers to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. *See* Compliance Programs of Investment Companies and Investment Advisers (Final Rule), Advisers Act Release No. 2204, 68 Fed. Reg. 74714 (Dec. 24, 2003) [hereinafter Compliance Programs of Investment Companies and Investment Advisers].

50. Section 15(b)(4)(D) of the Exchange Act provides, in pertinent part:

> The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such [action] is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated . . . has willfully violated any provision of [the Securities Act], [the Advisers Act], [the Investment Company Act], the Commodity Exchange Act, this chapter, the rules or regulations under any of such statutes, or the rules of the [MSRB], or is unable to comply with any such provision.

15 U.S.C. § 78o(b)(4)(D) (2018). (Elsewhere, the Exchange Act allows for fines and injunctive relief to compel measures to prevent recurrence and to disgorge ill-gotten gains. *See* Sections 21B and 21C(a) and (e) of the Exchange Act, § 78u-2, 78u-3(a), (e) (2018) (added as part of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931).) The provision operates like *respondeat superior*. *See* Armstrong, Jones & Co. v. SEC, 421 F.2d 359, 362 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970). Indeed, it goes beyond vicarious liability to authorize discipline where the *associated person* controls or is under common control with the *broker-dealer*. *See* 15 U.S.C. § 78c(a)(18) (2018).

51. *See id.* § 78o(b)(4)(E).

52. Section 15(b)(6)(A) provides, in pertinent part:

> With respect to any person who is associated, who is seeking to become associated, or, at the time of the alleged misconduct, who was associated or was seeking to become associated with a broker or dealer . . . the Commission by order, shall censure, place limitations on the activities or functions of such person, or suspend for a period not exceeding 12 months, or bar any such person from being associated with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization . . . if the Commission finds, on the record after notice and opportunity for a hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person (i) has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph . . . (D) [or] (E) . . . of paragraph (4) of this subsection . . . .

Id. § 78o(b)(6)(A). Consistent with the limitation at common law, an associated person is not vicariously liable for a broker-dealer's or another associated person's offense.

associates.[53] Added to the Exchange Act as part of the 1964 Amendments,[54] and to the Advisers Act in 1975,[55] the provisions provide recourse against broker-dealers, investment advisers, and the individuals in varying degrees responsible for violations—the perpetrators, their enablers, and those who failed to supervise them. The sections themselves do not contain a duty to supervise.[56] Like other bases for discipline, the grounds for supervisory liability originate outside of them—under other federal or state laws, SRO rules, or even foreign law.[57] Responsibility rests primarily on broker-dealers' and investment advisers' discretionary efforts, which, if sufficient, prevent sanctions notwithstanding derivative liability for their associates' misconduct. SRO rules requiring members to have comprehensive supervisory systems and procedures set expectations for broker-dealers. Normally, there is no supervisory liability for associates apart from those systems and procedures.

Supervisory Responsibility in Early SEC Enforcement Actions

Prior to 1964, the SEC could not discipline anyone other than a broker or dealer under the Exchange Act. Under Section 15(b), the Commission could revoke a broker-dealer's registration if it found, after notice and opportunity for a hearing, that the action was in the public interest and the registrant or anyone controlling or controlled by it willfully violated the Securities Act or the Exchange Act.[58] The broker-dealer was responsible without fault for its agent's

53. *See id.* § 80b-3(e)(5), (6); *id.* § 80b-3(f).

54. *See* Pub. L. No. 88-467, § 6(b), 78 Stat. 565, 571–72 (1964).

55. *See* 1975 Amendments, Pub. L. No. 94-29, § 29, 89 Stat. 97, 167–69.

56. The language does not direct anyone to do anything. By contrast, Section 15(g) and Section 204A clearly compel action to prevent statutory violations. *See supra* note 49. At the time Section 15(g) (originally Section 15(f)) and Section 204A were enacted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, the House Report described them as "a significant change from current law, *which contains no affirmative statutory obligation on a securities firm to adopt procedures designed to prevent insider trading and other misuse of material, nonpublic information*," H.R. Rep. No. 100-910, at 38 (1988) (emphasis added), notwithstanding the offenses were covered by Sections 15(b)(4)(E) and 203(e)(6).

57. *See* 15 U.S.C. § 78o(b)(4)(B) (2018) (conviction in a U.S. or foreign court of a felony or misdemeanor (or equivalent) involving dishonesty or financial misconduct); *id.* § 78o(b)(4)(C) (injunction from acting as a broker, dealer, or other financial services provider); *id.* § 78o(b)(4)(G) (finding by a foreign financial regulatory authority of a false or misleading statement in a foreign registration filing; violation of foreign law involving a transaction in securities or commodity futures; aiding, abetting, counseling, commanding, inducing, or procuring such a violation by someone else, or failing reasonably to supervise, with a view to preventing violations, another person who commits such a violation, if the person is subject to his supervision); *id.* § 78o(b)(4)(H) (final order by a state securities, bank, or insurance regulator, federal banking agency, or the National Credit Union Administration barring the person from associating with a regulated entity, engaging in securities, insurance, banking, savings association, or credit union activities, or based on violation of any law prohibiting fraudulent, manipulative, or deceptive conduct). *See also id.* § 80b-3(e)(2)–(4), (8), (9).

58. Section 15(b) provided, in pertinent part:

> The Commission shall, after appropriate notice and opportunity for hearing, by order . . . revoke the registration of any broker or dealer if it finds that such . . . revocation is in the public interest and that (1) such broker or dealer . . . or (2) any partner, officer, director or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer . . . (D) has willfully violated any provision of [the Securities Act, the Exchange Act], or of any rule or regulation thereunder[.]

misconduct. The remedy, however, was extreme—effectively putting it out of business. In addition, under Section 15A(*l*)(2) or Section 19(a)(3), the Commission could suspend or expel a member from a securities association or exchange for violating the Exchange Act.[59] The sanctions were less severe, but the provisions did not expressly provide for vicarious liability.

The SEC had no recourse against individuals.[60] However, a broker-dealer could not maintain its NASD membership if it associated with someone who was the *subject* or the *cause* of an order of revocation, suspension, or expulsion,[61] effectively banishing anyone who committed a violation or, more controversially,

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Act of May 27, 1936, Pub. L. No. 74-621, 49 Stat. 1375, 1377–78 (codified at 15 U.S.C. § 78o(b)).

59. Section 15A(*l*) provided, in pertinent part:

> The Commission is authorized, if such action appears to it to be necessary or appropriate in the public interest or for the protection of investors or to carry out the purpose of this section—
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> * * *
>
> (2) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding 12 months or to expel from a registered securities association any member thereof who the Commission finds (A) has violated any provision of this title or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of [the Exchange Act] or any rule or regulation thereunder[.]

Maloney Act, *supra* note 36, § 1, 52 Stat. at 1074–75 (codified at 15 U.S.C. § 78o-3(*l*)(2)). Section 19(a) provided, in pertinent part:

> The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors—
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> * * *
>
> (3) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a national securities exchange any member or officer thereof whom the Commission finds has violated any provision of [the Exchange Act] or the rules and regulations thereunder, or has effected any transaction for any other person who, he has reason to believe, is violating in respect of such transaction any provision of [the Exchange Act] or the rules and regulations thereunder.

Exchange Act, *supra* note 20, § 19(a)(3), 48 Stat. at 898 (codified as amended at 15 U.S.C. § 78s(h)).

60. Under Section 15(b), the SEC could institute proceedings against an individual acting as a "broker" or "dealer" in interstate commerce; however, the remedy was inconsequential to someone who was not *registered*. Sections 15A(*l*)(2) and 19(a)(3) applied only to an NASD or exchange *member*.

61. Section 15A(b)(4) provided, in pertinent part:

> An applicant association shall not be registered as a national securities association unless . . . the rules of the association provide that, except with the approval or at the direction of the Commission . . . no broker or dealer shall be admitted to or continued in membership in such association, if (1) such broker or dealer . . . or (2) any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer . . . (B) is subject to an order of the Commission denying or revoking his registration pursuant to section 15 of this title, or expelling or suspending him from membership in a registered securities association or a national securities exchange, or (C) by his conduct . . . was a cause of any suspension, expulsion, or order of the character described in [clause (B)].

Maloney Act, *supra* note 36, § 1, 52 Stat. at 1070–71 (codified at 15 U.S.C. § 78o-3(b)(4)).

was instrumental in one. Aided by settlements in administrative proceedings, the Commission used a theory of supervisory responsibility to impose lesser sanctions on broker-dealers for isolated misconduct by their agents, to extend its reach over individuals, and to compel greater oversight by registrants.

THE SEC USES SUPERVISION TO JUSTIFY LESSER SANCTIONS AGAINST BROKER-DEALERS AND TO DISCIPLINE INDIVIDUALS

In an early SEC decision,[62] a registered broker-dealer and NASD member employed a salesman who, acquiring bonds as agent for a corporate customer, made misleading statements to convince others to sell, then confirmed the trades as principal to hide profits.[63] The conduct violated Section 17(a) of the Securities Act.[64] The questions squarely before Commissioners Robert Healy, Sumner Pike, and Robert O'Brien were: Was the company responsible for the salesman's misconduct? And, if so, what sanction was appropriate in the public interest?[65]

The broker-dealer was responsible for the salesman's violations under Section 15(b)(D) of the Exchange Act.[66] The more difficult issue was whether it was liable itself under the section and as an NASD member for purposes of Section 15A(*l*). Citing evidence the customer considered the salesman to be the company's agent,[67] the Commissioners found his conduct "imputable" to the broker-dealer for purposes of Section 15(c)(1) and its rules.[68] If vicarious liability was ambiguous

62. *See* Bond & Goodwin, Inc., 15 S.E.C. 584 (1944).

63. *See generally id.* at 585–98.

64. *See id.* at 597.

65. *Id.* at 599. They acknowledged the salesman was beyond their reach. *Id.* at 601 ("Under the provisions of the [Exchange] Act we cannot take remedial action with respect to [the salesman] individually, as he is not a registered broker-dealer.").

66. *Id.* at 601 ("The [Exchange] Act . . . empowers us to revoke the registration of any broker-dealer (assuming that such action is in the public interest) if we find that any person controlled by it—as [the salesman] was controlled by respondent—has violated the statute.").

67. *See id.* at 599.

68. *Id.* at 602. Section 15(c)(1) provided, in pertinent part:

> No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security . . . otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

Maloney Act, *supra* note 36, § 2, 52 Stat. at 1075 (codified at 15 U.S.C. § 78o(c)(1)). Rule X-15C1-2 defined the term "manipulative, deceptive, or other fraudulent device or contrivance" to include:

> (a) . . . any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person [or] (b) . . . any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with the knowledge or reasonable grounds to believe that it is untrue or misleading.

Securities Exchange Act Release No. 1330, 1937 SEC LEXIS 542 (Aug. 4, 1937) [hereinafter Release 1330] (originally promulgated as Rule MC2); Securities Exchange Act Release No. 1763, 1938 SEC LEXIS 634 (June 28, 1938) [hereinafter Release 1763] (re-adopted and re-numbered as Rule X-15C1-2) (later codified at 17 C.F.R. § 240.15c1-2). Rule X-15C1-4 defined the term to include:

under Section 15A(*l*)(2), nevertheless it was consistent with the statutory scheme and common law.[69] It also allowed for lesser sanctions.

Faced with losing its ability to do business nationally, the broker-dealer insisted no one knew about the salesman's misconduct.[70] Invoking the policies behind vicarious liability, the Commissioners said that was irrelevant and criticized the company's oversight.[71]

> [T]he protection of investors can obviously not be achieved if the firm is permitted to shield itself from the consequences of a subordinate's undetected violations by pleading the very conditions which made the violations possible. It cannot, therefore, be allowed to point to the officers' ignorance of the actual violations to insulate itself from the consequences of such actions. With responsibility imposed by statute upon the firm, *and with business prudence, in addition, requiring the exercise of supervision*, "wide eyed disavowals" of fraud committed by a subordinate can all too readily lead to a firm's enjoying the fruits of wrongful conduct while avoiding the statutory consequences when such conduct is discovered.[72]

They observed that "supervision" was a matter of "business prudence," not a legal obligation, no less one under the federal securities laws. But the "public interest" hardly justified absolving liability that existed in large part to encourage oversight when it was missing.[73] They were reluctant, however, to impose the

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> any act of any broker or dealer designed to effect with or for the account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security . . . unless such broker or dealer, at or before the completion of each such a transaction, gives or sends to such customer written notification disclosing (1) whether he is acting as a broker for such customer, as a dealer for his own account, as a broker for some other person, or as a broker for both such customer and some other person; and (2) in any case in which he is acting as a broker for such customer or for both such customer and some other person, either the name of the person from whom the security was purchased or to whom it was sold for such customer and the date and time when such transaction took place or the fact that such information will be furnished upon the request of such customer, and the source and amount of any commission or other remuneration received or to be received by him in connection with the transaction.

Release 1330, *supra* (originally promulgated as Rule MC4); Release 1763, *supra* (re-adopted and renumbered as Rule X-15C1-4) (later codified as amended at 17 C.F.R. § 240.15c1-3).

69. By their terms, Rules X-15C1-2 and X-15C1-4 did not require intent (although the U.S. Supreme Court later would determine that enabling language in Section 10(b) similar to Section 15(c)(1) required *scienter*. *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)). The missing element made attribution of the salesman's conduct more intelligible. However, while the salesman's actions ostensibly were carried out on behalf of the broker-dealer, they were not identified to it under agency law because the conduct was illegal. *See supra* note 10 and accompanying text. Nevertheless, the company was responsible for it civilly under the principle of *respondeat superior* in tort. *See supra* note 11 and accompanying text. By then, assigning statutory liability to companies for regulatory or low-level crimes without *mens rea* was an accepted practice. *See* Francis B. Sayre, *Public Welfare Offenses*, 33 COLUM. L. REV. 55 (1933).

70. *See generally* Bond & Goodwin, Inc., 15 S.E.C. 584, 599–601 (1944).

71. The Commissioners found "supervision over [the salesman] was slight, if it existed at all." *Id*. at 599. According to the company, its precautions consisted primarily of "employ[ing] intelligent, experienced men, and rel[ying] on their judgement." *Id.*

72. *Id*. at 601.

73. *See id*. ("We cannot view the laxity of respondent's controls over its salesmen as a reason *to relieve it of responsibility for [the salesman's] fraudulent conduct*." (emphasis added)).

harshest remedy for malfeasance "on the part of only one salesman out of many,"[74] and suspended the company from the NASD for thirty days.[75]

The SEC addressed supervision again a year later.[76] The manager of the St. Louis "suboffice" of an established OTC broker-dealer headquartered in New York charged excessive, undisclosed mark-ups in numerous sales (mostly bonds) to customers (primarily three charitable funds), churned their accounts, and made fictitious or unauthorized trades.[77] The manager, himself a registered broker-dealer and NASD member, was counter-party on some of the trades.[78] Chairman Ganson Purcell and Commissioners Healy, Pike, and Robert McConnaughey, found the manager and the company violated Section 17(a) of the Securities Act and Section 15(c)(1) and Rule X-15C1-2 of the Exchange Act.[79] The manager's registration was revoked and he was expelled from the NASD.[80] The issue was whether it was in the public interest for the company to suffer the same fate.[81]

The broker-dealer was a substantial underwriter "that participated . . . in a larger number of registered issues than any other securities dealer."[82] It had five principal offices and twenty-four lesser offices across the country.[83] St. Louis was supervised primarily by the midwest regional manager, a vice president and director, in the Chicago office.[84] The manager was the region's leading producer.[85] He received 45 percent of the profit on business he generated; the regional manager earned 25 percent.[86] The company professed its offices

74. *Id.* at 602. They also credited the company's "new office procedure . . . and controls over the conduct of its employees" and its "large business . . . conducted over many years[.]" *Id.*

75. *See id.*

76. *See* E. H. Rollins & Sons, Inc., 18 S.E.C. 347 (1945).

77. *See generally id.* The manager also paid secret rebates to a fund trustee—his brother. *See id.* at 382–86.

78. *See id.* at 351, 374–75.

79. *See generally id.* at 355–82. Under Section 15(b), the broker-dealer was responsible as a control person for the manager's fraud. *See id.* at 393. His behavior in effecting bogus trades and churning accounts was attributed to the company for purposes of Section 15(c)(1) and Rule X-15C1-2. *See id.* at 378–79 n.45 ("The willful violations by [the manager], committed in the course of his employment, constitute willful violations by [the company]." (citing N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481 (1909))); *id.* at 382. The undisclosed mark-ups apparently were sufficient by themselves to establish liability under the rule. *See id.* at 374. The fictitious trades resulted in false records in violation of Section 17(a) and Rule X-17A-3 of the Exchange Act, *see id.* at 378–79, and credit violations under Regulation T, *see id.* at 386–87. Attributing the manager's state of mind to the company made the violations "willful" with respect to the broker-dealer as prescribed in Section 15(b)(D). It was a fiction that by then had long outlived its necessity:

> The statute requires that an actual malicious intention . . . shall be found . . . but we are of the opinion that the Legislature, in enacting this statute, did not intend to change the rules of law whereby one person is made responsible in damages for the wrongs done by another, but left them to be applied according to the principles which govern the administration of the law[.]

Lothrop v. Adams, 133 Mass. 471, 481–82 (1882).

80. *See E. H. Rollins & Sons, Inc.*, 18 S.E.C. at 390.

81. *See id.*

82. *See id.* at 350.

83. *See id.*

84. *See id.*

85. *See id.*

86. *See id.*

"enjoyed a high degree of independence" and "wide discretionary power over their own operations."[87] It emphasized the mischief was limited to "one of a large number of suboffices" and implored the repercussions for "the organization as a whole would injure a large number of people . . . who had no knowledge whatsoever of the violations."[88] The Commissioners countered that the public interest called for vigorous supervision to thwart bad behavior; nescience was no excuse when it ensued.

> It is, of course, inherent in the very nature of a large organization that the bulk of transactions are handled by subordinates, that principal officers do not as a matter of course concern themselves with details, and that many officers and employees are ignorant of what other members of the organization may do. *These facts make it especially imperative that the internal controls of such an organization be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication of possible irregularity reaches their attention.*[89]

They held up an arduous standard of oversight. But again it was to relieve liability—not to impose it.[90] Any obligation, they affirmed, was prudential.[91]

Although others were on notice of the manager's transgressions, reprobation fell heavily on the regional manager:

> With responsibility on [him] for the administration of [the broker-dealer's] activities over a large area, he was, as far as the record shows, completely oblivious to the necessity for protecting the funds from [the manager's] depredations, and a willing participant in the exorbitant profits therefrom.[92]

Clearly, the Commissioners' concerns went beyond substandard oversight. They observed, he "passed upon orders submitted by all salesmen in the area . . . including [the manager]" and "approved or fixed the prices on bonds sold . . . to the funds."[93] "He obviously was . . . aware of the spreads being charged them."[94] In their opinion, he knew enough about the excessive trading to be "deemed to have participated in the scheme."[95]

87. *Id.* at 391.

88. *Id.*

89. *Id.*

90. *Id.* ("Whenever a large organization neglects such safeguards, responsibility for the consequences of remedial action on officers and employees who are innocent of wrongdoing rests directly upon it. It can hardly argue that such consequences are grounds for us refraining from taking action.").

91. *Id.* at 391–92 (quoting Bond & Goodwin, Inc., 15 S.E.C. 584 (1944)). *See also* Kidder Peabody & Co., 18 S.E.C. 559, 573 (1945) (quoting *Bond & Goodwin, Inc.*, 15 S.E.C. 584, and citing *E. H. Rollins & Sons, Inc.*, 18 S.E.C. 347, in assessing sanctions in the public interest under Section 15(b) and Sections 15A(*l*)(2) and 19(a)(3)).

92. *E. H. Rollins & Sons, Inc.*, 18 S.E.C. at 393.

93. *Id.* at 358.

94. *Id.* at 359. "[He] *must have known* that even mark-ups of approximately five points might . . . often result in the funds being charged prices not reasonably related to the market." *Id.* at 361 (emphasis added). "[W]e find [he] was *at least grossly negligent* in not asking for evidence of [their] consent . . . ." *Id.* at 361–62 (emphasis added).

95. *Id.* at 382.

The broker-dealer was an "old organization" with no prior proceeding or evidence of misconduct elsewhere in the company, and the Commissioners credited steps taken "to increase the extent of supervision of its internal operations."[96] Still, the case had been made for revocation.[97] They offered, however, "this result might well be avoided, and hardship on many innocent persons be made unnecessary, if [the manager] and [the regional manager] were separated from the organization," and reserved action pending confirmation they were terminated.[98] The case thus forced discipline against someone who apparently aided and abetted the violations apart from his oversight; although he was not in appearance.[99] In the meantime, the company was suspended from the NASD for sixty days.[100]

A Broader Theory of Supervisory Responsibility Extends Jurisdiction over Individuals and Commands Greater Oversight by Broker-Dealers

In 1961, Congress commissioned a broad study of the securities markets.[101] The "Special Study of Securities Markets,"[102] published two years later, reported that the period after World War II saw a dramatic increase in investors across the country, many with limited experience, met by corresponding growth in the brokerage industry. Many broker-dealers had large networks of branch offices great distances from headquarters. Rapid demand for salespersons in remote locations left many novices working beyond the watchful eye of seasoned professionals. Proper training and supervision were more important than ever to protect investors from incompetence and fraud by unscrupulous agents. The NASD and the NYSE adopted rules requiring minimum qualifications for representatives and internal controls to oversee their activities.[103]

Competency and oversight became priorities for the Commission as well. But jurisdictional limits prevented it from addressing them directly. Instead, it exerted influence through legal theories and settlement tactics in enforcement cases. One effort involved re-characterizing supervision as a statutory obligation to discipline individuals perceived to have facilitated violations or done too little to prevent them.

Reynolds & Co.[104] was a particularly egregious case. The order of proceedings alleged that between December 1, 1953, and January 9, 1959, the firm, a registered broker-dealer, "together with or aided and abetted by certain partners,

96. *Id.* at 392.
97. *Id.* at 393.
98. *Id.* at 393–94.
99. *See id.* at 348.
100. *See id.* at 394.
101. *See* Pub. L. No. 87-196, 75 Stat. 465, 465 (1961).
102. Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95 (1963) [hereinafter Special Study].
103. *See generally id.* at 9–30 ("The Structure and Growth of the Securities Industry").
104. 39 S.E.C. 902 (1960).

branch managers, and employees," traded excessively in customers' accounts, made unauthorized trades, and coaxed investments by false or misleading information in willful violation of the anti-fraud provisions.[105] The company also "permitted" the violations and the misappropriation of funds by another employee through inadequate supervision.[106]

The action took place in the New York-based firm's Chicago, Minneapolis, San Francisco, Berkeley, and Carmel, California, offices.[107] In Carmel, a salesman abused discretion to burn through customers' accounts.[108] Under NYSE rules, discretionary authority had to be in writing and orders approved and initialed by a partner.[109] The managing partner of the west coast offices, located in San Francisco, responsible for the accounts, did not endorse or review the transactions.[110] He and the office manager were informed of a high volume of trades in two accounts, which they discussed with the salesman, but took no action.[111] The partner relied on the office manager to monitor the salesman; the manager, in turn, trusted the salesman.[112] In Chicago, another salesman made unauthorized trades in several accounts for over a year.[113] The head cashier, the resident manager, and the resident partner were apprised of information that "should have resulted in the detection of the employee's fraudulent activities," including a complaint of unauthorized trading, several cancellations, and forged customers' signatures on non-solicitation letters.[114] In the Bay Area, an assistant manager and others in the Berkeley office engaged in a classic pump-and-dump scheme involving companies with interests in uranium claims in Utah.[115] The west coast managing partner and

105. *Id.* at 904. The allegations were under Section 17(a) of the Securities Act, and Section 10(b) and Rule 10b-5 and Section 15(c)(1) and Rule 15c1-2 under the Exchange Act. *See id.* In addition, it was alleged that the firm, through various individuals, extended credit in violation of Regulation T. *See id.*

106. *Id.*

107. *Id.* at 905. *See generally id.* at 905–16.

108. *See id.* at 905–07.

109. *See id.* at 907.

110. *See id.* at 907–08. The salesman relied on oral discretion for two accounts until the partner required written authorization (which absolved the firm of liability). *See id.* at 907. The partner purportedly arranged to have the trades approved by another partner in New York (which did not happen) because he did not have access to customer statements and relied on the office manager onsite to review the account activity. *See id.* at 908.

111. *See id.* at 908. Later, after the firm prohibited discretionary accounts, the partner noticed continued high levels of activity in the salesman's accounts. He asked the office manager to review it and to check with the customers. The salesman lied to the manager saying he no longer had discretion, which the manager didn't verify. *See id.* at 908–09.

112. *Id.* at 909.

113. *See generally id.* at 909–11. In one instance, a customer instructed the salesman to perform a single sale before leaving on a trip to Europe. Upon returning, he noticed additional purchases and sales creating a debit balance. The customer complained. The salesman told his superiors the trades were authorized by letter, which he failed to produce. He said another customer was willing to take some of the securities at the original prices despite a loss of about $1,800, and forged the customer's signature on a letter authorizing the transfer. *See id.* at 909–10.

114. *See id.* at 910–11. The salesman was put under investigation for the forgeries but allowed to continue business as usual, whereby he performed additional unauthorized trades, changing one customer's address to his own and taking delivery of confirmations in violation of firm policy. *See id.* at 911.

115. *See generally id.* at 912–13. They touted the stocks as the "hottest thing," "going up tomorrow," "the sky was the limit"; exaggerated the value of uranium claims; initiated a publicity campaign in newspapers and other publications overstating claims and understating shares outstanding; and

the office manager knew about the promotions and stock sales despite a firm policy against recommending speculative investments.[116] In Minneapolis, insufficient controls enabled a salesman to misappropriate funds, requesting cashier checks payable to customers and forging their signatures.[117]

The broker-dealer and the partners and managers overseeing the offices submitted offers of settlement agreeing the Commission could find they "willfully violated" the anti-fraud and other provisions of the Securities Act and Exchange Act; the firm consented to suspension from the NASD, and the individuals agreed to findings they caused the suspension.[118]

Chairman Edward Gadsby and Commissioners Harold Patterson and Earl Hastings found "[t]he activities in registrant's branch offices . . . demonstrate serious and extensive misconduct by employees . . . and grave deficiencies in the supervision and internal control . . . by registrant and the individual stipulating respondents[.]"[119] They recast supervision as an inexorable duty, its origin obscured in a footnote:

> We have repeatedly held that brokers and dealers are under a duty to supervise the actions of employees and that in large organizations it is especially imperative that the system of internal control be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention.[120]

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held up customer purchase orders while bidding up the stock in a regional exchange publication and then directing the orders there instead of the dealer market in New York where the shares were cheaper. At the same time, the assistant manager was selling his shares. *See id.*

116. *See id.* at 914. The managing partner admonished an employee for using the firm's name in an interview promoting the stocks despite the policy and without verifying the information. *See id.* If he had reviewed teletype messages with regional dealers, "[he] would have learned that questionable activities [in] the mining companies were being conducted." *Id.* The manager didn't review sales literature and permitted his assistant to bypass the order room and negotiate directly with dealers, enabling him to sell his shares against customers' orders. *See id.* The managing partner "acquiesced to the practice as a temporary measure" after the assistant said the order room was too slow. *Id.* at 914–15.

117. *See id.* at 915–16 ("Had there been proper internal auditing and supervision, the endorsements of these checks would have been examined and it would have been ascertained that the salesman's name appeared in a number of instances under the purported endorsement of the customer, and further inquiry would have been made which would have exposed the improper activities of the salesman.").

118. *See id.* at 904–05. They also consented to the SEC Division of Trading and Exchange staff's participation in preparing the Commission's opinion. *See id.* It was agreed the SEC would not institute additional proceedings based on the violations against them or other broker-dealers they might join provided they did not serve in administrative or supervisory capacities, allowing them to continue to work in the industry. *See id.* at 905 n.8.

119. *Id.* at 916.

120. *Id.* In the footnote, they cited *Bond & Goodwin, Inc.*, 15 S.E.C. 584 (1944), *E. H. Rollins & Sons, Inc.*, 18 S.E.C. 347 (1945), and *Kidder Peabody & Co.*, 18 S.E.C. 559 (1945), as well as R. H. Johnson & Co., 36 S.E.C. 467 (1955), *aff'd*, 231 F.2d 523 (D.C. Cir. 1956), *cert. denied*, 352 U.S. 844 (1956), a case, like the others, that based the obligation on business standards, specifically the NASD Rules of Fair Practice, *see id.* at 485–86. The reference continued:

> The need for diligent supervision to prevent and promptly detect any wrongdoing is well recognized in the securities industry. Thus, for example, Rule 405 of the New York Stock Exchange requires every member through a general partner or officer to supervise diligently all accounts and use due diligence to learn the essential facts about each new account, and Section 27 of Article III of the Rules of Fair Practice of the NASD imposes similar obligations upon members of that association.

The omission was tantamount to "participation" in the underlying misconduct in "willful violation" of federal securities laws, notwithstanding the obligation resided outside of them.[121]

The broker-dealer was suspended from the NASD for thirty days, based on the employees' violations and its own failure to supervise them.[122] The partners and managers, who did not commit the violations but nevertheless "participated" in them, including the firm's supervisory offense,[123] by their deficiencies in oversight, were found to have caused the suspension.[124] Again, it was apparent there was as much if not more concern about their active involvement in the violations.[125] Nevertheless, their official transgressions were a mixed bag

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Reynolds & Co., 39 S.E.C. at 916 n.26. The opinion also referred to a decision by the U.S. Court of Appeals for the Second Circuit, R. H. Johnson & Co. v. SEC, 198 F.2d 690 (2d Cir. 1952). *See Reynolds*, 39 S.E.C. at 916 ("As the Court said . . . in affirming our action sustaining a decision of the NASD in a similar situation, a contrary rule 'would encourage ethical irresponsibility by those who should be primarily re[s]ponsible.'"). In *R. H. Johnson & Co. v. SEC*, the court upheld findings by the NASD and the SEC that the controlling partner of an NASD member firm caused an order of expulsion by failing to ensure the firm implemented a system of supervision required by Article III, Section 27, to prevent sales practices violations under NASD rules. *See* 198 F.2d at 695 & n.8; *id.* at 696. The partner asserted the omission could not logically be the "cause" of the underlying violations. *See id.* at 696. The judges disagreed, saying "[i]t overlooks the context in which the word is used, *i.e.*, a statute explicitly concerned with adherence to 'just and equitable principles of trade.'" *Id.* In effect, the rule requiring a member to establish supervisory procedures, imposed on the partner as the *de facto* member by his domination of the partnership, created an antecedent duty to take steps to prevent the relevant misconduct, non-performance of which rendered the controlling partner a cause of the underlying violation.

121. *See id.* at 917.

> [W]e are of the opinion that, where the failure of a securities firm and its responsible personnel to maintain and diligently enforce a proper system of supervision and internal control results in the perpetration of fraud upon customers or in other misconduct in willful violation of the Securities Act or the Exchange Act, for purposes of applying the sanctions provided under the securities laws such failure constitutes participation in such misconduct, and willful violations are committed not only by the person who performed the misconduct but also by those who did not properly perform their duty to prevent it.

Id. (citing *R. H. Johnson & Co.*, 36 S.E.C. 467, and *Merrill Lynch, Pierce, Fenner & Beane*, 31 S.E.C. 494 (1950) (A broker-dealer effecting trades for a correspondent broker's customers "led to believe that they were in reality dealing with the [broker-dealer]" was responsible for the correspondent broker's fraud and reporting violations by, among other things, failing "adequately to supervise the activities of the correspondent.")).

122. *See id.* at 918–20. Several factors were considered in determining not to revoke the firm's registration, including "that only a very small number of [its] partners and employees and only about one-half of one percent of the overall business and income . . . were involved in the questioned activities," efforts to make restitution to customers, enhancements to supervisory controls, and business lost to bad publicity. *Id.*

123. The order alleged "that *registrant*, through lack of supervision and internal control, permitted the [alleged] activities and the misappropriation of funds of customers by . . . its salesmen." *Id.* at 904 (emphasis added). The duty to supervise thus was attributed to the broker-dealer alone. The individuals blamed for its omission therefore couldn't have done more than aided and abetted the violation.

124. *See id.* at 919–20.

125. Although it was contended "none of [the] partners or supervisory personnel knowingly participated in the misconduct or knew that it was being perpetrated," *id.* at 918, the opinion recounted several incidents of highly unorthodox superintendence that bordered on willful participation in some of it: The west coast managing partner and Carmel office manager discussed with the salesman the volume of trading in his accounts and "*agreed with [his] position*" that "*as long as the accounts were*

of supervisory deficiencies under NYSE rules,[126] firm policies and directives,[127] and prudential norms.[128] In addition to terminating the primary offenders, the firm, hoping to reduce its sanction, submitted: one of the branch managers "resigned by request"; one partner "has become a limited partner [with] no operating responsibilities"; the rest were "relieved of their supervisory responsibilities."[129]

The legal basis for disciplining the firm and its personnel for supervisory deficiencies was tenuous: The federal securities laws did not contain a duty to supervise and NYSE rules and internal policies and directives were not grounds for sanctions. The external obligations might have provided a causal nexus, but they were merely contractual. It was one thing to banish a person for intentionally committing or knowingly facilitating a violation; it was another to ban someone for failing voluntarily to prevent it. Certainly, it was disingenuous to equate the two.

In *Reynolds*, there was at least some evidence of suspicion if not outright knowledge of wrongdoing by the respondents. However, there was no such evidence in two cases against another broker-dealer shortly before the statutes were amended. In the first, nearly two dozen salesmen in four branch offices arranged for customers (mostly related accounts) to obtain credit from a factor that exceeded limits under Regulation T.[130] The New York firm instituted a policy

making money, the volume of trading was unimportant," *id.* at 908 (emphasis added); the resident partner, office manager, and head cashier in Chicago accepted "the obviously irregular suggestion" of the salesman accused of unauthorized trading to transfer the securities to another customer's account "at a price substantially in excess of the current market price" without checking for authorization, *id.* at 910–11 ("The conduct of registrant's three officials represented *a reckless failure to inquire into highly questionable circumstances as well as active participation in an improper transfer of a loss to another customer*." (emphasis added)); and the west coast regional partner and the Berkeley office manager knew about the speculative mining stock sales and permitted direct negotiations with dealers against firm policy, *see id.* at 914–15. Even the conclusion emphasized active involvement instead of failure to intervene: "Accordingly, we conclude that registrant, together with or aided and abetted by [the primary offenders and their superiors], willfully violated the anti-fraud provisions . . . ." *Id.* at 918. While failing to do something required by law or contract to prevent misconduct might be the *cause* of it, the omission hardly equated to *aiding* or *abetting* it.

126. *See, e.g.*, *id.* at 907 ("Under a rule (now Rule 408) of the New York Stock Exchange, of which registrant and its partners were members, written authorization of the customer is required with respect to any discretionary power and all orders in a discretionary account must be initialed and approved by a partner.").

127. *See, e.g.*, *id.* at 908–09 (The firm's "Code of Practices," which was "published and distributed to its branch offices," prohibited discretionary accounts; while the west coast managing partner instructed the Carmel office manager to review the salesman's accounts.).

128. *See, e.g.*, *id.* at 910 ("The unauthorized transactions [in the Chicago office] involved a course of conduct extending over more than a year. During this period, various circumstances came to the attention of supervisory personnel which should have resulted in the detection of the employee's fraudulent activities."); *id.* at 915–16 ("The practice of giving [the Minneapolis salesman], without question, checks drawn on the accounts of customers would not have been permitted under an effective system of internal control and supervision.").

129. *Id.* at 918–19.

130. *See* Sutro Bros. & Co., 41 S.E.C. 443 (1963) [hereinafter *Sutro I*]. The violations took place over seventeen months beginning in January 1960. *See id.* at 448. The salesmen's activity included furnishing information about the factor to clients, preparing instructions, and filling out forms, promissory notes, and other documentation. *See generally id.* at 452–56. The broker-dealer conceded it amounted to "arranging" for credit. *See id.* at 456.

early on disallowing the practice.[131] A branch manager in the Huntington, Long Island, office continued to encourage it, while he and others conspired with the lender to conceal the arrangements.[132] In the second, a representative, working surreptitiously with a company's controlling shareholder, and two other salesmen in the Washington, D.C. office sold unregistered shares of the company while the representative contemporaneously bid for and purchased the stock.[133] The factoring arrangements violated Section 7(c) of the Exchange Act.[134] The broker-dealer and the salesmen in the District of Columbia violated Section 5 of the Securities Act; the firm violated Section 10(b) and Rule 10b-6 of the Exchange Act.[135]

131. *See generally id.* at 452–56. In May 1960, following warnings by the NYSE, the broker-dealer instructed personnel not to execute orders for trades that appeared to be factored and the factor's account used to facilitate loans was closed. The salesmen continued to perform trades financed by the factor using other broker-dealers and banks to hide the arrangements. *See id.* at 449.

132. *See generally id.* at 452–56.

133. *See* Sutro Bros. & Co., 41 S.E.C. 470 (1963) [hereinafter *Sutro II*]. The activity took place between January and May 1961. *See id.* at 472–75. The company had filed notice with the SEC on Form 2-A of an offering under Regulation A representing the sale of 39,685 shares out of 120,000 offered before it was discontinued. *See id.* at 472. In fact, the underwriter sold only 9,685 shares without remitting the proceeds. *See id.* The rest (30,000 shares) was retained by the company and the controlling shareholder. *See id.* at 472–73. The shareholder met privately with the representative and both arranged to open an account with the broker-dealer for another person, a onetime director and control group member, to sell 10,000 shares of the unsold stock. *See id.* (Lots of 10,000 shares were placed with two other broker-dealers in the area. *See id.* at 473.) Shares in the accountholder's name were delivered to the representative. *See id.* The representative, working with the controlling shareholder, published bids in the "pink sheets" and purchased shares to support the price. *See id.* at 473–74. He and the other salesmen sold approximately 4,500 shares to almost two dozen customers above the original offering price. *See id.* at 474. (The customers' positions eventually were sold at a profit. *See id.* at 475.) The broker-dealer, the office manager, and the two other salesmen made appearances, stipulated to facts, and the decision was binding only on them. *See id.* at 471 & n.3.

134. *See Sutro I*, 41 S.E.C. at 450 ("Since the salesmen's actions and knowledge are chargeable to the registrant as their employer, it follows that registrant willfully violated Section 7(c) of the [Exchange] Act and Regulation T."). The salesmen "willfully" aided and abetted the violations.

> [W]e have consistently found persons associated with a broker or dealer but not themselves brokers or dealers to have participated or "aided and abetted" in the violations . . . by a broker or dealer[.]
>
> * * *
>
> And there is no doubt that the salesmen's conduct was willful, at least in the sense that they intended to do the acts which constituted the violations.

Id. at 458–59. Section 7(c) imposed strict liability for arranging credit in excess of the amount prescribed by Regulation T. The salesmen merely needed to know what they were doing, and there was no question most of them knew they were circumventing the restriction. *See generally id.* at 452–56. The SEC might have proceeded against them independently as "brokers," but the sanction in Section 15(b) was inapposite. Any meaningful action required finding they caused an order of discipline against the firm. *See id.* at 464.

135. *See Sutro II*, 41 S.E.C. at 478. Rule 10b-6, 17 C.F.R. § 240.10b-6 (adopted 1955, replaced in 1997 by Regulation M) prohibited an underwriter, broker, dealer, or other person participating in a distribution from bidding for or purchasing the securities subject to distribution. The Commissioners also found the representatives made false or misleading statements in selling the stock to customers, *see Sutro II*, 41 S.E.C. at 474–75, for which the firm was responsible, *see id.* at 478–79.

The broker-dealer's managing partner "was charged with the over-all responsibility for supervision of all the operations of the firm[.]"[136] He issued the factoring prohibition but there were no procedural controls beyond disciplining individuals that violated it.[137] He and the firm blamed the failure to discover the extent of the ongoing arrangements on the participants' efforts to hide their activities and a "tremendous administrative burden" on the managing partner and others from increased business at the time.[138] In Washington, D.C., the office manager, a general partner, inquired about the ability to sell the shares in exempt transactions.[139] Unaware of the representative's dealings with the controlling shareholder,[140] the manager was shown information suggesting the company had sold a block of stock to the public with no indication the nominal accountholder was an affiliate.[141] He approved trades with dealers only.[142] He and the broker-dealer conceded the firm had a responsibility to assure customer sales complied with registration requirements.[143] They contended the manager made a reasonable investigation and was deceived by the representative, "a victim and not a perpetrator of a fraudulent scheme."[144]

Chairman William Cary and Commissioners Manuel Cohen, Jack Whitney, and J. Allen Frear found the broker-dealer and its managing partner had a "responsibility . . . effectively to prevent violations of the credit regulations."[145] Given the firm's previous involvement with the creditor, they had "to do more

136. *Sutro I*, 41 S.E.C. at 459 (His responsibilities included "the hiring and firing of salesmen and the compliance by salesmen with all relevant statutes, rules and regulations affecting the securities business.").

137. *See id.* at 460. The factor's principals continued to visit the broker-dealer's offices to solicit business (leaving forms of promissory notes, instructions, and business cards), communicated freely with salesmen, and had "ready access" to the margin department for information on customer accounts. *See generally id.* at 452–56. Factored accounts that were discovered went unreported; indications of broader arrangements weren't investigated. *See id.* at 460–63.

138. *See id.* at 459, 460–61.

139. *See Sutro II*, 41 S.E.C. at 473.

140. *See id.* at 476.

141. *See generally id.* at 473. The manager was shown a copy of the offering circular for the 120,000 shares, which did not identify the accountholder as a shareholder, officer, or director. *See id.* The firm also received copies of Form 2-A and an escrow agreement for the shares outstanding at the time of the offering, neither of which included his name. *See id.* The issuer's attorney advised that the transfer agent had informed him 10,000 shares in the accountholder's name were part of 39,685 shares sold under Regulation A and that a company vice president had certified they were paid for in full. *See id.* The certificates were endorsed in the accountholder's name and his signature was guaranteed by a bank. *See id.*

142. *See id.* at 481. The allegations included supervisory deficiencies related to the customer sales. *See id.*

143. *See id.* at 479.

> Registrant and [its partner] do not dispute that a broker-dealer asked to sell a substantial amount of securities has a responsibility to take reasonable steps to determine that the proposed sales would not constitute participation in transactions by an issuer, controlling person or an underwriter which require registration under the Securities Act.

Id.

144. *Id.* at 479.

145. *Sutro I*, 41 S.E.C. at 461–62.

than issue notices, hold meetings and discipline some salesmen when and as instances of factoring came to [the managing partner's] attention."[146] Despite its "policy and intent . . . more specific and self-executing procedures should have been instituted to discover and prevent factoring."[147] The managing partner in particular "should have made special inquiries or instituted special procedures to insure that [the owners] would not continue their factoring business with registrant or its representatives after [the prohibition]."[148] The same Commissioners accepted the D.C. office manager was not involved in the scheme to distribute stock illegally, took steps to assure sales were proper, and was entitled to an extent to trust his subordinates.[149] Nevertheless "there were factors present which should have called for a more searching inquiry and which indicate that effective supervision would have prevented the violations."[150]

The broker-dealer was liable for the underlying violations. However, in order to discipline the managing partner and the office manager, who, if they participated in them at all, did so unwittingly, supervision needed the imprimatur of the federal securities laws.[151] In *Sutro I*, the Commissioners reasserted "brokers and dealers are under a duty to supervise the actions of employees" and reaffirmed expectations for an adequate and effective system of internal controls and utmost vigilance by those in authority to any indication of irregularity.[152] Citing *Reynolds*, there was no reference to any external origin this time.[153]

146. *Id.* at 462. While there were indications the arrangements were continuing, *see id.* at 460, it was not alleged the managing partner was involved in them, *see id.* at 462 ("[T]he Division concedes, there is no evidence that [the managing partner] himself ever made any arrangements for the factoring of accounts or counseled anyone else to do so . . . .").

147. *Id.* at 462.

148. *Id.*

149. *See Sutro II*, 41 S.E.C. at 480.

150. *Id.* Among other things, the transaction involved the sale of a substantial block relative to the amount purportedly sold on Form 2-A, and the offering circular stated the company could not do business unless it sold all the shares offered, which the filing indicated it failed to do. *See id.* The attorney's confirmation also raised suspicions. *See id.*

> Under these circumstances the actions taken by [the office manager] cannot be considered to have been an appropriate or adequate inquiry or investigation into the identity of the seller of the stock or into the circumstances of his acquisition of such stock.

Id. In addition, the firm's controls were "defective" in allowing a representative to publish quotations without branch manager approval: "[E]ven if such procedure was permissible under registrant's regulations, [the manager] could and should have exercised supervision over quotations submitted by salesmen in his office." *Id.* at 480–81.

151. Grounds for disciplining the broker-dealer were limited to violations of the Securities or Exchange Acts. Therefore, supervisory responsibility, previously a factor only in relieving sanctions, had to stem from one of them for the managing partner's or manager's performance to have caused the deficiency in that part of the order. *See Sutro I*, 41 S.E.C. at 459 ("The question as to [the managing partner's] responsibility for the violations revolves around the issue of whether the supervision he provided was adequate under the circumstances. This issue is intertwined with that of the sanction, if any, required in the public interest against registrant and [him] . . . ."); *Sutro II*, 41 S.E.C. at 479 ("Since the issues with respect to the public interest and [the manager's] responsibility turn largely on the question of the adequacy of the supervision by registrant and [himself], we [] consider these issues together.").

152. *See Sutro I*, 41 S.E.C. at 463.

153. *See id.* at 463 n.36.

Under similar accommodations,[154] they found "for purposes of applying the sanctions" the broker-dealer's supervisory deficiency constituted participation in the violations by the firm and its managing partner.[155] The same in *Sutro II*.[156]

The broker-dealer was suspended from the NASD for fifteen days in both cases, running concurrently;[157] each partner was found to be a cause of the order of suspension, with limited impact.[158] The sanctions were light, but a message was sent that comprehensive oversight was essential to compliance with the federal securities laws.

Congress Affirms Supervision Is an Industry Responsibility, Encourages Broker-Dealers to Develop Supervisory Systems and Authorizes the SEC to Discipline Individuals for Primary Violations, Aiding and Abetting, and Failure to Supervise

Early cases found the SEC's administrative powers wanting in some respects and excessive in others. It could discipline broker-dealers but the sanctions were extreme and affected innocent people. It could not proceed against their associates but could punish them indirectly. The basis in "causation" was unlimited, the consequences were severe, and the individuals had no procedural rights.[159] At the same time it became clear that to administer the securities laws effectively, broker-dealers, the principal instrumentalities for administering them, had to implement compliance and police adherence by their employees and others—issuers, lenders, correspondents, and customers—at least as it pertained to their businesses. Derivative liability provided some impetus, but no obligation. *Sutro I* sought to compel broker-dealers through management to establish supervisory policies and procedures and enforcement systems;[160] *Sutro II* demanded performance from those assigned to administer them.

But the design lacked substance. There was no accepted cannon of supervision—evidenced by so many unsubstantiated pronouncements of what should

154. The broker-dealer and the managing partner submitted an offer of settlement agreeing the SEC could make findings "as may be legally permitted" and impose penalties other than revocation of the firm's registration or expulsion from the NASD or expulsion of the firm or managing partner from any stock exchange. *See id.* at 445. There was a similar agreement in the registration case. *See Sutro II*, 41 S.E.C. at 471.

155. *Sutro I*, 41 S.E.C. at 463.

156. *See Sutro II*, 41 S.E.C. at 481 ("We conclude that under all the circumstances there was a laxity in office procedures and supervision and a failure to make a proper inquiry and investigation with respect to the . . . stock, which in our opinion requires in the public interest a sanction against registrant and a finding that [the manager] was a participant in the violations." (citing Reynolds & Co., 39 S.E.C. 902 (1960))).

157. *See Sutro I*, 41 S.E.C. at 464; *Sutro II*, 41 S.E.C. at 482.

158. The managing partner, who was removed from his position and subsequently left the firm, was assessed "no sanction other than that which is entailed in finding him a cause of the firm's suspension." *Sutro I*, 41 S.E.C. at 464. The finding did not prevent the D.C. office manager's continued association with the firm. *See Sutro II*, 41 S.E.C. at 482.

159. Although they began to invoke them under the Administrative Procedure Act. *See Reynolds*, 39 S.E.C. at 904–05.

160. A later case, arising before the 1964 Amendments, held a broker-dealer's executive committee responsible for inadequate controls. *See* Shearson, Hammill & Co., 42 S.E.C. 811, 843–44 (1965).

have been done under the circumstances, which was infinitely clearer in hindsight. Actually, it depended on myriad considerations relating to operations, personnel, resources, and risks that did not lend themselves well to statutory prescription. It was questionable whether the SEC was in the best position to set those standards. In addition, it faced considerable jurisdictional constraints: Oversight ordinarily was a matter of corporate or firm governance controlled by state law, contract, and equity.[161] And while the privilege to do business nationally might be conditioned on actions a broker-dealer had to take to supervise its employees and others, it was far from clear the Commission could compel a broker-dealer's employees to perform functions—like examining trade blotters and statements—that did not involve their own activities in interstate commerce. Meanwhile, without reference to a statutory prescription or rule, establishing in disciplinary proceedings what a broker-dealer or an associate should have done under the circumstances smacked of legislating while adjudicating the case in violation of the separation of powers.

Those issues would be resolved in amendments enabling the Commission to discipline individuals for conduct that included violating the federal securities laws, aiding and abetting a violation, and failure to supervise under state law and industry standards.

The *Special Study* Recommends Increased Supervision by Broker-Dealers and Standards for Oversight

In commissioning the *Special Study*, Congress directed the SEC to review the adequacy of SRO rules for protecting investors and to report its findings and make recommendations including the need for additional legislation.[162] The report followed a "very broad study of the rules, practices and problems of the securities business and the securities markets."[163] It reiterated the roles of the SEC and the SROs in the regulatory framework:

> Under the statutory scheme of the Exchange Act, contemplating both Federal regulation and industry self-regulation, a natural division of labor allocates to the Commission control over clearly illegal selling practices . . . while improprieties in the nature of unethical practices are left to the industry bodies.[164]

A section in the first part of the report, entitled "Supervision and Controls Over Selling Practices,"[165] identified broker-dealers' internal controls as the first level

161. *See* Cort v. Ash, 422 U.S. 66, 84 (1975) ("Corporations are creatures of state law . . . except where federal law expressly requires certain responsibilities of directors with respect to shareholders, state law will govern the internal affairs of the corporation."); Franchard Corp., 42 S.E.C. 164, 176 (1964) ("The [Securities Act] does not purport to define federal standards of directors' responsibility in the ordinary operations of business enterprises and nowhere empowers [the SEC] to formulate administratively such regulatory standards.").

162. *See* Pub. L. No. 87-196, 75 Stat. 465, 465 (1961).

163. Special Study, *supra* note 102, at 1.

164. *Id.* at 326.

165. *See generally id.* at 290–330.

of investor protection in a system of overarching responsibility under SRO rules, state laws, and the federal statutes.[166] It referred to an employer's "legal duty to adequately supervise his salesforce";[167] though the motivation was attributed more accurately to the desire to stave off derivative liability and to comply with external supervisory commitments.[168]

An examination of "internal supervision" identified three features of effective oversight: (1) centralized controls,[169] (2) defined objectives,[170] and (3) policies and procedures.[171] Systems varied according to the size of the broker-dealer and its business;[172] methods depended on practicality and expense.[173] In larger companies, they included (1) executive management, audit programs, and computer support;[174] (2) networks of supervisors,

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166. *Id.* at 290 ("First, each salesman is covered by the supervisory activities and policies of his own employer. . . . Second, he is subject to the rules and sanctions of the several external regulatory bodies, both governmental and industry: the Commission, the State securities administrators, the NASD, and the exchanges . . . .").

167. *Id.*

168. The report referred to actions taken for supervisory deficiencies under the anti-fraud provisions:

> Under the broad category of "fraud" the Commission has disciplined broker-dealers when customers' accounts have been churned; when salesmen have in the sale of securities used misrepresentations and gross exaggerations or have omitted to state material facts; when, in connection with other high-pressure selling techniques, unsuitable securities have been sold to public investors; when customers have been charged excessive commission or markups for securities; *and when brokerage firms have failed to supervise their salesmen adequately*.

Id. at 302 (referring to cases cited in the Introduction to Chapter III, "Broker-Dealers, Investment Advisers and Their Customers—Activities and Responsibilities," subtitled "Legal and Ethical Obligations of the Industry to the Public" (emphasis added)). The basis was consistent with derivative liability:

> Broker-dealers are charged with the responsibility for supervising the activities of their employees. Failure to perform this function adequately can result in disciplinary action with sanctions up to an including revocation of the firm's registration. *The requirement to supervise is embodied in the rules of the NASD and the NYSE and in the Federal Securities Acts, and is consistent with the existing pattern of regulation in its emphasis on the ultimate responsibility of members and registrants for the conduct of their agents and employees.*

Id. (citations omitted)*; see also id.* at 325 ("Broker-dealers are charged with the responsibility for supervising the activities of their employees by the Federal securities laws and the rules of the NASD and the exchanges.").

169. *See id.* at 291–96.

170. *See id.* at 296–99 ("Objects of supervision" included "churning" and unsuitable recommendations.).

171. *See id.* at 296–302 (Examples of "policies" included prohibitions on discretionary accounts, soliciting OTC stocks, or those not recommended by research; "procedures" included sales manager and margin clerk review of customer account activity and branch manager, regional manager, or legal department approval of commission charges.).

172. *See id.* at 291 ("As one would expect, the complexity of the structure of supervision systems varies with the overall size of the firm, measured in terms of the number of branch offices, salesman, supervisory personnel, and the variety of the firm's business.").

173. *See id.* at 292–93 (quoting one executive saying: "[T]the objective of supervision is 'to balance the desire to make money against proper control.'").

174. *See id.* at 325 ("Centralized, or home office, controls form a . . . keystone of internal supervision. Principally these consist of senior supervisory personnel (an executive committee of partners, regional and national managers, or some similar organization), an internal audit system, and electronic data processing equipment[.]").

relying heavily on branch managers;[175] (3) practices to review business in general;[176] and (4) routines to monitor for specific abuses.[177] But overall, the assessment was negative. Procedures were inadequate or did not exist in important areas.[178] Findings of objectionable sales practices met with "neglect of the problem by home office supervisory personnel" in one case and "a total breakdown in supervision" in another.[179] Although there was "growing awareness of the importance of adequate supervision,"[180] more needed to be done.

A review of "external controls" focused on SEC and SRO rules and enforcement. It described the kinds of actions brought against broker-dealers under the federal securities laws.[181] The Commission advised it could revoke a broker-dealer's registration or suspend or expel it from the NASD or an exchange,[182] but it could not "institute any administrative proceeding directly against an individual salesman."[183] Limited jurisdiction and remedies narrowed the cases it could bring.[184] The NASD and the NYSE had broader authority.[185]

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175. *See id.* ("In firms with numerous branch offices a complex organizational structure may exist, but all firms and authorities emphasize that the key to proper supervision is the branch manager.").

176. *See id.* ("In almost all large firms the branch manager is required to review all transactions on a daily basis, and in many he must approve large or unusual orders, new customer accounts, and transactions of new and inexperienced salesmen.").

177. *See id.* at 326 ("The types of selling practices [warranting special efforts] include overtrading of customer accounts, misrepresentations and high-pressure sales tactics, and recommendations of securities unsuited to the customer's financial resources and investment objectives.").

178. *See id.* ("The evidence of overtrading found by the study even in firms [with procedures to detect it] suggests either inadequate review of the information developed or inadequacy of the existing procedures themselves[.]"); *id.* ("Most firms appear to place little emphasis in their supervisory processes on the important NASD requirement of suitability of recommendations.").

179. *Id.* at 324–25.

180. *Id.* at 326.

181. *See id.* at 302–03.

182. *See id.* at 306 (The Commission also advised it could sue a broker-dealer and others in federal court to enjoin violations and refer matters for criminal prosecution.).

183. *See id.* at 304. The report noted "[t]he Commission can indirectly reach a salesman for unlawful conduct by finding him to be a willful violator in a broker-dealer revocation proceeding," in which case "any registered broker-dealer who "controls" [the person] . . . is itself subject to the revocation of its registration . . . as well as its membership in the NASD" subject to SEC approval. *Id.* at 304 n.150 (citing Sections 15(b)(2) and 15A(b)(4) of the Exchange Act).

184. *See id.* at 326–27 ("For isolated instances of illegal selling in a large, essentially well-run firm, the Commission's sanctions may often be too severe to justify their use.") (explaining the enforcement program's emphasis on serious frauds and boiler room operations). Exceptions were made for "serious selling practice violations and defects in firm supervision." *Id.* at 304–05.

185. *See id.* at 308, 315 (citing Sections 15A and 6(b) of the Exchange Act). The report found the NASD's rules were "sufficiently broad and inclusive to cover the major abuses found to exist." *Id.* at 327. The NYSE's rules required members to "adhere to principles of good business practice," and contained provisions addressing specific concerns including standards for advertisements and sales literature, a prohibition on rumors, "churning" and "bucket shop" practices, and a "know your customer" rule requiring members to learn the essential facts about customer orders and accounts. *See id.* at 314–16. The NASD could discipline members "by expulsion, suspension, fine, censure, or any other fitting penalty[.]" *Id.* at 308. It could not proceed against an employee separately, but it could join the individual to a member proceeding. *See id.* at 309 n.172. In that way, the proceeding could be used to discipline the individual instead of the member where supervision was proper:

Both had rules requiring members to supervise their employees,[186] but they were insufficient and not well enforced.[187] As an ethical responsibility, however, it fell primarily to the industry to regulate supervision. Accordingly, the *Special Study*'s recommendations on the subject were directed to broker-dealers and the SROs:

> The supervision by broker-dealers of the selling activities of their personnel, particularly in branch offices, should be generally strengthened by the adoption of appropriate procedures[.][188]
>
> * * *
>
> The self-regulatory agencies should establish clearer standards and stronger surveillance and enforcement procedures to assure more effective supervision by their member firms.[189]

There was no mention of direct federal regulation in the area.[190]

> Supervision cases also arise where the firm itself finds that a registered representative is engaged in improper conduct and so reports to the NASD. In such cases the employing firm is charged with violating the rules on supervision in order to obtain NASD jurisdiction to discipline the salesman, and the supervision charge against the firm is generally dismissed.

Id. at 312.

186. The SEC reported that Article III, Section 27, of the NASD's Rules of Fair Practice provided:

> A member who employs any registered representative shall supervise all his transactions and all correspondence relating thereto. All transactions made by a registered representative with or for a customer shall be approved by a partner, a duly accredited executive, or a branch office manager of such member. Approval shall be evidenced by written endorsement made upon a copy of the original memorandum or other record of such transaction, and each memorandum or other record, so endorsed, shall be made a part of the permanent records of such member.

Id. at 309. Under NYSE Rule 405, a member had to "supervise diligently all accounts handled by registered representatives." *Id.* at 315. The NYSE had issued a manual entitled "Supervision and Management of Registered Representatives and Customer Accounts." *See id.* at 296–97, 319.

187. The report found most charges brought under Article III, Section 27, "involve noncompliance with mechanical rules of initialing transactions and checking correspondence," *id.* at 313, and "[the NASD] has no procedure by which it can evaluate the efficacy of its members' supervisory systems," *id.* at 327. It observed the NYSE's "know your customer" rule initially was intended to protect members from feckless customers, *id.* at 316, and a new exam module to review supervisory policies and procedures with branch managers had yet to be implemented, *id.* at 319–20.

188. *Id.* at 328 (Specific recommendations included "the designation of one home office senior executive responsible for internal supervision and regulatory and self-regulatory matters generally; increasing the branch manager's supervisory role while deemphasizing his selling activities in branches having large numbers of salesmen; and in large firms with many branches, the tightening of home office control procedures, with more extensive use of electronic data processing equipment programed to expose overtrading, undue concentration in speculative securities, and other potential abuses.").

189. *Id.*

190. It was recommended that "[t]he Commission should adopt rules to *facilitate and reinforce* controls by firms, the self-regulatory bodies, and the Commission over selling practices." *Id.* at 329 (emphasis added) (examples included rules requiring retail transactions be designated "solicited" or "unsolicited," customer complaints be kept in a single file available for inspection by regulators, account records include information on investment objectives, occupation, and desired service).

Congress Gives the SEC Authority to Discipline Individuals and Circumscribes Liability for Aiding and Abetting and Failure to Supervise

A year later, Congress passed the 1964 Amendments,[191] addressing many of the issues and recommendations in the *Special Study*. Provisions for SEC administrative proceedings against broker-dealers were contained in Section 15(b)(5) (currently Section 15(b)(4)); grounds for discipline were expanded and itemized in subparagraphs (A) through (F).[192] Advisers Act and Investment Company Act violations were included in subparagraph (D),[193] while a new subparagraph (E) added willfully aiding or abetting a violation and failure to supervise to prevent one.[194] The SEC was authorized to censure or to suspend a broker-dealer up to a year.[195] As before, the Commission could sanction the broker-dealer if an employee or other "associated person" committed a violation.[196] For the first time, under Section 15(b)(7) (currently Section 15(b)(6)(A)), it could proceed separately against the individual on "notice and opportunity for a hearing."[197]

The SEC had identified the need to discipline a broker-dealer's representatives while limiting the effect on the broker-dealer. The Senate Report accompanying the bill explained:

> At the present time, if an individual member or employee of a securities firm defrauds customers or otherwise violates the law . . . the Commission can take

191. Pub. L. No. 88-467, 78 Stat. 565 (1964).

192. *See id.* § 6(b), 78 Stat. at 571–72.

193. *See id.* at 571.

194. *See id.* at 571–72.

195. *See id.* at 571. The 1975 Amendments gave the SEC further authority to "place limitations on the activities, functions or operations" of a broker-dealer. Pub. L. No. 94-29, § 11(2), 89 Stat. 97, 122–23 (1975).

196. The term "person associated with a broker or dealer" was defined to include "any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, including any employee of such broker or dealer." *See* 1964 Amendments, *supra* note 36, § 2, 78 Stat. at 565. A subsequent amendment expanded the relationship to "common control." 1975 Amendments, *supra* note 195, § 3(4), 89 Stat. at 98.

197. Section 15(b)(7) provided in pertinent part:

> The Commission may, after appropriate notice and opportunity for hearing, by order censure any person, or bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer, if [it] finds that such [action] is in the public interest and that such person has committed or omitted any act or omission enumerated in clause . . . (D) or (E) of paragraph (5) of this subsection . . . .

1964 Amendments, *supra* note 36, § 6(b), 78 Stat. at 572. Practically, the Commission had prosecutorial discretion and "may" subsequently was changed to "shall" to be consistent with the broker-dealer provision. *See* 1975 Amendments, *supra* note 195, § 11(2), 89 Stat. at 122, 124. Later, jurisdiction was narrowed to persons "associated" with a broker-dealer. *See id.* at 124. The "person" could be an individual or entity—notwithstanding the primary focus on individuals. *See* 15 U.S.C. § 78c(9) (1964). After the 1975 Amendments, the Commission could "place limitations" on the person's "activities or functions." *See* 89 Stat. at 124. (The NASD had to have rules enabling it to discipline a person associated with a member, *see* 1964 Amendments, *supra* note 36, § 7(a)(5), 78 Stat. at 576; and Section 15A(*l*)(2) was amended to allow the Commission to bar or suspend an individual from association with a member for violating the Securities or Exchange Acts, *see id.* § 7(f), 78 Stat. at 578–79.)

> disciplinary action only by a proceeding against the entire firm, which, particularly in the case of large firms, may involve many people wholly innocent of the violation in question. This approach is awkward and may be unfair, and for this reason, violations by individuals may sometimes go unpunished.[198]

Where appropriate, "the Commission would be authorized to proceed directly against offending individuals, *in lieu of proceeding against the entire firm*[.]"[199]

The expansion did not shift liability away from the broker-dealer or diminish its supervisory responsibility.[200] It remained accountable for associates' misconduct based solely on control.[201] However, under the new provision, supervision—the relevant consideration behind vicarious liability—could be evaluated for purposes of finding fault rather than relieving discipline. It *increased* the incentive to supervise by supplying a basis to avoid liability if it was performed properly. But while the amendments potentially curbed responsibility for broker-dealers, they broadened it for associates. Under the circumstances, it was important to define expectations, especially with respect to secondary liability.[202]

Only affirmative conduct that *willfully* contributed to a violation was remediable under the aiding and abetting clause. Causation was not enough; *mens rea* was required.[203] Innocent or negligent acts, the illegality of which could not be known ahead of adjudication, were excluded.

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198. S. Rep. No. 379, 88th Cong., 1st Sess. 44 (1963) [hereinafter Senate Report].

199. *Id.* (emphasis added); *see also* H.R. Rep. No. 1418, 88th Cong., 2d Sess. 2 (1964) [hereinafter House Report] (identifying among the legislation's purposes "[p]ermitting the Commission, and the securities association, in a disciplinary action to proceed directly against an employee of a broker-dealer, *in lieu of against the firm*" (emphasis added)).

200. *See* Senate Report, *supra* note 198, at 44 ("This proposed change [the ability to proceed against individuals] would not reduce the responsibility of a firm to supervise its employees."). There were further assurances by the SEC's Chairman:

> Concern has been expressed that the effect of these provisions will be that individual salesmen will be disciplined, while their firms go undisturbed. Let me assure this subcommittee that this bill is not intended to, and in no way will, relieve firms of their legal or moral responsibility for the conduct of their personnel or replace Commission discipline of firms with discipline of individuals only. Indeed, the bill expressly codifies the Commission view that a failure to supervise is a basis for proceeding against a firm. In nearly all cases, action will be taken against both firms and individuals. Only in the relatively unusual case where it is clear that no administrative sanction against the firm is warranted will action be taken solely against individuals . . . .

Hearings Before a Subcomm. of the H. Comm. on Interstate & Foreign Commerce on H.R. 6789, H.R. 6793, and S. 1642, 88th Cong., 1st & 2d Sess., pt. 1, at 1219 (Feb. 18, 1964) (statement of SEC Chairman William L. Cary).

201. *See id.* at 76 ("Proposed clause (E) would not limit the existing power of the Commission to discipline a broker or dealer firm for any violation by a person associated with such broker or dealer.").

202. *See id.* at 45 ("This change will . . . expressly state on the face of the statute, the law on this matter, which becomes more important in view of the proposed authority for the Commission to proceed directly against individuals."). The parameters for supervisory responsibility were just as important for the broker-dealer where liability rested on a violation by someone other than an associated person for which it was not responsible as a control person under subparagraph (D).

203. *See id.* at 76.

Supervisory liability also required clarification. Until then, only the broker-dealer was considered to have supervisory responsibility.[204] Section 15(b)(5)(E) provided, in pertinent part:

> The Commission shall, after appropriate notice and opportunity for hearing, by order censure, deny registration to, suspend for a period not exceeding twelve months, or revoke the registration of, any broker or dealer if it finds that such [action] is in the public interest and that such broker or dealer . . . or any person associated with such broker or dealer . . . has failed reasonably to supervise, with a view to preventing violations of [the federal securities laws], another person who commits such a violation, if such other person is subject to his supervision.[205]

The broker-dealer was liable for its own deficiency as well as any lapse by an associated person.[206] (An associate was responsible only for his or her omission.[207]) Responsibility was limited to oversight for compliance with federal securities laws.[208] Failure to supervise by itself was not grounds for discipline; there had to be a predicate violation.

Otherwise, the provision was quite open-ended: A broker-dealer and everyone associated with it—principals, employees, major shareholders, parent companies, subsidiaries (later, affiliates), their principals, employees, and agents—had supervisory responsibility.[209] Anyone's violation could trigger it—not just an associated person's.[210] The only limitation was that the person—individual or

204. *See id.* at 45 ("The Commission has long held that *brokers and dealers* have a duty to supervise their employees; and under existing law, violations committed by employees and others connected with the firm are a basis for disciplinary proceedings." (emphasis added)).

205. 1964 Amendments, § 6(b), *supra* note 36, 78 Stat. at 571. The Commodity Exchange Act and MSRB rules were added later. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 6(b)(3), 98 Stat. 1264, 1265–66 (CEA); 1975 Amendments, *supra* note 195, § 11(2), 89 Stat. at 123 (MSRB).

206. Derivative liability was consistent with the broker-dealer's primary obligation to supervise, which contemplated establishing policies and procedures, delegating enforcement, and ensuring it was carried out.

207. According to legislators, "the primary purpose" of the provision was to enable the Commission "to reach more directly *supervisory personnel* who fail to discharge *their responsibilities*." Senate Report, *supra* note 198, at 76 (emphasis added). Cases generally found principals and employees responsible only for deficiencies in performing supervisory assignments entrusted to them by the broker-dealer; no case had extended derivative liability and concomitant responsibility for oversight or imposed a duty to supervise on a natural person other than a broker-dealer or someone controlling the broker-dealer.

208. Failures to prevent violations of other federal statutes, state blue sky laws, SRO rules (other than MSRB rules), and professional and ethical standards were not actionable.

209. The term "associated person" excluded "persons associated with a broker or dealer whose functions are clerical or ministerial" for purposes of Section 15(b), including Section 15(b)(5), but not Section 15(b)(7). *See* 1964 Amendments, *supra* note 36, § 2, 78 Stat. at 565. Later, it was amended to clarify the person must act "solely" in a clerical or ministerial capacity. *See* 1975 Amendments, *supra* note 195, § 3(4), 89 Stat. at 98. Accordingly, the SEC could discipline a broker-dealer's employee no matter what his or her capacity. At the same time, it was unlikely an employee acting as a supervisor would be considered *solely* performing clerical or ministerial functions to enable the broker-dealer to escape responsibility for his or her performance.

210. Supervisory liability was not limited by control as it was under *respondeat superior*. In *Sutro Bros. & Co.*, 41 S.E.C. 470 (1963), the firm and its office manager acknowledged responsibility for assuring a customer's sales complied with registration requirements. *See supra* note 143 and accompanying text. In *Reynolds & Co.*, 39 S.E.C. 902 (1960), the broker-dealer's review of private securities

entity—had to be "subject to [their] supervision." The term was undefined. The language did not specify what was required "reasonably to supervise, with a view to preventing violations"; or whether oversight was expected for all statutory provisions and rules, all the ways in which they could be violated, or just some of them (and if so, which ones).[211] The broker-dealer and its associates potentially were responsible for monitoring compliance with laws that did not apply to their business, by persons with whom they had no professional relations. The shadow of supervisory liability eclipsed the ability to do anything else. And there was no authority to clarify or delineate expectations by rulemaking. It wasn't necessary.

Supervisory Liability Is Based on Internal Systems and Procedures Subject to State Law and SRO Rules

Section 15(b)(5)(E) did not contain any duty to supervise. It referred to obligations outside the provision.[212] States had laws of company governance and

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transactions by representatives might have revealed an assistant manager's personal sales of stock he was promoting to customers. *See supra* note 115 and accompanying text. Similar inquiry might have uncovered the manager's trades as a dealer in *E. H. Rollins & Sons, Inc.*, 18 S.E.C. 347 (1945). *See supra* note 78 and accompanying text. The result in *Merrill Lynch, Pierce, Fenner & Beane*, 31 S.E.C. 494 (1950), suggested a clearing broker might be responsible for monitoring certain activities of its introducing brokers. *See supra* note 121. Control was necessary for the broker-dealer to ensure its agents performed their supervisory duties. It was not essential for either the broker-dealer or its associated persons to monitor other persons "with a view to preventing violations." Prevention itself might be someone else's responsibility: the broker-dealer's, if the subject was another associated person; the SEC's, an SRO's, or other law enforcement authority's, if it was someone other than an associate.

211. It was not inconsistent with the language imposing liability for failure "reasonably to supervise, with a view to preventing violations" to do nothing to prevent one of them. The *Special Study* reported that the SEC, the SROs, and broker-dealers focused their attention and resources on specific violations, accepting that some selection or prioritization was inevitable. *See generally* Special Study, *supra* note 102, at 296–99, 302–04.

> No system of supervision can be expected to be totally effective as to all the improper practices which can be employed in the sale of securities. However, certain characteristic abuses occur with sufficient frequency to require that firms as a minimum gear their supervision to the detection of such conduct.

Id. at 296 (identifying overtrading, misrepresentation, and unsuitable recommendations as common violations warranting methods of detection). At the same time, state law allowed management wide discretion in implementing systems to review for unlawful conduct. *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.").

212. The 1964 Amendments added a number of offenses outside the federal securities laws for which broker-dealers and their associates could be disciplined under Sections 15(b)(5) and 15(b)(7), including "embezzlement," "conversion," and "misappropriation." *See* 1964 Amendments, *supra* note 36, § 6(b), 78 Stat. at 571–72. Supervision under external standards was in keeping with the formula. The legislative history referred to failure to supervise among the other added *bases* for discipline. *See* Senate Report, *supra* note 198, at 41 ("Certain other changes would be made, including: a slight broadening of the category of crimes, injunctions, acts and omissions that afford a basis for disciplinary proceedings by the Commission, including . . . failure reasonably to supervise employees and others who violate, as another basis for such proceeding[.]"). Later, Congress added infractions under foreign laws, including a finding of failure to supervise by a foreign financial

supervisory responsibility,[213] and the Senate Report referred to "failure reasonably to supervise" under state blue sky laws.[214] However, the main source of liability was expected to come from the policies and procedures of broker-dealers themselves, subject to SRO rules, as recommended by the *Special Study*. Increased reliance on self-regulation was central to the 1964 Amendments,[215] and the SROs were considered the appropriate instrumentalities for regulating supervision as a professional or ethical obligation.[216] Discussion of the provision came under the heading "Qualifications and Self-Regulation."[217] Legislators referred to noncompliance with SRO oversight requirements as grounds for discipline with other external offenses.[218] At the time, the SEC's Chairman wrote of the Commission's advisory role in helping SROs develop their rules of supervision.[219] Another Commissioner explained the provision was designed to "encourage" broker-dealers "to establish and enforce comprehensive supervisory procedures" to avoid derivative liability.[220]

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regulatory authority. *See* Securities Acts Amendments of 1990, Pub. L. No. 101-550, § 203(a)(1)–(7), 104 Stat. 2713, 2715–16.

213. *See, e.g.*, *Graham*, 188 A.2d at 130.

214. Senate Report, *supra* note 198, at 45 ("Failure reasonably to supervise is a ground for disciplinary action under the Uniform Securities Act, which is in force in many States.").

215. *See id.* at 42 ("A significant part of the regulation of the securities markets provided in the Exchange Act is based upon the concept of self-regulation by industry organizations, under the supervision of the Commission. * * * The [*Special Study*] has recommended that the responsibilities of the self-regulatory agencies be substantially expanded and that their self-regulation be made more rigorous and effective. These recommendations thus contemplate an even greater reliance upon self-regulation, although under somewhat more intensive Commission supervision.").

216. *See id.* ("[Self-regulation] . . . provides a more sensitive and effective device for regulation in the area of unethical as distinct from illegal conduct.").

States laws also classify supervision as an "ethical" responsibility. *See, e.g.*, Del. Code Ann. tit. 6, § 73-304(a)(7) (West 2022) (Under Section 304(a)(7) of the Delaware Securities Act, the Director of Investor Protection can deny, revoke, suspend, cancel, or withdraw the registration of a broker-dealer if it engaged in "dishonest or unethical practices." The Delaware Administrative Code provides "[f]or the purposes of [Section 73-304(a)(7)] dishonest or unethical practices by a broker-dealer shall include . . . [f]ailing to reasonably supervise such broker-dealer's agents or employees" and provides a nonexclusive list of deficiencies along those lines. 6 Del. Admin. Code § 609(b)(4) (2022)).

217. *See* Senate Report, *supra* note 198, at 38–47.

218. *See, e.g.*, Remarks by Sen. Harrison Williams, 110 Cong. Rec. 18386 (Aug. 6, 1964) ("This bill would require a broker-dealer to supervise its employees much more closely than it has in the past. A large firm would be required to check the activities of its branch offices, or suffer censure by the association."); Remarks by Rep. Oren Harris, 110 Cong. Rec. 17917 (Aug. 4, 1964) ("The list of grounds on which the Commission would be permitted to base a denial, revocation or suspension of registration or impose censure, would be broadened to include . . . failure to reasonably supervise employees who have committed violations.").

219. Letter from William L. Cary to Oren Harris, Chairman, H. Comm. on Interstate & Foreign Commerce (Aug. 20, 1964), *reprinted in* 110 Cong. Rec. 20776, 20777 (Aug. 21, 1964) ("The Commission staff has devoted considerable effort to assisting the self-regulatory groups in the formulation of effective rules governing selling practices. Primary emphasis was placed on supervision of salesmen by the principals of broker-dealer firms. The New York Stock Exchange adopted a new supervision rule this spring. The Board of Governors of the NASD has approved a package of rules which set out in detail the member's responsibilities for supervision. . . . These rules are now ready to be submitted to the NASD membership for adoption.").

220. Commissioner Hugh Owens clearly described a defense to liability rather than an affirmative obligation to supervise in explaining the significance of Section 15(b)(5)(E):

The NASD promptly revised Article III, Section 27, requiring members to "establish, maintain and enforce written procedures . . . to supervise properly the activities of each registered representative and associated person."[221] It mandated some specific routines but otherwise left it to members to formulate their own methods and objectives.[222] They had to "designate a partner, officer or branch manager in each office of supervisory jurisdiction . . . to carry out the written supervisory procedures," a copy of which had to be kept in the office.[223] The member itself ultimately was responsible for supervision.[224] The scope of the obligation was "to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with [NASD rules]."[225] The rule established parameters for identifying who was a supervisor, who was subject to his or her supervision, and what he or she was required to do to supervise.[226] Later, examinations were required to verify enforcement and to measure effectiveness.[227] Eventually, other NASD rules

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> The new sanction provisions . . . imposed by the 1964 Amendments bring the importance of supervision into sharp focus. Both the Commission and the NASD have enunciated the responsibility of broker-dealers and their supervisory personnel in this vital area on many occasions. Now, however, inadequate supervision of employees constitutes a specific statutory ground for disciplinary proceedings. In a specific statutory exception, the Congress has, to say the very least, *encouraged* broker-dealers to establish and enforce comprehensive supervision procedures. If such procedures can reasonably be expected to detect and prevent violations, and if they are properly implemented by both the firm and its supervisory personnel, no findings of failure to supervise may be made. Of course, many firms now have such procedures and enforce them wisely and well. Those who do not, however, *would do well* to follow these leaders.

Hugh Owens, Comm'r, U.S. Sec. & Exch. Commission, Comments Before the Bond Club of Chicago (Apr. 22, 1965) (emphasis added).

221. NASD Rules of Fair Practice, art. III, § 27(a) (1965); *see* 31 SEC ANN. REP. 15–16 (1965) ("A major step taken during the past year . . . was the adoption by the NASD of new rules which incorporate required standards of supervision by its members. These rules require the establishment and enforcement of written supervisory procedures and designation of a partner or officer as responsible for their execution."). Later it called for a system "reasonably designed" to achieve compliance with applicable rules. *See* Order Approving Proposed Rule Change Relating to Supervisory Procedures and Redefinition of Office of Supervisory Jurisdiction and Branch Office, Exchange Act Release No. 26177, 53 Fed. Reg. 41008 (Oct. 19, 1988) [hereinafter *1988 Amendments to Article III, Section 27*]; NASD Notice to Members 88-84 (Nov. 1, 1988).

222. *See* NASD Rules of Fair Practice, art. III, § 27(c) (1965) ("Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.").

223. *Id.* art. III, § 27(b).

224. *See id.* ("Final responsibility for proper supervision shall rest with the member.").

225. *Id.* § 27(a).

226. Subsequent amendments required the designation of a registered principal "with authority to carry out the supervisory responsibilities of the member for each type of business" engaged in as a broker-dealer. Each registered person had to be assigned to an appropriately registered representative or principal "responsible for supervising that person's activities." A writing had to "set forth the supervisory system," including the identification of all supervisors, the effective dates of their assignments, and "the responsibilities of each supervisory person." *1988 Amendments to Article III, Section 27, supra* note 221, 53 Fed. Reg. 41008; Notice to Members 88-84, *supra* note 221.

227. *See 1988 Amendments to Article III, Section 27*, *supra* note 221, 53 Fed. Reg. 41008 (requiring office examinations and designation of one or more principals to review supervisory procedures and to take or recommend action to achieve compliance with applicable securities laws and NASD rules); Notice to Members 88-84, *supra* note 221.

called for monitoring certain activities of employees and service providers normally outside of the member's control.[228]

Section 15(b)(5)(E) accepted these criteria for establishing whether and to what extent a broker-dealer or associated person had an obligation to supervise a person who committed a violation. The basis essentially was contractual.[229] While the antecedent duty was necessary under subparagraph (E), it did not foreclose derivative liability for the broker-dealer under subparagraph (D).[230] For an associated person, however, responsibility rested essentially on what he or she agreed to do with respect to the person under the broker-dealer's supervisory program.[231] The Commission was given greater influence over SRO rules, including supervisory requirements.[232]

The intention to rely primarily on industry parameters for purposes of supervisory liability was evident in the "SECO" provisions enacted at the same time.[233] Membership in a securities association was not compulsory, and some OTC broker-dealers were not SRO members.[234] A prior version of the bill would have required them to join the NASD.[235] Instead, they were allowed to submit

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228. *See* Order Approving Proposed Rule Change, Exchange Act Release No. 22617, 34 SEC Docket 674 (Nov. 12, 1985) (approving Art. III, Sec. 40, of the NASD Rules of Fair Practice, replacing the "Private Securities Transactions Interpretation" under Art. III, Sec. 27, requiring members to supervise associates' private securities transactions for compensation); NASD Notice to Members 85-84 (Dec. 18, 1985); Order Approving Proposed Rule Change Relating to Outside Business Activities of Associated Persons of Member Firms, Exchange Act Release No. 26178, 41 SEC Docket 1396 (Oct. 13, 1998) (approving Art. III, Sec. 43, of the NASD Rules of Fair Practice, requiring associated persons to provide notice of outside business activities for approval); NASD Notice to Members 88-86 (Nov. 1, 1988); NASD Notice to Members 05-48 (July 22, 2005) (requiring supervisory procedures and systems for outsourcing practices, including initial due diligence on outside service providers to ensure they are capable of performing regulated functions and continued oversight of covered activities).

229. The language in Section 15(b)(5)(E) providing recourse for failure "*reasonably* to supervise" was consistent with the contractual nature of the obligation. *See* 1 Arthur L. Corbin, Corbin on Contracts: A Comprehensive Treatise on the Working Rules of Contract Law § 1 (rev. ed. West 1963) ("That portion of the field of law that is classified and described as the law of contracts attempts the realization of *reasonable* expectations that have been induced by the making of a promise." (emphasis added)).

230. Congress acknowledged that vicarious liability under Section 15(b)(5)(D) might be appropriate notwithstanding subparagraph (E). *See* Senate Report, *supra* note 198, at 76 ("Proposed clause (E) would not limit the existing power of the Commission to discipline a broker or dealer firm for any violation by a person associated with such broker or dealer."). However, where the violation was committed by someone other than an associated person, subparagraph (E) was the only basis for derivative liability.

231. In addition, liability might arise under state law, SRO rules to which an associate agreed to be bound, *see* NASD By-Laws, art. IV, § 2 (amended in 1988), or other legal or contractual obligations that applied specifically to the individual.

232. *See* 1964 Amendments, *supra* note 36, § 7(e), 78 Stat. at 578; Senate Report, *supra* note 198, at 41 ("The Commission's powers to require alteration or supplementation of the rules of a registered securities association relating to organization, discipline, and eligibility for membership would be broadened."). Currently, the SEC can abrogate, add to, or delete from SRO rules, *see* 15 U.S.C. § 78s(c) (2018), or discipline an SRO, its officers, or directors for failing to enforce them, *see id.* § 78s(h)(1), (4). Also, it can sue in federal court to enjoin enforcement where the SRO is unwilling or unable to do so. *See id.* § 78u(e), (f).

233. *See* 1964 Amendments, *supra* note 36, § 6(b), 78 Stat. at 572–73 ("SECO" stood for SEC Only.).

234. *See* House Report, *supra* note 199, at 12.

235. *See id.* at 19–20; *see also* Senate Report, *supra* note 198, at 41–42.

to direct regulation by the SEC and the Commission's authority over them was expanded to mirror the NASD's authority under Sections 15A.[236]

Section 15(b)(8) of the Exchange Act prohibited a SECO broker-dealer from effecting OTC trades unless the broker-dealer and its associates adhered to SEC rules on training, experience, and other qualifications.[237] Section 15(b)(10) prohibited the broker-dealer from doing business in contravention of rules designed "to promote just and equitable principles of trade . . . and . . . to protect investors."[238] The Commission subsequently adopted Rule 15b10-4,[239] requiring a SECO broker-dealer to exercise "diligent supervision" over its associates' securities activities.[240] The broker-dealer was required to designate a qualified principal or employee to supervise each associate who would "be subject to [his or her] supervision."[241] It had to have written supervisory procedures,[242] and one or more individuals had to review supervisors' activities and inspect offices to ensure they were enforced.[243] According to the House Report, the SECO provisions were added "to insure that the

236. *See* House Report, *supra* note 199, at 23–24. (The SEC could regulate the broader spectrum of conduct because the broker-dealers agreed to it. *See id.* at 3, 12.).

237. *See* 1964 Amendments, *supra* note 36, § 6(b), 78 Stat. at 572–73 (amended in 1975 and repealed in 1983) (requiring that "[t]he Commission shall establish such standards by rules and regulations, which may . . . appropriately classify brokers and dealers and persons associated with brokers and dealers," including "supervisory employees," which term, as defined, was required to include branch managers).

238. *See id.* at 573 (amended in 1975 and repealed in 1983) (Section 15(b)(9) required a SECO broker-dealer to pay the SEC reasonable fees and charges to defray the cost of the additional regulation.).

239. *See* Rules Regarding Conduct, Supervision and Records of Brokers and Dealers Not Members of National Securities Association, Exchange Act Release No. 8135, 32 Fed. Reg. 11637 (Aug. 11, 1967) (to be codified at 17 C.F.R. § 240.15b10-4).

240. *See id.* at 11638 ("Rule 15b10-4 . . . imposes a general duty on nonmember brokers and dealers to supervise diligently the securities activities of their associated persons."); 17 C.F.R. § 240.15b10-4(a) (1968) ("Every nonmember broker or dealer shall exercise diligent supervision over all the securities activities of all of his associated persons.").

241. *See* 17 C.F.R. § 240.15b10-4(b) (1968) ("Every associated person of the nonmember broker or dealer shall be subject to the supervision of a supervisor designated by such broker or dealer. The supervisor may be a partner, officer, office manager, or any other qualified associated person, or in the case of a sole proprietor the broker or dealer."). The SEC's authority to designate "categories of supervisors" was limited in purpose to setting qualification standards. *See* 1964 Amendments, *supra* note 36, § 6(b), 78 Stat. at 570–73.

242. *See* 17 C.F.R. § 240.15b10-4(c) (1968) ("As part of his responsibility under this section, every nonmember broker or dealer shall establish, maintain and enforce written procedures, a copy of which shall be kept in each business office, which shall set forth the procedures adopted by the broker or dealer to comply with the following duties imposed by this section . . . ."); *id.* (listing, among other things, the review and approval of new accounts, transactions and correspondence, and the delegation and exercise of discretion by representatives).

243. *See id.* § 240.15b10-4(d) (1968) ("Every nonmember broker dealer who has designated more than one supervisor pursuant to paragraph (b) of this section shall designate from among his partners, officers or other qualified associated persons, a person or group of persons who shall: (1) Supervise and periodically review the activities of the supervisors designated pursuant to paragraph (b) of this section; and (2) Periodically inspect each business office of the broker or dealer to insure that the written procedures are enforced.").

Commission has *the necessary authority* to provide regulation of nonmember brokers and dealers comparable to that imposed by associations on their membership[.]"[244] That authority, including the power to define supervisory relationships and performances, was limited explicitly to SECO broker-dealers.[245]

Rule 15b10-4, SRO rules, and the systems, policies, and procedures under them, together with applicable state laws,[246] were the bases for supervisory liability under Section 15(b)(5)(E) and Section 15(b)(7). Exculpatory language was consistent with them and the desire to promote compliance with those regimes. It provided:

> [N]o person shall be deemed to have failed reasonably to supervise any other person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, in so far as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[247]

The word "deemed" implied responsibility originated outside the provision;[248] however, it was not actionable if the conditions in clauses (i) and (ii) were met.

Clause (i) related to the broker-dealer, which alone was required to have "procedures, and a system for applying [them] . . . to prevent and detect violations."[249] It was sufficient if they "would reasonably be expected to prevent

244. House Report, *supra* note 199, at 12 (emphasis added). SECO broker-dealers ceded discretion to the Commission to decide matters of professional and ethical conduct, including what constituted "diligent supervision," the same way members agreed to allow the NYSE and the NASD to decide what practices were consistent with just and equitable principles of trade. *See supra* note 236 and accompanying text.

245. The express authority over SECO broker-dealers belied the same authority over other broker-dealers. For them, the authority rested with the SROs, and the Commission's power was limited to modifying SRO rules. Moreover, it was simply inconceivable that standards required to be established by rulemaking for some broker-dealers under Section 15(b)(10) could be made by adjudication for other broker-dealers and individuals under Sections 15(b)(5) and 15(b)(7).

246. Some states recognized an affirmative duty on an employer to supervise its employees to prevent harm (mostly physical) to others under a negligence or recklessness standard, *see* Restatement (Second) of Agency § 213(c) cmt. g (Am. L. Inst. 1958) ("A master is negligent if he fails to use care to provide such regulations as are reasonably necessary to prevent undue risk of harm to third persons or to other servants from the conduct of those working under him."); while under corporate law, management was expected to investigate suspected misconduct, *see* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

247. 1964 Amendments, *supra* note 136, § 6(b), 78 Stat. at 570–73.

248. *See* Black's Law Dictionary 504 (4th ed. 1968) (defining "deem" to mean "to hold"; "consider"; "treat as if"; "construe"). *Cf.* 17 C.F.R. § 240.3a4-1 (2022); Persons *Deemed* Not to Be Brokers, Exchange Act Release No. 22172, 33 SEC Docket 652 (June 27, 1985) ("The Commission is adopting Rule 3a4-1 specifying a non-exclusive safe harbor under which persons associated with an issuer of securities who participate in sales of that issuer's securities will not *be considered* to be acting as "brokers" as that term is defined in the [Exchange Act]." (emphasis added)).

249. Rule 15b10-4 and SRO rules each imposed the duty to have supervisory procedures and a system to enforce them on the broker-dealer. Associates were responsible only for carrying out their duties under them. The Senate Report explained:

and detect, in so far as practicable," the offense.[250] Rule 15b10-4 or SRO rules and other obligations informed expectations.[251] Automatic liability, arbitrary or overly stringent standards had to be overlooked.[252] Strict or excessive demands defeated the objective: to withhold discipline where the broker-dealer had a *reasonable* system of supervision. Arguably, good faith and rationality on the part of those charged with establishing, maintaining, and enforcing the system in compliance with external requirements was dispositive—management being in the

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> Thus, for example, if a branch manager has established appropriate procedures (and an appropriate system for applying them) for supervising the personnel of his office and appropriately discharges his own responsibilities without reasonable cause to believe that such procedures and system are not being followed, he is not responsible, even if notwithstanding these precautions, one of his employees violates. Similarly, partners in the home office of a firm would not be responsible for violations in a branch office if appropriate supervisory procedures (and an appropriate system for applying them) for the branch office have been established and the partners have reasonably discharged their own duties and have no reason to believe that the established procedures and system were not being followed. *It would, however, be the responsibility of the managing partners to see to it that appropriate procedures and system are established and observed.*

Senate Report, *supra* note 198, at 76 (emphasis added). Although the illustration recognized a branch manager or other supervisor might be involved in "establishing" those procedures, it implied the broker-dealer, through management, was responsible for them. *Cf. Compliance Programs of Investment Companies and Investment Advisers*, *supra* note 49, at 74720 n.73 (identifying the same clause in the defense under Section 203(e)(6) of the Advisers Act as applicable to the investment adviser, not an associated person). A broker-dealer could review to see how supervisory discretion was exercised, and under Rule 15b10-4 and SRO rules it was required to do so. Presumably, then, what the manager did without objection from the broker-dealer was acceptable to it (with the corollary assumption that there was no authority to do more at the company's, its shareholders' or partners' expense). In general, decisions that held individuals responsible for a broker-dealer's failure to have proper supervisory procedures—rather than failure to enforce them—involved the most senior principals. *See, e.g.*, R. H. Johnson & Co. v. SEC, 198 F.2d 690 (2d Cir. 1952) (firm's dominant partner); Sutro Bros. & Co., 41 S.E.C. 443 (1963) (firm's managing partner); Shearson, Hammill & Co., 42 S.E.C. 811 (1965) (company's executive committee). Arguably, liability turned on the individual's position of *control* over the broker-dealer. *See R. H. Johnson & Co.*, 198 F.2d at 695–96 ("There is ample evidence (1) that [the partner] had *complete control of all persons in the organization including the other partners* (who were such in little more than name) and (2) that he signally failed to provide any adequate supervision [as required of the member firm under Article III, Section 27, of the NASD Rules of Fair Practice] *although his extensive control put upon him that responsibility*." (emphasis added)); *but see Sutro I*, 41 S.E.C. 443 (finding the managing partner was "charged with the over-all responsibility for supervision of all the operations of the firm").

250. Section 15(b)(5)(E) did not require a broker-dealer to have a supervisory system and procedures. While the exculpatory language prevented liability for failure to supervise, none was imposed by failing to meet its conditions. Nevertheless, the broker-dealer remained liable under subparagraph (D) if it did not have such a program.

251. "Reasonableness" and "practicability" rendered the evaluation of compliance with specific prescriptions at once general with regard to the requirement and specific in terms of adaptation.

252. Strict liability for oversight under *respondeat superior* continued to exist and failure to supervise could be implied by the underlying violation under various state blue sky laws. *See, e.g.*, Del. Code Ann. tit. 6, § 73-304(a)(10) (West 2022) ("[T]he Director may *infer* such failure [reasonably to supervise] from an agent's . . . or employee's violations." (emphasis added)). Also, there was the possibility an SRO could impose an unreasonable or impracticable demand, in which case it could be ignored under the statute. *Cf.* Restatement of Contracts § 454 (Am. L. Inst. 1932) (discharge of contractual liability based on impossibility of performance, including "impracticability because of extreme and unreasonable difficulty, expense . . . or loss involved").

best position to decide what was reasonable and practicable for the company under the business judgement rule.[253]

Clause (ii) pertained mostly to associated persons. Unless a broker-dealer was a sole proprietor, enforcement of supervisory procedures had to be delegated. If an associate accepted the delegation, "the duties and obligations incumbent upon [him or her] by reason of such procedures and system" framed responsibility.[254] There was no liability if they were reasonably discharged.[255] The broker-dealer was responsible for a supervisor's delinquency if there was reason to know about it.[256] Likewise, the supervisor was answerable for a delegate's performance.[257]

Section 15(b)(5)(E) was artfully crafted to promote supervision by relieving broker-dealers of derivative liability for associates' misconduct where they established and enforced reasonable systems of supervision that complied with industry standards. Discipline then centered on individuals more or less culpable in the line of causation: the primary violators; aiders and abettors; and associates derelict in their supervisory duties under the system. Language guarded against stricter standards that removed the incentive and protected individuals against un-assumed liability.

Unfortunately, the regime was ignored to overcome legacy constraints in pending enforcement actions. Early decisions after the amendments effectively reinstated automatic liability and advanced a tenet of supervision that undermined all the main objectives.

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253. Although couched in terms of ordinary care, liability for an officer or director under the business judgement rule ordinarily required a showing of dishonesty or gross negligence commensurate with irrational decision-making. *See* Moskowitz v. Bantrell, 190 A.2d 749, 750 (Del. 1963).

254. The language was consistent with contractual liability. Unlike a broker-dealer, an associated person was not responsible for another person's violation on the principle of *respondeat superior*. Besides requiring an affirmative act, negligence and strict liability in tort involved considerations of public policy that went beyond "the duties and obligations incumbent . . . by reason of [the broker-dealer's] procedures and system." *See* Restatement of Torts § 285 (Am. L. Inst. 1934); Restatement of Torts § 520 (Am. L. Inst. 1938).

255. The expectation in contract was for the promisor strictly to do what he or she promised to do according to the "natural," "objective," or "reasonable" meaning of the words and other manifestations of the promise, *see* Eustis Mining Co. v. Beer, Sondheimer & Co., 239 F. 976, 984–85 (S.D.N.Y. 1917) (L. Hand, J.); Restatement of Contracts § 230, and to use "reasonable efforts" in good faith to accomplish the objective if it entailed the exercise of discretion, *see* Wigand v. Bachmann-Bechtel Brewing Co., 222 N.Y. 272, 277 (1918); Wood v. Lucy, Lady Duff-Gordon, 222 N.Y. 88, 92 (1917) (Cardozo, J.).

256. Under Rule 15b10-4, and later under NASD rules, a broker-dealer had to examine supervisors regularly to ensure they carried out their duties. Presumably, there was no reason for the broker-dealer to know of a supervisor's failure where the associates assigned to review his or her activities as required did so in good faith. While a company was on notice of the facts known to all employees within the scope of their employment, an employee's procedural omission was not something another employee normally would notice unless he or she was assigned to see it was carried out. The objective was to encourage broker-dealers to implement *reasonable* systems of supervision, not to punish them for any imperfections.

257. *See* Restatement (Second) of Contracts § 318(3) (Am. L. Inst. 1981) (Delegation of Performance of Duty); Restatement of Contracts § 160(4). A delegate was not necessarily obligated to perform the delegated activity. *See* Restatement of Contracts § 160(2).

The SEC Disregards the Legislative Scheme for an Independent "Duty to Supervise" to Deal with Legacy Cases

Of course, the Commission continued to address cases arising before the amendments. One involved a classic boiler room operation and manipulation scheme.[258] The president of a securities dealer and a number of associates fraudulently sold shares in a company they organized and charged excessive mark-ups in secondary sales.[259] The president persuaded the head trader of another broker-dealer to publish "suggested" quotations for the stock at prices well above what the trader paid or received for the shares.[260] No one else at the broker-dealer, a company of substantial size, was involved. Nevertheless, a hearing examiner recommended revoking its registration because of the trader's actions.[261]

Chairman Manuel Cohen and Commissioners Owens, Byron Woodside, Hamer Budge, and Francis Wheat agreed "[the trader] entered into an arrangement with [the president] to place quotations . . . pursuant to [his] instructions and thereby assist the latter in the creation of an artificial market."[262] Citing *Reynolds*, they said "the firm's failure of supervision made it a participant in [the trader's] misconduct[,]"[263] finding "[the broker-dealer], together with or aided and abetted by [the trader,] . . . willfully violated the cited anti-fraud provisions."[264] If the 1964 Amendments were in effect, the Commission could have proceeded against the trader separately and found he manipulated the market or willfully aided and abetted the president's fraud. Instead, in order to discipline him, it had to sanction the broker-dealer. The case, and others like it,[265] set the stage for an eventual confrontation between the theory in *Reynolds* and the basis of supervisory liability contemplated by Section 15(b)(5)(E).

Less than three years later, the SEC decided an action involving a salesman in the Cleveland office of a large wire-house who misled customers about another client's investments to entice them to trade excessively from 1962 to 1963.[266] A hearing examiner recommended a four-month suspension for the salesman for

258. *See* F. S. Johns & Co., 43 S.E.C. 124 (1966), *aff'd sub nom*. Dlugash v. SEC, 373 F.2d 107 (2d Cir. 1967).

259. *See generally id*. at 126–30.

260. *See id*. at 134 (Most of the trades were with the broker-dealer.). There were similar arrangements with three other, "ostensibly independent" broker-dealers: a sole proprietor; a company wholly owned by its president; and two partners with no employees. *See generally id*. at 130–34.

261. *See id*. at 125–26 (The examiner also recommended expulsion from the NASD and two exchanges.)

262. *Id*. at 137.

263. *Id*. at 138.

264. *Id*. at 139. The broker-dealer argued it was not in the public interest to revoke its registration where, among other things, "[the trader] was the only person out of approximately 100 employees who participated in or had knowledge of [the] activities[.]" *Id*. at 143 (adding that the trader and his supervisor were gone and the company had strengthened its supervision). Obviously sympathetic after advocating for lesser sanctions in isolated incidents, the Commissioners suspended the broker-dealer from the NASD for sixty days, noting in justification a "total lack of supervision." *Id*. The trader was barred from associating with any broker-dealer without permission. *See id.*

265. *See, e.g*., Richard J. Buck & Co., 43 S.E.C. 998 (1968); Kamen & Co., 43 S.E.C. 97 (1966).

266. *See* Paine, Webber, Jackson & Curtis, 43 S.E.C. 1042, 1043–47 (1969).

personally violating the anti-fraud provisions.[267] The examiner advised that proceedings against the broker-dealer and its office manager be dropped.[268] The firm's supervisory procedures, "although not above criticism, constituted a 'reasonably acceptable system[.]'"[269] And "while negligence [by the manager] in the enforcement of established procedures had been shown . . . the record did not establish that absent such negligence [the salesman's] violations would have been prevented or detected."[270]

Chairman Cohen and Commissioners Owens, Budge, and Richard Smith agreed with the finding against the salesman,[271] deciding to bar him instead,[272] but not on the issue of oversight.[273] In a footnote, they claimed:

> Although Section 15(b)(5)(E) was not adopted until 1964 the standards of supervision which it prescribes in substance represented a codification of the standards which the Commission had established prior to 1964 through administrative adjudication.[274]

"That Section," they said, "requires reasonable supervision with a view to preventing violations of the securities acts."[275] *Reynolds* offered the criterion for evaluating it.[276] In their opinion, "the[] procedures left important gaps,"[277] and the broker-dealer and the manager "did not reasonably discharge their supervisory

267. *See id.* at 1043, 1047 (There was no finding of a comparable violation by the broker-dealer.).

268. *See id.* at 1043.

269. *Id.* at 1047–48.

270. *Id.* at 1048.

271. *See id.* at 1047.

272. *See id.* at 1050–51 (The bar provided the salesman could associate with a broker-dealer after a year in a non-supervisory capacity on a showing of appropriate supervision.).

273. *See id.* at 1048.

274. *Id.* at 1048 n.9 (citing Reynolds & Co., 39 S.E.C. 902 (1960), in connection with what they described as "[the broker-dealer's] and [the manager's] conten[tion] the supervisory procedures . . . and the manner in which [they] were carried out met the standards of the [Exchange] Act as expressed in Commission decisions and now codified in Section 15(b)(5)(E)"). *See also* Richard M. Phillips & Morgan Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 Duke L.J. 706, 808 ("This provision [subparagraph (E)] largely codifies the aider, abettor and failure-of-supervision doctrines which the Commission had developed to deal with associated persons.").

275. *Paine, Webber*, 43 S.E.C. at 1048. They suggested the language absolving external liability instead framed the statutory duty:

> [N]o person shall be deemed to have failed *to meet that requirement* if (a) procedures and a system for applying them have been established which would reasonably be expected to prevent and detect, insofar as practicable, any such violation and (b) he has reasonably discharged his duties under such procedures and system without reasonable cause to believe that the procedures and system were not being complied with.

Id. (emphasis added).

276. *Id.* at 1050 ("As we said in *Reynolds & Co.*, 'in large organizations it is especially imperative that the system of internal control be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention.'") (also citing Shearson, Hammill & Co., 42 S.E.C. 811 (1965)).

277. *Id.* at 1049. Among other things, the daily trade review was inadequate, *see id.* (A chronological listing of trades on the blotter was "not likely to uncover excessive activity or changes in the nature of the securities traded in a particular account."); the customer trade ledger inquiry performed by the manager's deputy was not "systematic," *see id.* (It was a "spot check" of monthly statements for "only about two-thirds of the accounts in the office each year" that was "unlikely to uncover a change in the activity in an account."); and the branch manager was not given sufficient guidance on the kinds of activities warranting further review, *see id.*

duties."[278] Both were censured.[279] The examiner's decision was consistent with the intentions behind Section 15(b)(5)(E). Seemingly little was accomplished by imposing the least possible sanctions. But Section 15(b)(7) was unavailable. So unless an order was issued against the broker-dealer, there was no basis for disciplining the salesman (whose conduct was egregious enough to warrant a much stiffer sanction).

At once, the rubric from an obsolete jurisdictional device replaced the SECO and SRO regimes for supervisory responsibility. Congress clearly intended to govern oversight through self-regulation. The Commission's authority over it was limited to a small number of broker-dealers by rulemaking and influence over SRO rules for the rest (also subject to legislative process).[280] The decision asserted the power over all broker-dealers and their associates by adjudication. Moreover, the formula was completely different: SECO and SRO rules provided for company-level responsibility, central administration, definite supervisory relationships, and procedures that emphasized proactive surveillance. The injunction in *Reynolds* diffused responsibility among employees, was silent on administration, shed no light on relationships or performances, and centered on reaction to evidence of wrongdoing. The implacable standard invoked to relieve vicarious liability clearly conflicted with the more measured one intended to promote greater oversight:

> It is a rare violation that, when viewed in retrospect, cannot be said to have been preceded by at least "a remote indication" of an irregularity. And the stated obligation to exercise "utmost vigilance" makes virtually any oversight, no matter how minor, a potential basis for imposing sanctions against a firm.[281]

There was no limit to the violations it covered.[282] Not surprisingly, the SEC has never dismissed a failure-to-supervise claim against a broker-dealer.[283]

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278. *Id.* The manager admitted "he had to prod [his deputy] to make the [ledger] check" and "knew it was not being done on a regular basis." *Id.* (Also, he didn't know how many accounts it covered.). He detected unusual trading in two accounts that "should have caused him to examine the accounts of [the salesman's] other customers." *Id.* at 1049–50.

279. *See id.* at 1051.

280. The SECO program was eliminated in 1983. *See* Pub. L. No. 98-38, 97 Stat. 205, 206 (1983); *see also* H.R. Rep. No. 98-106, at 597 (1983) (describing a preference for self-regulation over direct regulation by the Commission in the areas covered by the program).

281. Ralph C. Ferrara, Phillip D. Parker & Colby A. Smith, Managing Marketeers § 1.03 (CCH Inc. 2000) [hereinafter Ferrara et al., Managing Marketeers]. The violation itself impugned the "adequacy and effectiveness" of the "system of internal controls." Thus, procedures that uncovered violations only produced liability.

282. In *Paine, Webber*, the firm and its manager argued that even if they were alerted to the underlying trades they could not have prevented the abuse because the customers were in league with the salesman and would not have revealed their motives. *See* Paine, Webber, Jackson & Curtis, 43 S.E.C. 1042, 1050 (1969). Therefore, "there was no causal relationship between any supervisory deficiency and the violations." *Id.* Dispensing with the argument, the Commissioners suggested no conduct was exempt from oversight:

> In our opinion . . . the essence of the allegation taken as a whole is a charge of failure to provide appropriate supervision, and a sufficient relationship between the supervisory failures and the violations has been established when it is shown that such failures existed in the very area in which violations occurred.

Id.

283. *See* Ferrara et al., Managing Marketeers, *supra* note 281, § 1.03.

The departure would hinder the development of supervisory systems and procedures by broker-dealers and investment advisers. It would affect more acutely individuals for whom "guarantor" liability was rejected and un-assumed, indefinite responsibility was anathema.[284] With discipline no longer tied to procedures they agreed to perform with regard to particular individuals, two questions would continue to arise: "Who was a supervisor?" and "What was he or she supposed to do to avoid liability (if, indeed, that was possible)?" Answers, often inconsistent, would emerge over time through pronouncements in decisions and settlements. Unfortunately for those involved, the effects were retroactive.

The "*Reynolds* Doctrine" Breeds Ambiguity in Supervisory Relationships and Standards and Impedes Development of Centralized Controls

Initially, discipline against individuals for failure to supervise centered on branch managers and their superiors, and liability for them was as stringent as it was for the broker-dealer. Over time, companies expanded their approach to compliance, largely in response to SRO rules: They appointed chief compliance officers and qualified principals in specialized areas; employed additional personnel to perform oversight functions alongside branch managers and department heads; built out legal, compliance, and audit departments; developed computer systems and exception reports; and hired dedicated surveillance analysts to support them. Supervisory cases, however, continued to focus on an associated person's performance apart from the broker-dealer's system and procedures, rendering individual liability uncertain and diminishing the significance of institutional oversight.

Tennenbaum

In *Michael E. Tennenbaum*,[285] three Commissioners, Philip Loomis, John Evans, and Barbara Thomas, upheld an administrative law judge's decision that the senior registered options principal ("SROP") of a New York broker-dealer failed to supervise a salesman in San Francisco who abused his discretion over customers' accounts while misrepresenting the risks of options trades and the effects of commissions on their returns.[286]

284. *See* Senate Report, *supra* note 198, at 76 ("A supervisory employee is . . . not an absolute guarantor of the conduct of those whom [he or she] has the power to supervise.").

285. Michael E. Tennenbaum, 47 S.E.C. 703 (1982).

286. *See id.* at 711. The activity took place between 1974 and 1977. *See id.* at 704–06. The salesman settled a charge he violated Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act. *See* Richard A. Graham, Exchange Act Release No. 16237, 18 SEC Docket 565 (Oct. 3, 1979). (Since the SEC could discipline the salesman separately, there was no longer any need to resort to the fiction he aided and abetted a violation by the broker-dealer.) A partner located in Los Angeles consented to a finding he failed to supervise. *See id.* (The settlement merely identified him as the person in charge of the San Francisco office.). The broker-dealer agreed to findings it violated the antifraud provisions and failed to supervise based apparently on their conduct. *See* Bear Stearns & Co., Exchange Act Release No. 16025, 17 SEC Docket 1315 (July 16, 1979). In addition, the firm

Tennenbaum was responsible for developing the broker-dealer's options compliance program.[287] Among other things, the program called for a registered options principal ("ROP") "[i]n every office where sales personnel dealt in options" to "assume responsibility for the options transactions in their branches."[288] Representatives generally were forbidden to have discretion over options accounts.[289] There were few exceptions.[290] Tennenbaum had "sole authority" to make them.[291] He made one for the salesman even though there was no ROP in the San Francisco office.[292]

Tennenbaum admitted he was in charge of the program but denied supervisory responsibility for the salesman.[293] He was not identified as the salesman's supervisor under the firm's written supervisory procedures.[294] Nevertheless, for the Commissioners the circumstances painted "a picture of parallel or collateral responsibilities shared by different individuals depending upon the nature of the matter to be supervised" that included Tennenbaum.[295] "Of critical importance" was that "[he] had sole authority to permit a salesman to handle discretionary options accounts" and the "power to revoke that permission."[296] In their view, "[o]nce Tennenbaum had given . . . his approval, he assumed responsibility for ensuring that this grant of authority, over which he continued to exercise control, was not being abused."[297] However, "[he] failed to fulfill his concomitant responsibility."[298]

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agreed to a finding it willfully aided and abetted the violation ostensibly by another representative with responsibility for the salesman's accounts. *See id.*; Philip A. Schaefer, Exchange Act Release No. 16392, 18 SEC Docket 1200 (Dec. 3, 1979).

287. *See Michael E. Tennenbaum*, 47 S.E.C. at 704.

288. *Id.* at 704–05. In addition, it called for customers to acknowledge suitability in writing and for the Compliance Department to monitor options trades in their accounts using a computer surveillance system, the "Portfolio Status Review" or "PSR." *See id.* at 704. ROPs "were to be responsible to the SROP with respect to any variation from the compliance program." *Id.* at 705.

289. *See id.* at 707.

290. *See id.* at 704.

291. *See id.* at 707.

292. *See id.* at 704 (The partner in charge of the San Francisco office, located in Los Angeles, was not an ROP; there was no ROP in the office for most of the period.).

293. *See id.* at 707. According to Tennenbaum, supervisory responsibility rested with various office managers, the partner in Los Angeles, and the firm's managing partners in New York, *see id.*; he, like the compliance department, was expected "merely to bring potential problems to management's attention." *Id.*

294. There was no reference to supervisory designations and procedures required by SRO rules. On the other hand, there was evidence it was not possible for Tennenbaum to review the salesman's trading from where he was located in New York. *See id.* at 707–08 ("As Tennenbaum put it, 'whether or not the sales personnel are behaving properly with respect to [their] customers [cannot really be determined] anywhere except on a local level.'" (brackets in original)). The firm's compliance director said he considered Tennenbaum the salesman's supervisor in connection with questions he raised about the salesman's trades. *See id.* at 708. Tennenbaum himself sent a memorandum on options compliance to branch managers and ROPs saying he had "personal regulatory responsibility." *Id.* at 709. He added, however, "that it was 'impractical for him to personally supervise all options transactions,' and that primary supervisory responsibility would rest with the ROPs." *Id.* at 709–10.

295. *Id.* at 707.

296. *Id.*

297. *Id.*

298. *Id.* at 711.

The origin of that responsibility and what it entailed were clear only through construction and hindsight.[299] As the Commissioners observed, there were fundamental deficiencies in the broker-dealer's supervisory program with respect to the salesman—chiefly, the failure to have an ROP onsite to review his trades.[300] Under SRO rules, the member had to provide for proper supervision of the salesman. In Tennenbaum's case, knowledge of its failure to do so created or enlarged his own supervisory responsibility.[301]

299. There was no evidence Tennenbaum was assigned by the broker-dealer to supervise the salesman. The statement implied the function was ancillary to his authority to approve discretionary trading. Evidently, however, the monitoring it entailed could not be done remotely. *See id.* at 707–08. The firm's compliance program considered it sufficiently complex to require onsite performance with technical support from the compliance department. *See id.* at 704, 710 n.22. Tennenbaum testified "his 'only power' over [the salesman] was the power to revoke that permission," *id.* at 707, which did not foreclose monitoring by others. (It was not clear that the power was absolute; perhaps requiring input from other executives given its effect on existing relationships.) He might have been expected to fill in for the missing ROP as a "variation" in the compliance program; the opinion did not say.

300. Although an important part of the compliance program called for an ROP in each office, the firm did not provide for one in San Francisco. *See id.* at 704–05. The partner in charge of the office was not qualified to supervise options trading and could not do so effectively from Los Angeles. *See id.* at 704 n.14. The branch managers and others with authority in the office in the beginning were weak. *See id.* at 709. It was not suggested Tennenbaum was responsible for the firm's failure to employ qualified supervisors. Indeed, he complained to senior management about the lack of appropriate supervisory staff at the location. *See id.* at 709–10 (Tennenbaum testified he had concerns about local managers' abilities to administer the options program after visiting the office in 1975. Later that year, he wrote to the compliance director: "The fundamental problem is lack of supervision over the San Francisco office. Hopefully you and the managing partner can remedy this." He visited the office again in the fall of 1976, where he found options compliance procedures were not being distributed and "wrote to the firm's top management advising them of the risks the firm was taking."). There was uncertainty about where options surveillance was taking place and whether it was effective. *See id.* at 709 n.20, 710–11 (Asked how an issue related to the salesman that he identified would have been monitored, Tennenbaum said it was a matter for "compliance in New York"; correspondence from the compliance director lamented "[b]ecause . . . the daily review of [the salesman's] activity is made by you [Tennenbaum] in New York and the monthly review of his accounts is made by [the branch manager] in San Francisco, supervision is made more difficult."). In designing the program, "Tennenbaum did not think it practical to supervise options compliance without computer support," *see id.* at 704 n.5, yet the firm's computer system, PSR, relied on for that purpose was referred to as a "mechanical monster" for its operational difficulties, *see id.* at 710 n.22. All of these deficiencies in the *firm's* supervisory program were cited as putting Tennenbaum on notice of *his* increased responsibility with respect to the salesman.

301. Other cases would hold individuals charged with administering the broker-dealer's supervisory system and procedures responsible for failure to supervise based on deficiencies in the program. *See, e.g.*, Gary W. Chambers, Exchange Act Release No. 27963, 46 SEC Docket 200 (Apr. 30, 1990). (The senior vice president of compliance and operations failed to supervise representatives committing sales practices violations: He was responsible for developing and administering the broker-dealer's compliance procedures, which put him on notice they failed to provide for proper review of customers' accounts. Under the circumstances, he was responsible for reviewing the transactions himself (because the system did not vest the responsibility in someone else). It was accepted without discussion that he was the representatives' supervisor despite having no authority over them. His ability to fill the "void" in the company's supervisory procedures apparently was enough to make him their supervisor.); *see also* First Albany Corp., 50 S.E.C. 890 (1992) (The chief compliance officer and general counsel of a broker-dealer failed to supervise a representative committing trading violations based in part on the company's failure to have procedures to monitor restrictions on his activities. Knowing the restrictions were in place, the compliance officer failed to implement a system to ensure they were enforced. He had the ability to impose fines and other penalties on the representative.).

> As Tennenbaum admitted, *registrant's supervisory system* required an ROP in any office where there were retail options transactions. . . . One function of such a qualified supervisor was to analyze the transactions being effected to make sure that they were suited to the objectives expressed by the customers. * * * Despite that fact, there was no ROP in San Francisco until the spring of 1977. *Absent was the effective local supervision on which Tennenbaum should have been able to rely in granting and continuing [the salesman's] authority to handle discretionary accounts. And Tennenbaum was soon put on notice that stringent supervision of [the salesman] was required.*[302]

In effect, Tennenbaum was enlisted to fill the vacancy left by the firm because of his ability, in their view, to preempt the violations he should have foreseen.[303]

The firm's procedures did not govern Tennenbaum's supervisory responsibility;[304] the Commissioners decided it based on the facts and circumstances presented to them. Although he and others took steps to address the salesman's conduct,[305] the situation warranted Tennenbaum take or recommend

302. *Michael E. Tennenbaum*, 47 S.E.C. at 707–08 (emphasis added). Evidently, Tennenbaum was on notice of the deficiency in the firm's supervisory system by recommending a program that would have avoided it and calling management's attention to the risk associated with its failure to act on his advice. Those efforts effectively increased his liability. The result created a perverse dynamic: Associates recommending enhancements or measures to remedy weaknesses in broker-dealers' supervisory systems risked heightened liability for themselves.

303. In a bit of circular reasoning, Tennenbaum's supervisory responsibility stemmed primarily from his authority to do what the Commissioners considered should have been done to prevent the violation—terminate or limit the salesman's discretion. *See id.* at 707, 711 (Other noted deficiencies included failing to recommend investigation of customers' investment objectives and to examine or recommend examination of their accounts.). Had they determined the violation could have been prevented by limiting or suspending transactions on margin, liability might have befallen someone in the margin department. Thus, supervisory responsibility was arbitrary inasmuch as it turned on what a majority of Commissioners decided in retrospect should have been done by someone in position to do it.

304. There was no allegation Tennenbaum was given any assignment or directive he did not perform to the firm's satisfaction. Like *Paine, Webber,* 43 S.E.C. 1042 (1969), the firm's supervisory procedures had no bearing on responsibility.

305. In March 1975, Tennenbaum received a memorandum from the Compliance Department questioning the salesman's trades in three accounts; he concluded the activity was excessive in two of them. *See Michael E. Tennenbaum*, 47 S.E.C. at 708. However, "[he] did not recommend that an inquiry be made of the customers in question. Nor did he recommend that any steps be taken to investigate whether the trading in other [of the salesman's] accounts was consistent with customer instructions." *Id.* (adding he did not discuss the matter with the salesman or speak with customers about their trades). Instead, he sent a memorandum to the salesman, copying the firm's managing partner, the compliance director, and the branch manager, stating his conclusions and advising him the firm would require written justification for similar trades going forward. *See id.* at 708–09. "Tennenbaum did not otherwise restrict [the salesman's] discretionary options activities, and the compliance director deferred to Tennenbaum's judgement in the matter." *Id.* at 709. If his response was deficient, apparently it was acceptable to other senior officials in the firm including the managing partner.

Later, in October 1975, the compliance director advised Tennenbaum the salesman's accounts were generating heavy commissions and losing value; he recommended the salesman be instructed to send letters to some customers advising them of their positions. *See id.* Tennenbaum argued against it, later testifying he saw no evidence the salesman was doing anything wrong. *See id.* The firm's managing partner overruled him and directed the letters be sent. *See id.* at 708 n.21. Presumably, they were.

In April 1977, Tennenbaum and the new branch manager in San Francisco were informed about losses and heavy commissions in another of the salesman's accounts that escaped detection by the mechanical monster. *See id.* at 710. The following month, Tennenbaum was advised by the compliance

additional action to examine the salesman's accounts and to curtail his discretion.[306]

> Here it is clear that Tennenbaum had far more than "a remote indication of irregularity" with respect to [the salesman's] activities. Yet he did not take appropriate action.[307]

Tennenbaum was *suspended* for a month.[308] The firm, instrumental to his liability by the aperture in its controls, was *censured* and ordered "to revise and amend its existing procedures, with a view to preventing similar violations in the future."[309]

Decisions that ignored supervisory designations and procedures under SRO rules already showed signs of fostering their neglect. But instead of the deficiencies foreclosing individual liability, they engendered it. If broker-dealers had no more incentive to supervise where they were not rewarded for their efforts, they had even less where the repercussions for defective programs were shared by associates who bore much of the blame and relatively stiffer sanctions.

In *Tennenbaum*, the broker-dealer and its associate were evaluated according to the same stringent standard,[310] which was inconsistent with the language in the statute (by then renumbered Sections 15(b)(4)(E) and 15(b)(6)).[311] Several years later, another associate's performance was judged under a more forgiving—if not informative—combination of agency and negligence precepts.

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director of another such account following a complaint by the customer. *See id.* at 710–11. Shortly after, the branch manager restricted the salesman's trading and he was fined. *See id.* at 711 (He left the firm several months later.).

306. *See id.* at 711 ("Despite specific warnings that [the salesman] might be engaging in excessive trading [including his conclusions regarding the accounts in March 1975], [Tennenbaum] failed to take or recommend any action to investigate [his] activities. And he never sought to place any meaningful restraints on [the salesman's] authority to handle discretionary accounts.").

307. *Id.* at 712 (citing Reynolds & Co., 39 S.E.C. 902 (1960), and other cases). The managing partner, compliance director, and others were on notice of some or all of the same irregularities under the same standards, and presumably had similar ability to *take or recommend* further action to investigate or curtail the salesman's conduct, but were not disciplined. The Commissioners acknowledged they too had supervisory responsibility, *see id.* at 707, 711, but emphasized Tennenbaum's position as the senior options official and authority over discretion, *see id.* at 711.

308. *See id.* at 703–04.

309. Bear Stearns & Co., 17 SEC Docket 1315, 1315 (1979). In addition, the firm was suspended from trading options in the San Francisco office for twenty days. *See id.* (The suspension applied to customer accounts for which an options suitability form was not submitted prior to the order date.). The Los Angeles partner was suspended from serving in a retail supervisory capacity for sixty days and required to become an ROP prior to resuming, *see* Richard A. Graham, Exchange Act Release No. 16237, 18 SEC Docket 565, 566 (Oct. 3, 1979), addressing the principal deficiency in the firm's procedures.

310. *See id.* at 712 (i.e., "the utmost vigilance whenever even a remote indication of irregularity reaches their attention"). In a later SEC decision upholding an NASD disciplinary action, Wedbush Securities, Inc., 48 S.E.C. 963, 967 (1988), the Commissioners referred to "particular vigilance" in response to "indications" of irregularity. One commentary has suggested the departure may have been inadvertent rather than a relaxation of the standard, noting a return to the original language while citing *Wedbush* for the proposition that "*any indication of irregularity* brought to a supervisor's attention must be treated with the *utmost vigilance*." *See* FERRARA ET AL., MANAGING MARKETEERS, *supra* note 281, § 1.03 n.23 (emphasis added) (quoting Consol. Inv. Servs., Inc., Exchange Act Release No. 36687, 61 SEC Docket 19, 24) (Jan. 5, 1996).

311. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 11(2), 89 Stat. 97, 121–24.

TRUJILLO

A salesman in the San Francisco office of a national retailer based in New York misrepresented the risks of trading options on margin, made unauthorized trades, and churned accounts.[312] The company and the branch manager agreed they failed to supervise him.[313] The manager was cited for not performing certain supervisory procedures and for negligence in responding to signs of wrongdoing.[314] The manager's assistant, Louis Trujillo, also was accused of failure to supervise.[315] A law judge ruled against him;[316] he appealed to the Commission.[317]

Trujillo's duties included several compliance functions.[318] In performing them, he discovered the salesman had extended a customer beyond his means.[319] He monitored the salesman's activities, discovered additional misconduct, and reported it to the manager and a senior compliance official.[320] The company imposed a series of guidelines and enhanced supervision over the salesman.[321] Later, Trujillo discovered more churning, and the salesman was dismissed.[322]

Chairman David Ruder and Commissioners Joseph Grundfest and Edward Fleischman assumed for purposes of the decision that Trujillo was the salesman's

312. *See* Victor G. Matl, Exchange Act Release No. 22395, 33 SEC Docket 1352, 1353 (Sept. 10, 1985).

313. *See id.* at 1353–54.

314. *See id.* The settlement alleged that "[b]etween 1980 and 1983, [the broker-dealer and the manager] became aware, or should have become aware of the violations and complaints of the violations . . . by various means," including customer complaints, SEC and internal examinations, lawsuits, arbitrations, and management level communications. *Id.* "Notwithstanding the above, [the manager] did not reasonably discharge the duties and obligations incumbent upon them by reason of certain of [the broker-dealer's] supervisory procedures and systems . . . ." *Id.* at 1354 (The procedures included verifying the accuracy of information on new account forms, reviewing suitability of customer trades and accounts for excessive purchases and sales of options and other products.). The broker-dealer's responsibility apparently derived from the manager's failure. *See id.* The broker-dealer was censured and the manager was suspended. *See id.* Undertakings supported liability based on the broker-dealer's supervisory procedures: The company had to review its procedures and adopt new ones as needed to monitor customer complaints, which had to specify the persons assigned to review the complaints and to take or recommend disciplinary action; it also had to provide an overview of its procedures for supervising brokers and handling complaints to the manager, who was required to review them. *See id.* at 1354–55.

315. *See* Louis R. Trujillo, Exchange Act Release No. 34-22394, 33 SEC Docket 1352, 1352 (Sept. 10, 1985).

316. *See generally* Louis R. Trujillo, SEC File No. 3-6555 (ALJ Apr. 23, 1987).

317. *See* Louis R. Trujillo, 49 S.E.C. 1106 (1989). The Division of Enforcement also appealed, seeking additional findings and penalties. *See id.* at 1106–07.

318. *See id.* at 1107 (They included examining new accounts, investigating customer complaints, and reviewing daily reports of customer trades.).

319. *See id.* Trujillo spoke with the customer who alleged the salesman refused to execute a sell order and churned his account, *see id.* at 1107–08; Trujillo admonished the salesman and advised the manager, *see id.* at 1108.

320. *See id.* at 1107–09. Trujillo informed the official he spent more than 60 percent of his time reviewing the salesman's activity; he identified several potential violations, including failure to deliver options risk disclosures to customers, excessive trading, unsuitable recommendations, and unauthorized trades, and investigated and reported dozens of complaints. *See id.* at 1109.

321. *See id.* at 1109.

322. *See id.* (The salesman's "parting words" to Trujillo were "You did this to me.").

supervisor even though there was no explicit designation and he had little or no authority over the salesman.[323] It was not alleged Trujillo failed to carry out any assignment. Instead, the Enforcement staff claimed "[he] *failed to uncover* many of [the salesman's] offenses that later came to light, and that he *reacted inadequately* to customer complaints."[324] Although the Commissioners called Trujillo's performance "less than exemplary,"[325] they decided it did not warrant discipline under the statute:

> It is "with a view to preventing violations" that the statutory proscription of failure to supervise is directed, and it is for the same preventative purpose that we have interpreted the statute to require "that those in authority exercise particular vigilance when indications of irregularity reach their attention." However, the statute only requires *reasonable supervision* under the attendant circumstances, and, applying that standard, we cannot conclude that Trujillo's overall performance with respect to the activities of [the salesman] amounted to a failure to supervise within the meaning of the statutory language.[326]

They acknowledged responsibility under the broker-dealer's procedures, but liability turned on Trujillo's reaction to "indications of irregularity."[327] The standard for measuring it, however, was walked back, at least for individuals, to something akin to negligence.[328]

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323. *See id.* at 1107 n.4. There was no evidence that Trujillo was the salesman's supervisor under the broker-dealer's written supervisory procedures. Although Trujillo's title was "administrative manager," his functions "were tightly controlled by [the manager], who retained final responsibility for all branch activities." *Id.* at 1107. And while "Trujillo was given substantial responsibility for detecting problems, he was given only limited authority to correct them." *Id.* Clearly, he undertook to monitor the salesman for compliance purposes, *see id.* at 1107–09, but whether it was by direct authority or delegation from the manager was unresolved.

324. *See id.* at 1109 (emphasis added). Despite "generally tight surveillance," the record showed that "in at least two instances, Trujillo failed to make an adequate investigation of a customer's complaint, and in a third, failed to detect churning in a customer account when he should have done so." *Id.*

325. *See id.*

326. *Id.* at 1110 (emphasis added) (quoting Wedbush Sec., Inc., 48 S.E.C. 963 (1988)). They considered Trujillo's full body of work and the limited authority he had over the broker. *See id.*

327. Supervisory responsibility purportedly rested on the broker-dealer's supervisory procedures:

> Under the particular circumstances of this case, we cannot conclude that, given the limited scope of his authority, Trujillo's overall "discharge[] [of] the duties and obligations *incumbent upon him by reasons [sic] of [the broker-dealer's] procedures and system*" fell below a standard of reasonableness so as to amount to a failure to supervise within the meaning of Section 15(b)(4)(E) of the Securities Exchange Act.

Id. at 1111 (emphasis added). The opinion, however, suggested that every manager had a duty to supervise regardless of procedures. *See id.* at 1110 ("Our standard is that a manager (of any stripe) 'must respond reasonably when confronted with indications of wrongdoing.'" (citing William L. Vieira, 49 S.E.C. 1091 (1989); Nicholas A. Boccella, 49 S.E.C. 1084 (1989)). If so, broker-dealers' supervisory procedures were not the bases for associates' obligations, but merely reflected duties originating outside of them. Being superfluous, they only added to liability.

328. *See* Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 100 (N.Y. 1928) (Cardozo, C.J.) ("The risk reasonably to be perceived defines the duty to be obeyed[.]"). The duty in negligence, however, attended to a person's action—not his or her inaction. *See id.* at 99–100. It was something much greater to require the person to guard against all the foreseeable dangers presented by the rest of society.

The rationale created alternative bases for liability: failure to perform assigned procedures and responding inadequately to signs of misconduct. And though the standard for assessing the latter was more forgiving, still it was impossible to know precisely what it required. Consequently, even associates had reason to eschew procedures that could assure discipline if they were not followed but did not protect them when they were (and any protection there was resided outside of them). More uncertainty would follow attempts to define who was a "supervisor."

Huff

Arthur James Huff joined the compliance department of a major wire-house as the SROP in July 1979.[329] Prior to his arrival, a salesman in the broker-dealer's Miami office embarked on an elaborate scheme to defraud customers in options trades by falsifying account records, intercepting their mail, and issuing them false statements.[330] The compliance department was leery enough to examine his accounts.[331] In June, the compliance director, members of his staff, and an attorney in the legal department met with the salesman and his branch manager to go over the findings, which included a number of accounts with identical or post office box addresses.[332] The compliance director was sufficiently satisfied and the legal department approved the accounts with additional documentation.[333] Upon starting, Huff was handed the file and instructed by the compliance director, his boss, "to keep on top of [the salesman's] activities and to follow through if any question arose[.]"[334] He reviewed the dossier and selectively monitored the salesman's accounts.[335] Aware of the results of the earlier review, he did not consider the salesman a "compliance concern" at the time.[336] In April 1980, the compliance director instructed Huff to contact one of the salesman's clients who had reported making money in his account—the result of bogus statements.[337] Huff spoke with the customer but could not locate his account.[338] So he analyzed twenty-five other accounts covered by the salesman, identifying

329. *See* Arthur James Huff, 50 S.E.C. 524, 526 (1991). The author was Mr. Huff's colleague in the compliance department of PaineWebber Incorporated from 1989 to 1995.

330. *See id.* at 525. The salesman eventually pled guilty to criminal fraud and was sentenced to ten years in prison. *See id.* at 525 n.2; *see also* United States v. Greenman, SEC Litigation Release No. 9572, 24 SEC Docket 852 (M.D. Fla. Feb. 1, 1982). His branch manager and the regional manager were sanctioned for failure to supervise: the former was barred from associating with a broker-dealer in a supervisory or managerial capacity and suspended in all capacities for sixty days; the latter was censured and suspended from serving in a supervisory or managerial capacity for 180 days. *See* Philip Huber, Exchange Act Release No. 23542, 36 SEC Docket 384, 385–86 (Aug. 18, 1986).

331. *See Arthur James Huff*, 50 S.E.C. at 525. Between January and June of 1979, compliance staff performed profit and loss analyses of the accounts and reviewed account documentation, correspondence, and trades. *See id.* at 525–26.

332. *See id.* at 526.

333. *See id.*

334. *See id.*

335. *See id.*

336. *See id.*

337. *See id.* at 528.

338. *See id.*

losses in twenty-four of them totaling $7.6 million.[339] He reported the results and recommended the salesman be fired.[340] Still, a law judge found that prior "red flags" required he investigate sooner the salesman who was subject to his supervision.[341]

Chairman Richard Breeden and Commissioner Richard Roberts did not find it necessary to decide whether Huff was the salesman's supervisor.[342] Rather, they determined his conduct was sufficient.[343] Though it too was "less than exemplary," citing *Trujillo*, they agreed "the statute only requires reasonable supervision under the attendant circumstances."[344]

In a separate opinion, Commissioners Philip Lochner and Mary Schapiro disagreed with their colleagues' approach, fearing it lowered expectation.[345] They favored the benchmark in *Reynolds*, as expressed in *Wedbush,* calling it an "exacting standard."[346] Since the duty arose from the relationship, they "prefer[red] to ask, first, whether Huff was a supervisor."[347] They concluded he wasn't, thereby avoiding his performance.[348]

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339. *See id.*

340. *See id.* (The recommendation was rejected.).

341. *See generally* Arthur James Huff, SEC File No. 3-6700 (ALJ Dec. 15, 1987).

In October 1979, Huff received part of an internal audit report highlighting an unusual number of the salesman's accounts with the same partner (several with the same P.O. box address) advising the information be verified. Early the following year, a regional exchange requested the names and addresses of the persons authorized to enter orders for five of his accounts. The information, supplied by Huff, identified five different persons, three with the same street address and one with a P.O. box. During the same period, he performed some profit and loss computations on the salesman's accounts, identifying some losses. *See Arthur James Huff*, 50 S.E.C. at 527–28.

342. *See Arthur James Huff*, 50 S.E.C. at 526 n.3, 529 n.7. Nevertheless, they found support for the relationship in his assignment to monitor the broker. *See id.* at 526 & n.3 ("[W]e cannot find that Huff failed reasonably to perform *the supervisory duties with respect to [the salesman] that were vested in him by [the compliance director]*." (emphasis added)). They suggested their approach might have been different had he not met the requisite standard. *See id.* at 529 n.7.

343. *Id.* at 529 ("Under the particular circumstances of this case, we cannot conclude that Huff's overall discharge of 'the duties and obligations incumbent upon him by reason of [the broker-dealer's] procedures and system' fell below a standard of reasonableness so as to amount to a failure to supervise within the meaning of Section 15(b)(4)(E) of the Securities Exchange Act.").

344. *Id.* at 528–29. For them, the hue of earlier incidents was more verdant considering Huff knew the compliance director had greenlighted the representative after vetting similar issues. *See id.* at 527–28 ("Critical to our decision in this case is that Huff inherited a situation which had been of great concern to [the broker-dealer] but had apparently been resolved to his superior's satisfaction prior to his arrival on the scene. Thus, it was not unreasonable for Huff to conclude that, at that juncture, [the salesman] did not present a serious problem. Moreover, during the months that followed Huff's arrival, there were no new developments that raised substantial questions about [his] program.").

345. *Id.* at 530 ("In our view . . . Huff's performance hardly provides a model of how supervisors ought to behave, and the risk inherent in the Commission's approach is that it may be read to lower the standard of what is expected of supervisors.").

346. *See id.* at 531 (quoting Wedbush Sec., Inc., 48 S.E.C. 963, 967 (1988)). The Commissioners did not address the more lenient interpretation of the same language in *Trujillo*, which their colleagues merely echoed. In choosing the terminology in *Wedbush*, it's possible they meant to introduce a standard less than the guarantor liability suggested by *Reynolds* but stricter than ordinary care.

347. *Arthur James Huff*, 50 S.E.C. at 530.

348. *Id.*

Ambiguity in the absence of an explicit supervisory relationship obviously weighed on their analysis:

> The statute requires a supervisory relationship and such a relationship can only be found in those circumstances when, among other things, it should have been clear to the individual in question that he could take effective action to fulfill that responsibility. Basic notions of fairness and due process reinforce this conclusion.[349]

The key to it, they said, was "whether the person has the power to *control* the other person's conduct."[350] They observed that the vast majority of cases involved persons in the "line" of authority.[351] Branch managers, regional managers, and others up to and including the board of directors "have clear and direct authority and responsibility to control the conduct of salespersons."[352] Accordingly, "employees in a broker-dealer's administrative structure are, at least presumptively, supervisors of those whom they have the authority and the responsibility *to hire and fire and reward and punish*."[353] For others, the relationship still rested on control. Recounting decisions involving non-line administrators, they noted each had authority to affect the activity involved.[354] They concluded:

> [A] supervisor for purposes of Section 15(b)(4)(E) ought to be defined . . . as a person at a broker-dealer who has been given (and knows or reasonably should know he has been given) the authority and the responsibility for exercising such control over one or more specific activities of a supervised person which fall within the Commission's purview so that such person could take effective action to prevent a violation of the Commission's rules which involve such activity or activities by such supervised person.[355]

Huff did not have the requisite control over the salesman, so he was not a "statutory supervisor."[356]

The rationale helped protect personnel in non-business areas like legal, compliance, and audit, performing oversight functions but lacking authority over the

349. *Id.* at 532.

350. *Id.* (emphasis added). "Control . . . is the essence of supervision, and it is unlikely that anyone would consider his or her self another's employment 'supervisor' if he or she did not have authority to control the other's actions." *Id.* They found support, without reference, in the "common meaning" of the word "supervision" in an "employment relationship to which the statute refers," and the term "subject to his supervision," which "also seems to emphasize control." *Id.*

351. *See id.*

352. *Id.*

353. *Id.* (emphasis added).

354. *See id.* at 532–34 (analyzing Gary W. Chambers, Exchange Act Release No. 27963, 46 SEC Docket 200 (Apr. 30, 1990); Robert J. Check, 49 S.E.C. 1004 (1988) (finding a mutual fund manager responsible for trade processing failed to supervise brokers selling mutual funds); Michael E. Tennenbaum, 47 S.E.C. 703 (1982); and Alfred Bryant Tallman, 44 S.E.C. 230 (1970) (rejecting a settlement and dismissing proceedings against a compliance officer based on inexperience)) ("In *Tennenbaum* it was the power to control the salesperson's ability to deal with discretionary options accounts, and in *Check* it was the power to exercise control over approving salespersons' mutual fund sales orders. * * * If the salespersons' violations . . . had been unrelated to those particular powers, it seems evident that the Commission would not have found the individuals responsible for the failure to supervise.").

355. *Arthur James Huff*, 50 S.E.C. at 534–35.

356. *See id.* at 535.

people they monitored.[357] Business executives, on the other hand, presumably were supervisors whether or not they were assigned any preventative measures to take with respect to subordinates.[358] The formula defied the objective: to discipline associates who failed to perform their duties under the broker-dealer's supervisory system and procedures and to preserve their immunities when there weren't any.[359] It also lessened the significance of supervisory systems removed from business influence.[360] The false dichotomy stemmed from the apocryphal search for meaning to language in the statute that existed outside of it—in the supervisory relationships and performances agreed to between broker-dealers and their associates. Control over the person subject to supervision was not necessary and the provision did not require it.[361] Discipline

357. Theoretically, it also insulated administrators in business areas monitoring personnel with no power over them, like Louis Trujillo. The Commissioners did not address the presumption in *Trujillo* that the manager's assistant was a supervisor though he lacked authority over the salesman. *See supra* note 323 and accompanying text. Still, in *Huff* they refused to insulate non-line personnel completely:

> We do not find that Huff was not [the salesman's] supervisor merely because of Huff's position as a staff compliance officer (*i.e.*, he was not one of [his] 'line' supervisors); however his lack of authority to affect [his] violative behavior (by firing, demoting or disciplining him or by any other means) is, it seems to us, the most compelling factor in determining whether Huff was [his] supervisor, irrespective of what department Huff worked in.

50 S.E.C. at 536–37.

358. *See, e.g.*, Richard A. Graham, Exchange Act Release No. 16237, 18 SEC Docket 565 (Oct. 3, 1979) (The Los Angeles partner responsible for the San Francisco office in *Michael E. Tennenbaum*, 47 S.E.C. 703 (1982), was disciplined as the salesman's supervisor even though he was not qualified to supervise options and thus apparently played little or no role in overseeing his options activities under the firm's procedures.).

359. Huff was not identified as the salesman's supervisor for purposes of the broker-dealer's supervisory system and procedures under SRO rules. Nevertheless, he accepted the assignment to monitor him. If that was enough to support a supervisory obligation, a notion challenged by Commissioners Lochner and Schapiro, *see Arthur James Huff*, 50 S.E.C. at 536 ("The fact that [the compliance director] delivered [the salesman's file] to Huff with instructions to stay on top of the matter and follow through on any problems is clearly insufficient to bring [him] within Huff's supervision, based on the [firm's] administrative structure[.]"), his performance without any objection from the broker-dealer ordinarily was sufficient to satisfy it in contract. *See* Restatement (Second) of Contracts § 202(4) (Am. L. Inst. 1981) ("Where an agreement involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection is given great weight in the interpretation of the agreement.").

360. The *Special Study* recommended broker-dealers divest branch managers in large offices of production responsibilities, and SECO and SRO rules offered wide latitude in appointing supervisors, thereby encouraging the separation of supervision from business influence and expanding it beyond line managers to minimize conflicts of interest and to maximize performance. *Cf.* Prudential-Bache Sec., Inc., 48 S.E.C. 372, 400 (1986) ("The Commission has long recognized that it is not sufficient for a broker-dealer to establish a system of supervisory procedures which rely solely on supervision by branch managers." (citing *Shearson, Hammill*, 42 S.E.C. 811 (1965))).

361. *See supra* note 210 and accompanying text. Under the language of Section 15(b)(4)(E), control was relevant only to the extent it was necessary "to supervise" or inherent in "supervision." Neither term was defined. In general, "supervise" meant "[t]o have general oversight over, to superintend or to inspect," *see* Black's Law Dictionary 1438 (6th ed. 1990), while "supervision" was "[a]n act [or] occupation of supervising; inspection," *id.* Control over the subject was not essential to either. For Commissioners Lochner and Schapiro, control found its way into the relationship through the word "supervisor," *see supra* note 350 and accompanying text, which was not in the statute. *Black's Law Dictionary* defined it as "one having *authority* over others, to superintend and direct," with reference to Section 2(11) of the National Labor Relations Act (the "NLRA"), Black's Law Dictionary at

founded on contractual responsibility also alleviated concerns about fairness and due process;[362] control alone did nothing to indicate how it was to be used.[363]

Chairman Breeden and Commissioner Roberts purportedly tied Huff's liability to the broker-dealer's supervisory system and procedures.[364] In assessing his performance, however, they looked beyond what he had agreed to do under them to whether he responded appropriately to abnormalities. On that basis, his supervisor status alone was sufficient to establish responsibility, which explained why the "procedures" could consist of as little as an instruction to "keep on top of the salesman."[365] A spectacular case involving novel improprieties abandoned all pretext to broker-dealers' procedures as the basis of supervisory responsibility for associated persons.

GUTFREUND

In the spring of 1992, the SEC charged a primary dealer in U.S. Treasury securities with fraud and recordkeeping violations for false bids by its head

1438 (emphasis added), which may have been where they obtained their indicia of control for line managers. *See supra* note 353 and accompanying text. (Although, it is unclear whether control is necessary even under the NLRA definition, which, in addition to identifying the powers to hire and fire, reward and discipline, includes the ability "effectively to recommend such action." *See* 29 U.S.C. § 152(11) (2018).) The construction ignored that neither the "associated person" nor the "person" subject to his or her supervision had to be an *employee* of the broker-dealer; therefore, the provision went beyond an "employment relationship." *See supra* note 350. It rendered surplus the phrase "with a view to preventing violations," which encompassed more than prevention. *See supra* note 210. Indeed, if Congress had meant for the relation to be governed by control, it might simply have added the word. *See* BLACK'S LAW DICTIONARY, *supra*, at 1438 (defining the term "supervisory control" to include the element of control).

362. Neither was compromised in holding a person accountable for failing to perform as promised under circumstances that gave rise to an obligation in contract.

363. By then, NASD rules required proper training of designated supervisors. *See* Rules of Fair Practice, art. III, § 27(a)(6), NASD Manual (CCH) ¶ 2177 (1990) (requiring members to use "[r]easonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities"); *1988 Amendments to Article III, Section 27, supra* note 221, 53 Fed. Reg. 41008; Notice to Members 88-84, *supra* note 221.

364. *See Arthur James Huff*, 50 S.E.C. at 528 (". . . Section 15(b)(4)(E) provides that no person shall be held responsible for deficient supervision if he 'reasonably discharged the duties and obligations incumbent upon him by reason of [his firm's] procedures and system.' Thus, different supervisors may have different responsibilities depending on how each firm devises its compliance program." (brackets and punctuation in original)).

365. *See id.* ("Here Huff was assigned specific supervisory duties with respect to [the salesman]. [The compliance director] gave him [the salesman's] file and instructed him to keep on top of [his] activities and to follow through if any question arose.").

The law judge also found that Huff failed to exercise reasonable supervision over the branch manager with a view to preventing *his* supervisory deficiency. *See id.* at 525. Commissioners Breeden and Roberts, in a part of their opinion with which Commissioners Lochner and Schapiro concurred, wrote "deficient supervision by a subordinate is not a 'violation' on the basis of which the subordinate's superior can be disciplined." *Id.* at 529. Sections 15(b)(4) and 15(b)(6), they asserted, "list[] separate and distinct bases for disciplining associated persons," including "violations of the securities acts and rules[] *and* deficient supervision." *Id.* The latter was excluded from the objects of oversight in subparagraph (E). *See id.* The explanation stopped short of saying the duty to supervise arose outside of the federal securities laws, implying it was contained within the provision.

government trader in auctions between August 1989 and May 1991.[366] In related settlements, the broker-dealer was censured and three officers were sanctioned and another admonished for improper supervision.[367]

In July 1990, the Treasury Department limited to 35 percent the amount of an issue a person could bid for at auction, partly in response to outsized purchases by the broker-dealer, a dominant market-maker in Treasuries.[368] In the February 21, 1991, auction for $9 billion of five-year notes, the trader requested $3.15 billion (35 percent of the offering) for the broker-dealer.[369] He submitted two other bids for $3.15 billion, ostensibly for customers, then secretly arranged to "buy back" the allocations.[370] One customer confronted him.[371] The trader reported the incident to his boss, the head of the division, who called the conduct "career threatening."[372] The next day, April 25, the division head met with the company's president and its senior legal officer to discuss the matter, and the three later conferred with the chief executive officer.[373] They decided the matter should be reported to the government.[374] They did not initiate a review, discipline the trader, or restrict his activities.[375] Subsequent events prompted an internal investigation uncovering more false bids before and after the February 21 auction.[376] On August 9, the CEO and the president disclosed the initial

366. *See* SEC v. Salomon Inc., Litigation Release No. 13246, 51 SEC Docket 817 (May 20, 1992). (The broker-dealer and its parent company consented to final judgements agreeing to pay $290 million in fine, forfeiture, and payment for civil claims.).

367. *See* Salomon Bros. Inc., Exchange Act Release No. 30721, 51 SEC Docket 749 (May 20, 1992); John H. Gutfreund, Exchange Act Release No. 31554, 52 SEC Docket 2849 (Dec. 3, 1992).

368. *See John H. Gutfreund*, 52 SEC Docket at 2850 n.3 (The trader publically criticized the initiative.).

369. *See id.* at 2850.

370. *See id.* at 2850–51. The trader instructed a clerk to write tickets selling the securities back to the broker-dealer and arranged to suppress the confirmations. *See id.* at 2851.

371. *See id.* at 2851. Another broker-dealer affiliated with the customer, a large asset manager, submitted its own bid, which, combined with the one submitted in its affiliate's name, exceeded the limit. Treasury Department officials determined to treat the affiliates as a single bidder in future auctions and notified the asset manager, copying the trader. A senior officer of the asset manager contacted the trader, who attributed the bid to a clerical error corrected internally and asked him to keep it confidential. *See id.*

372. *See id.* at 2851–52. When his boss asked him why he had done it, the trader said he needed the notes to meet demand on his and another desk. He denied having done it before. *See id.* at 2852.

373. *See id.* at 2852. The meeting with the CEO occurred several days later. The division head said he believed the incident was "an aberration"; the legal officer called it "a criminal act." *Id.*

374. *See id.* at 2852. They discussed whether it was preferable to go to the Treasury Department or the Federal Reserve Bank of New York. They decided on the Federal Reserve because of tension with Treasury over the trader's public comments on the auction limit. There was some confusion over who would report—the president or the CEO and the president—and how it would be made. *See id.* at 2852–53.

375. *See id.* at 2853. Later, "[e]ach . . . placed the responsibility for investigating [the trader's] conduct and placing limits on his activities on someone else." *Id.*

376. *See generally id.* at 2853–57. In the May 22, 1991, Treasury auction for two-year notes, the broker-dealer received approximately 86 percent of the issue, prompting press speculation about its involvement in a short squeeze. In June, the CEO met with Treasury officials to discuss the dealer's role in the auction without disclosing the false bid in February. In July, the company hired a law firm to review its participation in the May auction. Lawyers discovered an apparent buy-back with no trade ticket. The examination was expanded, uncovering numerous false bids and irregularities in auctions going back to December 1990. *See id.* at 2854–56.

incident together with the results of the investigation.[377] The trader was terminated the same day.[378]

All three officers were supervisors by virtue of their authority over the trader.[379] Their responsibilities were not based on supervisory procedures—there weren't any.[380] Each had an independent duty to supervise commensurate with his position.[381] The order recited a litany of measures that should have been taken.[382] All thought "someone else would take the supervisory action necessary."[383] Thus, each bore "some measure of responsibility for the collective failure of the group" to act.[384] The disjointed response was symptomatic of the removal of primary responsibility for supervision from broker-dealers to their associates.[385]

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377. *See id.* at 2857. Management was informed of the findings on August 7. *See id.* at 2856. The board of directors was apprised of the events for the first time on August 8. *See id.* at 2857 n.11. On August 18, the CEO, president, and division head resigned their positions with the broker-dealer and its parent. *See id.* at 2857. The senior legal officer resigned his position with the broker-dealer on August 23. *See id.*

378. *See id.* at 2853.

379. *See id.* at 2858. The division head was identified as a supervisor in the broker-dealer's compliance procedures. *See id.* at 2860.

380. *See id.* at 2860 n.20 ("[The broker-dealer] did not have established procedures, or a system for applying those procedures, which together reasonably could have been expected to detect and prevent the violations."). The deficiency should have prevented the officers' liability; instead it foreclosed their reliance on the exculpatory language. *See id.* ("The affirmative defense provisions of Section 15(b)(4)(E) thus do not apply in this case.") Nothing suggested the language was an "affirmative defense." *See* Ferrara et al., Managing Marketeers, *supra* note 281, § 1.01 n.4. The anomaly was that exoneration for an *associate person* depended on actions taken by a *broker-dealer* to institute the necessary procedures.

381. The familiar refrain exhorted "those in authority [to] exercise particular vigilance" in response to "indications of wrongdoing." John H. Gutfreund, Exchange Act Release No. 31554, 52 SEC Docket 2849, 2858 (Dec. 3, 1992). Information the conduct was illegal transcended the usual abstract warnings. *See id.* ("Many of the Commission's cases involving a failure to supervise arise from situations where supervisors were aware only of 'red flags' or 'suggestions' of irregularity, rather than situations where, as here, supervisors were explicitly informed of an illegal act." (citations omitted)). The CEO "bore ultimate responsibility to ensure that a prompt and thorough inquiry was undertaken and that [the trader] was appropriately disciplined." *See id.* at 2859. The president was "responsible for compliance with all of the requirements imposed on [the broker-dealer] unless and until he reasonably delegate[d] particular functions to another person." *See id.* at 2860 & n.21 (quoting Universal Heritage Invs. Corp., 47 S.E.C. 839, 845 (1982)). The division head had continuous supervisory responsibility, beyond simply reporting the misconduct, for as long as the relationship persisted. *See id.* at 2860.

382. *See id.* at 2859.

383. *See id.*

384. *Id.* The CEO failed to ensure a prompt and thorough investigation to determine the scope of misconduct and to prevent further violations, and did not promptly report the matter. *See id.* at 2859–60. Although the president "arranged several meetings to discuss the matter, [he] failed to direct that [the division head], [legal officer] or others . . . take the steps necessary to respond to the matter." *Id.* at 2860. The division head's escalation and admonishment "were not sufficient under the circumstances." *Id.*

385. SRO rules required members to implement policies and procedures to investigate suspected securities law violations. *See, e.g.*, NYSE Rule 342.21 (1992); Order Approving Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Regulatory Review Requirements, Exchange Act Release No. 25763, 53 Fed. Reg. 20925 (June 7, 1988) (approving amendments to NYSE Rules 342, 351, and 476 requiring member organizations to conduct timely "internal investigations" of trades in NYSE listed securities and related financial investments that may violate securities laws

The Commission issued a report under Section 21(a) of the Exchange Act on the senior legal officer's performance "to amplify [its] views on the supervisory responsibilities of legal and compliance officers in [his] position."[386] Unlike the others, he "was not a direct supervisor of [the trader] at the time he first learned of the false bid."[387] Nor did he control his actions. Control, however, no longer was necessary:

> [D]etermining if a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has *a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue*.[388]

True to earlier applications of *Reynolds*, his "ability" merely "to affect" the situation made him a supervisor once he was on notice of potential misconduct.[389] Also consistent was the expectation he "ensure" the proper outcome.[390]

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and rules prohibiting insider trading and manipulative and deceptive devices and to report such investigations to the exchange). Instead of the central direction afforded by such requirements, a duty was conjured requiring supervisors to coordinate among themselves. *See John H. Gutfreund*, 52 SEC Docket at 2859 ("In situations where supervisors are aware of wrongdoing, it is imperative that they take prompt and unequivocal action to define the responsibilities of those who are to respond to the wrongdoing.").

The broker-dealer was censured and ordered to install the missing procedures. *See* Salomon Bros. Inc., 51 SEC Docket 749, 751 (1992). The division head was suspended for three months and fined $50,000, the president was suspended for six months and fined $75,000, and the CEO was fined $100,000 and agreed not to serve as chief executive of a regulated entity. *See John H. Gutfreund*, 52 SEC Docket at 2861–62.

386. *Id.* at 2860. Section 21(a)(1) provides, in pertinent part:

> The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association . . . .

15 U.S.C. § 78u(a)(1) (2018). The investigation purportedly was made into whether the lawyer violated the Exchange Act—not SRO rules. *See John H. Gutfreund*, 52 SEC Docket at 2849 n.1.

387. *John H. Gutfreund*, 52 SEC Docket at 2849 n.1.

388. *Id.* at 2861 (citing the concurring opinion in Arthur James Huff, 50 S.E.C. 524 (1991)). *See* Richard Y. Roberts, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the Securities Law Committee of the Federal Bar Association Entitled "Failure to Supervise Liability for Legal and Compliance Personnel" 18–20 (Dec. 7, 1992).

> [I]t is unclear to me how "the *authority and* the *responsibility* for exercising such *control*" language of the concurring *Huff* opinion, purporting to define supervisor, is consistent with the "a requisite degree of *responsibility*, *ability*, *or authority* to affect the *conduct*" language which appears [in the 21(a) Report]. Among other things, "or" rather than "and" is used in the Report; and the word "control" is not used in the Report.

Id. at 19 (citation omitted).

389. *See John H. Gutfreund*, 52 SEC Docket at 2860–61. He was informed of the fraudulent bid with the others, advised them it was a criminal act that should be reported, and repeatedly urged them to do so. He could have directed an investigation or ensured one was performed; also he could have recommended restrictions on the trader's activities to prevent future misconduct and confirmed they or acceptable alternatives were implemented. *See id.* at 2861.

390. *See id.* at 2861 ("Once a person in [the lawyer's] position 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*." (emphasis added)). Moreover, because the duty was personal, the required response might involve action outside the scope of the person's

The executives who, after learning of the trader's initial misconduct, continued to direct his activities in general, were not cited for willfully aiding or abetting the subsequent violations,[391] even though they might have been inclined to turn a blind eye to conduct that enabled the broker-dealer to maintain its prominent position in the Treasury market.[392] Supervisory liability unencumbered by designations and procedures benefited them and others in similar positions under questionable circumstances.[393] However, it meant uncontained liability for those whose only responsibilities were to protect investors.[394]

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association with the broker-dealer. *See id.* ("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.").

391. *See id.* at 2850 ("The Respondents in this proceeding are not being charged with any participation in the underlying violations.").

392. *See* U.S. SEC. & EXCH. COMM'N, REPORT ON THE STATUTORY AUTHORITY AND OVERSIGHT RESPONSIBILITIES WITH RESPECT TO ALLEGATIONS OF WRONGDOING IN THE GOVERNMENT SECURITIES MARKET BY SALOMON BROS., INC. (Sept. 3, 1991).

> [A]ccording to Salomon, its previous senior management knew about the misconduct at the firm as early as April of this year. Despite this knowledge, the problems relating to the May auction were allowed to occur and to persist for a period of weeks. * * * [T]he firm's silence throughout this time frame raises serious questions about whether there was a climate within Salomon that appeared to tolerate or even to encourage wrongdoing.

Id. at 8. *Cf.* United States v. Lanza, 790 F.2d 1015, 1022–23 (2d Cir.) (recognizing "deliberate ignorance" as tantamount to knowledge in aiding and abetting liability), *cert. denied*, 479 U.S. 861 (1986).

393. The executives consented to conduct less inflammatory than aiding and abetting the violations. (For its part, the Commission staff avoided the stronger proof needed to support the charges.) Unfortunately, the lesser charge was not as intuitive for lower level employees. *See, e.g.*, Philip A. Schaefer, Exchange Act Release No. 34-16392, 18 SEC Docket 1200 (Dec. 3, 1979). In a settlement with the representative jointly responsible for discretionary accounts mishandled by the salesman in *Tennenbaum*, the Commission found that he:

> *willfully aided and abetted* violations . . . in that [he] *failed adequately to monitor the activities of another registered representative* by neglecting to review trading in discretionary accounts in which securities options transactions of [his] customers were effected by such other registered representative*, and by his omission failed to prevent trading inconsistent with statements that had been made to such customers with regard to the risks and rewards of such trading.*

Id. at 1200 (emphasis added). The aiding and abetting allegation, conspicuously devoid of any affirmative act in knowing contribution to the salesman's violations, sounded more like failure to supervise. But the charge didn't fit his position. He was censured, restricted from trading options, and prohibited from "act[ing] in any *supervisory capacity*" for a year. *Id.* at 1201 (emphasis added). Like other Commission-designated supervisors under the *Reynolds* regimen, apparently he suffered similar ignorance of what the assignment entailed:

> The respondent in his Offer of Settlement has stated that: (1) he was not fully knowledgeable as to the highly intricate and sophisticated nature of securities options transactions or of the risks attendant to those transactions; (2) he therefore was unable adequately to monitor trading in those accounts[.]

Id. at 1200–01.

394. The uncertainty surrounding supervisory liability has drawn special indignation from legal and compliance professionals, *see* Mary L. Schapiro, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the Securities Industry Association, Compliance and Legal Seminar, Entitled "Broker-Dealer Failure to Supervise: Determining Who Is a 'Supervisor'" 4–5 (Mar. 24, 1993) ("An impartial observer . . . might be tempted to think that any statute which has so many references to 'reasonableness,' would not be hard to administer, or generate much controversy. But, as you know, the manner in which the

Gutfreund and the *21(a) Report* concluded a formal shift in primary responsibility for supervision from broker-dealers to their associated persons. In 1985, Commissioner Aulana Peters described the traditional hierarchy for policing the industry:

> [A]t the top of the pyramid is the SEC, the federal watchdog. At the middle level are the SROs, and *finally*, at the largest and most important level are the broker-dealer firms themselves. *It is at this level that customer protection begins*.[395]

Five years later, the Head of the SEC's Enforcement Division wrote:

> Former SEC Commissioner Peters's pyramid metaphor, though accurate, is not quite complete. *The real base of the supervisory pyramid is occupied not by the broker-dealers but by their individual supervisory personnel, who are governed by an independent statutory duty to supervise*.[396]

While it sounded like an extension to greater effect, responsibility fell to individuals with little or no "independent authority." Their individual abilities did not approach what the broker-dealer could do through them by its authority. And though broker-dealers still had to maintain supervisory systems and procedures under SRO rules, there was far less incentive to build the comprehensive programs envisioned when responsibility at the federal level, where it mattered most, was measured by how associates performed autonomously under existing circumstances.

Following the SEC's lead, the SROs similarly have shifted expectations for supervision from members to their associates.[397] At each level, supervision has

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Commission has applied [sections 15(b)(4)(E) and 15(b)(6)], particularly against persons who work in the compliance or legal departments of a broker-dealer, has been the subject of continuing controversy."), and prompted its own navigational guide, *see 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*, U.S. SEC. & EXCHANGE COMM'N, DIV. OF TRADING & MKTS. (Sept. 30, 2013), https://www.sec.gov/tm/divisionsmarketreg faq-cco-supervision-093013htm.

395. Aulana L. Peters, Comm'r, U.S. Sec. & Exch. Comm'n, Address Before the Brooklyn Law School Securities Regulation Symposium, Entitled "Investor Protection: The First Line of Defense" 6 (Mar. 15, 1985) (emphasis added).

396. William R. McLucas & William E. Morse, *Liability of a Branch Office Manager for Failure to Supervise*, 23 REV. SEC. & COM. REG. 1, 1 (1990).

397. *See, e.g.*, Thaddeus J. North, Exchange Act Release No. 84500 (Oct. 29, 2018), https://www.sec.gov/litigation/opinions/2018/34-84500.pdf (sustaining FINRA sanctions against the chief compliance officer of a member organization for failing to ensure there were adequate supervisory procedures to review electronic correspondence and failing sufficiently to review correspondence under existing procedures), *petition for review denied sub nom*. North v. SEC, No. 18-1341 (D.C. Cir. Oct. 23, 2020); *see also* Luis Fernando Restrepo, FINRA Letter of Acceptance, Waiver and Consent, No. 2016047624501 (July 20, 2021); Linda L. Busby, FINRA Letter of Acceptance, Waiver and Consent, No. 2014043592001 (May 18, 2016) (The anti-money laundering (AML) compliance officer of a large, retail broker-dealer was found to have violated FINRA Rule 3310(a) requiring "[e]ach member [to] develop and implement a written [AML] program reasonably designed to achieve and monitor the member's compliance with the requirements of the Bank Secrecy Act" despite the fact that the obligation applied to the member organization and the entity: "did not dedicate resources to match [its] growth with reasonable AML compliance systems and procedures"; "failed to establish AML programs tailored to [its] business"; "relied on a patchwork of written procedures and systems across different departments"; and "systems and procedures were not coordinated to allow [it] to link patterns and trends of suspicious conduct, leaving certain risk areas and certain red flags unchecked."

become an employee's duty for which the company can be held responsible instead of the other way around.[398] Meanwhile, the *Reynolds* doctrine has been applied to investment advisers and their associates under Section 203(e)(6) and (f) of the Advisers Act,[399] with no corresponding SRO regime,[400] and expectations trained heavily on compliance officers under Rule 206(4)-7.[401] Not surprisingly,

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The compliance officer, a general securities representative—not a registered principal—for only part of the time, was held responsible for the company's failure to establish a proper AML compliance program. She was suspended from associating with a member in any capacity for three months and fined $25,000. At the time, she was separated from the company. The company was fined $8 million for its second offense, and ordered to review its AML policies, systems, procedures, and training and to certify compliance with Rule 3310.).

398. In *Thaddeus J. North*, the Commissioners questioned why FINRA did not charge the member (even though the company had terminated its membership). *See* Exchange Act Release No. 84500, *supra* note 397, at 13. Not because the organization was responsible for providing for appropriate supervision under the rules. According to them, that was the CEO's responsibility, delegated to the CCO in the company's compliance manual:

> The Commission has held repeatedly that the "chief executive officer of a brokerage firm is responsible for compliance with all of the requirements imposed on his firm 'unless and until he reasonably delegates particular functions to another person in the firm and neither knows nor has reason to know' that a problem has arisen."

Id. at 12 (quoting Michael J. Markowski, Exchange Act Release No. 43259, 73 SEC Docket 625 (Sept. 6, 2000), *reconsideration denied*, Exchange Act Release No. 43503, 73 SEC Docket 1520 (Nov. 1, 2000); Thomas F. White, 51 S.E.C. 1194 (1994)). But because it might be appropriate to hold the company responsible for its employee's failure to provide the requisite supervision on the principle of *respondeat superior*:

> "A firm . . . can act only through its agents, and is accountable for the actions of its responsible officers." We think it important to make it clear to firms—by holding them responsible when there are problems—that it is in their interest to have effective, diligent *compliance officers* to help them remain in compliance with their obligations. * * * *Indeed, in some cases it may be more appropriate to hold the firm liable rather than the compliance officer.*

Id. at 13 (quoting A. J. White & Co. v. SEC, 556 F.2d 619, 624 (10th Cir. 1977) (emphasis added)).

The Commissioners found that the CCO's failure properly to perform the procedures assigned to him "alone is sufficient to sustain FINRA's findings," *id.* at 8, lending a tinge of *obiter* to the part of their decision holding him accountable for their adequacy.

399. *See, e.g.*, Scudder Kemper Inv., Inc., Advisers Act Release No. 1848, 71 SEC Docket 828 (Dec. 22, 1999); Rhumbline Advisers, Advisers Act Release No. 1765 (Sept. 29, 1998), https://www.sec.gov/litigation/admin/ia1765.txt; Steven A. Cohen, Advisers Act Release No. 4307 (Jan. 8, 2016), https://www.sec.gov/litigation/admin/2016/ia-4307.pdf; Stephen Jay Mermelstein, Advisers Act Release No. 2961 (Dec. 14, 2009), https://www.sec.gov/litigation/admin/2009/ia-2961.pdf (all sanctioning investment advisers and associated persons for failing to respond vigorously to indications of wrongdoing under Sections 203(e)(6) and 203(f), respectively); *see also* Plaze, *supra* note 48, at 76–78.

400. At the time it proposed Rule 206(4)-7, the SEC requested comment on "approaches for involving the private sector in enhancing compliance with the federal securities laws," including by the "formation of one or more self-regulatory organizations" for investment advisers, Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2107, 68 Fed. Reg. 7038, 7043 (proposed Feb. 11, 2003), but chose not to pursue an SRO option, *see* Compliance Programs of Investment Companies and Investment Advisers, *supra* note 49, at 74723.

401. *See, e.g.*, Hamilton Inv. Counsel, LLC, Advisers Act Release No. 6061 (June 30, 2022), https://www.sec.gov/litigation/admin/2022/34-95189.pdf; *see also* SFX Fin. Advisory Mgmt. Enters., Inc., Advisers Act Release No. 4116 (June 15, 2015), https://www.sec.gov/litigation/admin/2015/ia-4116.pdf; Equitas Cap. Advisors, LLC, Advisers Act Release No. 3704 (Oct. 23, 2013), *at* http://www.sec.gov/litigation/admin/2013/34-70743.pdf (all stating that chief compliance officers aided and abetted or caused their registered investment advisers' failures to implement written supervisory procedures required by Section 206(4) and Rule 206(4)-7 of the Advisers Act).

the SEC's Division of Examinations (formerly the Office of Compliance Inspections and Examinations ("OCIE")), FINRA, and compliance professionals themselves routinely have found fault with broker-dealers' and investment advisers' supervisory programs and the resources dedicated to them.[402]

State Law and SRO Rules Provide Appropriate Standards for Purposes of Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(6) of the Advisers Act

In some states companies are compelled to provide sufficient internal regulations and controls to prevent undue risk of harm to others by their employees and agents.[403] In many cases, managers and directors are bound by fiduciary duty to ensure there are systems to report, investigate, and respond to potential illegalities within their companies, including violations of federal securities

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In a speech before the National Society of Compliance Professionals ("NSCP"), Commissioner Hester Peirce reflected on circumstances in which chief compliance officers were excused of "personal liability" for the failure to provide for proper oversight, implicitly recognizing an independent duty to supervise:

> The Commission has declined to impose personal liability on compliance officers who were ill-equipped for their jobs, who were denied the resources necessary to do their jobs, or who were genuinely over-burdened with other duties.

Remarks Before the NSCP, Entitled "When the Nail Falls" (Oct. 19, 2020), https://www.sec.gov/news/speach/peirce-nscp-2020-10-19 (citations omitted). She observed, "[t]he absence of a formal regulatory structure [for *compliance officers*] . . . makes room for *grass-roots based standards of conduct*," adding, "*compliance personnel* can point to adherence to *those standards* as a reason for why a regulator ought not to impose liability." *Id*. (emphasis added). In January 2022, the NSCP released a proposed "liability framework" to "provide guidance to regulators, chief compliance officers (CCOs), and firms regarding perceived or actual CCO liability." *See NSCP Firm and CCO Liability Framework*, Nat'l Soc'y. Compliance Pros. (Jan. 2022), NSCP+Firm+and+CCO+Liability+Framework+Jan+2022.pdf [hereinafter, *NSCP Liability Framework*]. The framework consists of nine questions the SEC and other regulators should consider in "evaluat[ing] the issue of CCO liability," which range from the officer's "responsibility, ability, or authority to affect the violative conduct," through his or her performance, to management's involvement and support. *See id.*

402. *See* U.S. Sec. & Exch. Comm'n, Risk Alert, OCIE Observations: Investment Adviser Compliance Programs (Nov. 19, 2020) (identifying common deficiencies in investment advisers' written supervisory procedures under Rule 206(4)-7, including (1) inadequate resources dedicated to programs for preventing, detecting, or correcting violations; (2) lack of authority and access to management and information by CCOs; (3) insufficient reviews for evaluating the efficacy of those systems; (4) failure to implement controls mandated by policies and procedures; (5) outdated or inaccurate descriptions of procedures, including "off-the-shelf" materials containing inaccurate or incomplete information; and (6) no procedures at all in some cases); FINRA, 2021 Report on FINRA's Examination and Risk Monitoring Program (Feb. 2021), https://www.finra.org/sites/default/files/2021-02/2021-report-finras-examination-risk-monitoring-program.pdf; *NSCP Liability Framework*, *supra* note 401 ("70% [of compliance professionals] believe the overall compliance function at their firms is under resourced; 35% reported insufficient resources to conduct compliance training; 20% reported insufficient authority to develop and enforce compliance policies and procedures at their firms; and 25% reported an inability to address compliance-related weaknesses and report concerns to senior management.").

403. *See* Restatement (Third) of Agency § 7.05 (Am. L. Inst. 2006); Restatement (Second) of Torts § 317 (Am. L. Inst. 1979). Many courts limit the common law obligation to preventing physical harm. *See, e.g.*, Piper Jaffray Cos. v. Nat'l Union Fire Ins. Co., 967 F. Supp. 1148, 1157 (D. Minn. 1997).

laws.[404] Proper supervision is expected of broker-dealers and investment advisers under state blue sky laws demonstrated by written supervisory procedures.[405] And under the regime created by Congress, broker-dealers and investment advisers are relieved of supervisory responsibility integral to vicarious liability for their associates' securities laws violations where they implemented and enforced systems reasonably designed to prevent them. State law and industry guidelines inform expectations, while SRO rules and Rule 206(4)-7 require them to devise written plans that specify *who* shall do *what* with regard to *whom*.

FINRA rules, in particular, require members to designate qualified supervisors for each representative, business, and major location,[406] and to establish written procedures to monitor compliance with applicable securities laws and association rules.[407] There are special requirements for brokerage,[408] trading,[409] investment banking,[410] research,[411] and other businesses. Members must review

404. *See, e.g.*, *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969–70 (Del. Ch. 1996) (Corporate directors have a duty to assure themselves "that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."); *see also* Marchand v. Barnhill, 212 A.3d 805, 824 (Del. 2019) ("[*Caremark*] . . . require[s] that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks."); Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006). Compliance with applicable regulatory requirements is a factor in assessing whether management has met its oversight responsibilities. *See Marchand*, 212 A.3d at 822–23; *Stone*, 911 A.2d at 371 n.11 (finding the "[b]oard dedicated considerable resources to the [Bank Secrecy Act] compliance program and put into place numerous procedures and systems to attempt to ensure compliance" in meeting its *Caremark* obligation).

405. *See, e.g.*, Del. Code Ann. tit. 6, § 73-304(a)(7) (West 2022); 6 Del. Admin. Code §§ 609(b)(4), 709(a)(4) (2022) (authorizing the Director of Investor Protection to deny, suspend, or revoke the registration of a broker-dealer or investment adviser if it (or any partner, officer, director or control person) has engaged in dishonest or unethical practices; defining the latter to include "failing to reasonably supervise" the broker-dealer's or investment adviser's agents, representatives or employees; and providing that "reasonable supervision" shall include, among other things, maintaining and enforcing written supervisory procedures).

406. *See* FINRA Rule 3110(a)(2), (4), (5) (requiring members to designate one or more appropriately registered principals to supervise each type of business conducted as a broker-dealer, to designate a registered principal(s) in each office of supervisory jurisdiction ("OSJ") and a registered representative(s) or principal(s) in each non-OSJ branch office to supervise that office, and to assign each registered person to a registered representative(s) or principal(s) responsible for supervising that person's activities). Supervisors must be qualified by training and experience. *See* FINRA Rule 3110(a)(6).

407. *See* FINRA Rule 3110(a)(1), (b)(1) (requiring members to establish, maintain, and enforce written procedures to supervise their businesses and the activities of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and FINRA rules).

408. *See, e.g.*, FINRA Rule 3110(b)(2) (requiring procedures for review of securities transactions by a registered principal); FINRA Rule 3260(c) (requiring approval and review by a designated person of orders for discretionary accounts).

409. *See, e.g.*, FINRA Rules 3110(b)(2), 3110(d)(1), (2) (requiring procedures designed to identify and investigate trades that may violate Exchange Act or FINRA prohibitions on insider trading, manipulation, and deception in accounts of the member and its associated persons).

410. *See, e.g.*, FINRA Rules 3110(b)(2), 3110(d)(1)–(3) (requiring procedures designed to identify, investigate, and report possible insider trading, manipulation, or deception for members engaged in investment banking).

411. *See, e.g.*, FINRA Rules 2241, 2242 (requiring members to establish, maintain, and enforce written policies and procedures to identify and manage conflicts of interest related to research reports, analysts' public appearances, and communications with persons outside the research department).

associates' outside business activities,[412] personal securities transactions,[413] investments,[414] and investigate their conduct prior to employment.[415] They have to monitor functions outsourced to third parties.[416] In some instances, the rules mandate specific practices[417] or objectives.[418] Otherwise, members have broad discretion over the substance of their programs.[419] They must test and inspect periodically to ensure policies and procedures are enforced,[420] and evaluate the efficacy of those procedures every year.[421] The emphasis on administrative *processes* reflects the *member organization*'s responsibility to provide for appropriate supervision.[422]

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412. *See* FINRA Rule 3270, Outside Business Activities of Registered Persons, and Supplementary Material 01 (addressing members' obligations on receiving notice of registered persons' outside business activities, including imposing conditions or limits on the activity).

413. *See* FINRA Rule 3110(d)(1)(c) (requiring members to review employees' personal securities transactions in accounts at other firms); *see also* FINRA Rules 3280 (Private Securities Transactions of an Associated Person), 3280(c) (requiring notice and approval of registered persons' private securities transactions for compensation or otherwise and supervision of such transactions for compensation).

414. *See* FINRA Rule 3110(d)(1), (2) (requiring procedures to identify and investigate possible insider trading in accounts of covered persons, including employees, their spouses and children).

415. *See* FINRA Rule 3110(e) (requiring members to investigate the character, business reputation, qualifications, and experience of an applicant before applying for his or her registration as a representative, and requiring procedures, including a search of public records, to verify the accuracy and completeness of information contained in an applicant's registration on Form U4).

416. *See* FINRA Regulatory Notice 21-29, Vendor Management and Outsourcing, FINRA Reminds Firms of Their Supervisory Obligations Related to Outsourcing to Third-Party Vendors (Aug. 13, 2021); *see also* FINRA Regulatory Notice 11-14, Third Party Service Providers, FINRA Requests Comment on Proposed New FINRA Rule 3190 to Clarify the Scope of a Firm's Obligations and Supervisory Responsibilities for Functions or Activities Outsourced to a Third-Party Service Provider (Mar. 2011).

417. *See, e.g.*, FINRA Rule 3170 (requiring tape recording and review of telephone conversations with customers by representatives previously associated with firms expelled for sales practice violations).

418. *See, e.g.*, FINRA Rule 3260(c) (requiring review of discretionary accounts to detect and prevent trades of excessive size or frequency); FINRA Rule 2210(b)(1) (requiring review and approval of retail communications for false or exaggerated statements); FINRA Rules 2241(h), 2242(g) (requiring review and approval of proprietary and third-party research for accuracy and a sound basis for any recommendation).

419. *See* FINRA Rule 3110(b)(1) ("Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."); FINRA Rule 3110(b)(4) (requiring procedures for reviewing incoming and outgoing correspondence and internal communications "appropriate for the member's business, size, structure, and customers"). *See also* Thaddeus J. North, Exchange Act Release No. 84500, 2018 WL 5433114, at *7 (Oct. 29, 2018), https://www.sec.gov/litigation/opinions/2018/34-84500.pdf ("[FINRA Rule 3110] gives firms wide latitude in 'establish[ing] and maintain[ing] a system' to review electronic communication . . . .").

420. *See* FINRA Rule 3110(c)(1), (2) (requiring annual or other regular testing and verification of supervisory policies and procedures in office inspections and reports).

421. *See* FINRA Rule 3120(a)(1), (2) (requiring members to designate one or more principals to test and verify that supervisory procedures are reasonably designed to achieve compliance with securities laws and FINRA rules, to create additional or amended procedures as necessary, and to report annually on the results to senior management).

422. While it is often stated that "a company can *act* only through its agents," whose actions are at one with it, it *thinks* through processes that transform its agents' ideas into the entity's alone, which accounts for its separate *personality*:

Rule 206(4)-7 provides a basic framework for similar efforts by investment advisers, supplemented by FINRA requirements for dual registrants.[423]

In order to promote greater oversight by broker-dealers and investment advisers, they should be relieved of discipline when they complied with applicable laws, SRO rules, and other obligations for establishing, maintaining, and enforcing systems and procedures to prevent violations as Congress intended. Management approval of rationally designed surveillance programs and reporting systems administered in good faith normally should be dispositive of those duties.[424] The companies themselves should be accountable for any substantive

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> When . . . we look at the association which has chosen to incorporate itself . . . less than the admission of a real personality results in illogic and injustice. * * * Law, of a certainty, is not the result of one man's will, but of a complex fusion of wills. It distils the quintessence of an infinite number of personalities. It displays the character not of a Many, but of a One,—it becomes, in fact, unified and coherent. Ultimately pluralistic, the interactions of its diversities make it essentially, within the sphere of its operations, a single thing. * * * Surely it is but a limitation of outlook not to extend the conception of personality into this incorporeal sphere.

Harold J. Laski, *The Personality of Associations*, 29 Harv. L. Rev. 404, 417 (1916).

Like corporate statutes and charters, FINRA rules require a member organization to adhere to *processes* for establishing and maintaining its supervisory system and procedures, resulting in a program that reflects the unique will of the institution rather than its individual constituents. *See* FINRA Rule 3130(b), (c) (requiring the member's chief executive officer to certify annually that the organization "has in place *processes* to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance" with securities laws, FINRA and MSRB rules, and requiring the CEO certification to state that: (1) the organization has *processes* to establish, maintain, and review compliance policies and procedures, modify, and test them that are reasonably designed; (2) the CEO has met with the CCO to discuss those *processes*; (3) those *processes* are evidenced in a report reviewed by the CEO, CCO, and other officers as necessary to make the certification, and the final report has been or will be submitted to the board of directors and audit committee or equivalents; and (4) the CEO has consulted with the CCO and other employees, outside consultants, lawyers, and accountants as appropriate to make the certification (emphasis added)); FINRA Rule 3130, Supplementary Material .03 ("Importance of Compliance Processes"). Accordingly, "[f]inal responsibility for proper supervision . . . rest[s] with the member." FINRA Rule 3110(a); *but see* FINRA Regulatory Notice 22-10, Supervision, FINRA Reminds Member Firms of the Scope of FINRA Rule 3110 as It Pertains to the Potential Liability of Chief Compliance Officers for Failure to Discharge Designated Supervisory Responsibilities (Mar. 17, 2022) (stating "[a] firm's supervisory obligations under Rule 3110 rest with the firm *and* its president (or equivalent officer or individual, *e.g.*, CEO)"). FINRA Rule 3130(a), requiring a member to designate "one or more principals to serve as a chief compliance officer," does not make the person(s) responsible for the member's supervisory system and procedures. *See* FINRA Regulatory Notice 22-10, *supra*, at 3 ("Neither Rule 3110 nor Rule 3130, by themselves, attach supervisory responsibilities to a CCO.").

423. In choosing not to pursue an SRO regime for investment advisers, the Commission observed, nevertheless, that Rule 206(4)-7 "may enhance efficiency . . . by encouraging third parties to create new informational resources and guidance to which industry participants can refer in establishing and improving their compliance programs." Compliance Programs of Investment Companies and Investment Advisers, *supra* note 49, at 74725.

424. Where minimum prescriptions are met, it should be sufficient that managers, directors, and officers charged with establishing, maintaining, reviewing, and approving the supervisory program acted in accordance with their fiduciary duties under the business judgement rule, which generally protects decisions made "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

deficiencies or lapses in enforcement.[425] Their associates—who do not have original supervisory responsibility—should be responsible only for performing their assignments under principles of agency and contract law.[426] Individuals

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> What should be understood . . . is that compliance with a director's duty of care can never appropriately be judicially determined . . . apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational', provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests. To employ a different rule one that permitted an 'objective' evaluation of the decision would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions."

In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68 (Del. Ch. 1996) (citations omitted) (emphasis and punctuation in original).

Additional incentives or requirements may be useful to promote even greater investment in oversight by broker-dealers and investment advisers, including: distinguishing or eliminating reportable events for misconduct by associates where oversight was proper, *see* U.S. Sec. & Exch. Comm'n, Form BD, Uniform Application for Broker-Dealer Registration, Item 11A-H (Exp. 2022), U.S. Sec. & Exch. Comm'n, Form ADV, Uniform Application for Investment Adviser Registration, Item 11A-H (Exp. 2023) (The events would continue to be reported for the associated persons, *see* FINRA, Form U4, Uniform Application for Securities Industry Registration or Transfer, Item 11A-H (2009); FINRA, Form U5, Uniform Termination Notice for Securities Industry Registration, Item 7C, D (2009).); mandatory disclosures such as management discussion and analysis of legal supervision, allocation of resources dedicated to oversight, and standards and metrics for comparison; and independent audit requirements for supervisory controls.

425. The broker-dealer or adviser should not be disciplined for an associate's failure to enforce any policy or procedure where it adhered to inspection requirements and the persons conducting the examinations complied with established protocols and were not aware of the omission, in line with the objective to reward reasonable—not flawless—systems of supervision.

426. Those principles typically require strict adherence to specific procedures, *see* Restatement (Third) of Agency § 8.07 (Am. L. Inst. 2006), and the exercise of discretion in good faith, *see id.* § 8.01 cmt. b; Restatement (Second) of Contracts § 205 cmt. d (Am. L. Inst. 1981). Expectations may be broader for partners and officers according to their fiduciary duties, but their performances also should be measured by informed, honest, and rational behavior. *See* Principles of Corporate Governance § 4.01 (Am. L. Inst. 1994) (Business Judgment Rule). Although expressed in terms of negligence, liability under the business judgement rule requires more than want of ordinary care:

> Most corporate statutes provide that a director or officer must act with "the care an ordinarily prudent person in a like position would exercise under similar circumstances" and "in a manner he reasonably believes to be in the best interests of the corporation." [Citing §§ 8.30 and 8.41 of the Model Business Corporation Act.] Under a straightforward reading of such a statute, a director would be liable for damages as a result of an imprudent decision. *In fact, however, no court imposes such liability*. Instead, the courts read such statutes against the background of the business judgment rule, established by case law, *which precludes the imposition of liability on a director simply because his conduct was imprudent,* provided the elements of the rule are satisfied.

Melvin A. Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 Bus. Law. 1271, 1281 (1993) (emphasis added). In Delaware, for example, breach of the duty of care requires a showing of gross negligence if not dishonesty. *See* Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985).

should not be held accountable for deficiencies in companies' supervisory programs except as control persons.[427] Indeed, consideration should be given

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427. In her NSCP Remarks, Commissioner Peirce discussed the bases for disciplining the chief compliance officer for a broker-dealer's or investment adviser's failure to have appropriate supervisory policies and procedures. *See supra* note 401. She observed that "aiding and abetting" the violation—limited to obligations like Section 15(g) of the Exchange Act and Section 204A and Rule 206(4)-7 of the Advisers Act—requires that "the [compliance officer] must have been aware of the danger." *Id.* (citation omitted) (brackets in original). In this regard, the standard is akin to bad faith. On the other hand, a cease-and-desist proceeding under Section 21C of the Exchange Act, 15 U.S.C. § 78u–3, she stated, requires only "'an act or omission the person knew or should have known would contribute' to the violation," noting that the SEC and the courts have found "negligence" sufficient where the violation does not require *scienter*. *Id.* (citations omitted). "Rule 206(4)-7," she suggested, "supports negligence-based charges against the investment adviser's CCO, whom the rule makes 'responsible for administering written policies and procedures' that must be 'reasonably designed to prevent violation . . . [of the Advisers Act and its rules].'" *Id.* The standard, nevertheless, should be the same for both.

For an "omission" to be the "cause" of an offense, there must be an antecedent duty to act—primarily at law, but also, perhaps, based on the promise to perform in contract. The investment adviser, not the chief compliance officer, is responsible for adopting the required policies and procedures. Rule 206(4)-7 provides, in pertinent part:

> If *you are an investment adviser* . . . it shall be unlawful within the meaning of section 206 of the [Advisers Act] for you to provide investment advice to clients unless *you* (a) . . . [a]dopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the [Advisers Act and its rules] . . . and (c) . . . [d]esignate an *individual* . . . *responsible for administering* the policies and procedures that *you adopt* under . . . this section.

17 C.F.R. § 275.206(4)-7(c) (2022) (emphasis added). The officer's responsibility is limited to *administering* the adviser's policies and procedures. The SEC emphasized the role's enforcement aspect in the adopting release:

> An adviser's chief compliance officer . . . should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. *Thus, the compliance officer should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.*

Compliance Programs of Investment Companies and Investment Advisers, *supra* note 49, at 74720 (emphasis added). When addressing the compliance officer's supervisory liability under Section 203(f) of the Advisers Act, the Commission placed responsibility for policies and procedures solely on the adviser:

> Section 203(e)(6) provides that a person shall not be deemed to have failed to reasonably supervise another person if: (i) the *adviser* had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws; (ii) the *adviser* had a system in place for applying the procedures; and (iii) the *supervising person* had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.

Id. at 74720 n.73 (emphasis added) (citation omitted). Thus, whether a compliance officer's (or anyone else's) conduct contributes to an adviser's deficiency under Rule 206(4)-7 depends on what, if anything, he or she agreed to do to "adopt" or "implement" its policies or procedures. *See* 17 C.F.R. § 275.206(4)-7(a) (2022).

Authority to develop policies and procedures for purposes of the rule connotes discretion. *See* Compliance Programs of Investment Companies and Investment Advisers, *supra* note 49, at 74715–16 ("[Rule 206(4)-7] requires only that the policies and procedures be *reasonably* designed to prevent violation of the Advisers Act[.]") ("Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations."). Enforcement authority too may convey discretion. The measure of its abuse is not negligence, but gross negligence or bad faith signifying irrational behavior. *See supra* note 426.

to curtailing individual supervisory liability, which has detracted from institutional responsibility.[428]

Conclusion

Undoubtedly, the vast majority of broker-dealers and investment advisers make genuine efforts to supervise their associates. Vicarious liability and reputational harm remain powerful incentives to prevent violations. As Congress recognized, however, more is needed to induce them to go further than visible risk would dictate and to extend their purview beyond employees.

The *Reynolds* doctrine, of questionable SEC judicial provenance, undermines the statutory regime created by Congress to promote comprehensive supervision by broker-dealers and investment advisers. Its vague exhortation to no one in particular supplants defined relationships and performances. The insuperable standard eliminates all added incentive to supervise. What remains is lessened by removing primary responsibility for oversight from companies to their employees. A false dichotomy places most of it with conflicted "line" managers over dedicated, unbiased, "non-line" professionals specially trained to administer complex legal requirements that take precedence over business considerations. Expectations focus on those individuals' reactions to signs of wrongdoing over their administration of company-ordained procedures to prevent and detect specific violations. Central coordination is replaced by an admonition that individual supervisors should work together. The principle that holds the CEO or president, his or her delegate, or the CCO responsible for the entire organization's policies and procedures lessens their potential. The 1964 Amendments and their legislative history make clear Congress intentionally withheld jurisdiction over supervision from the SEC in favor of state law, self-regulation, and the Commission's ability to amend SRO rules (later

Finally, as Commissioner Peirce observed, "[j]ust because the Commission *can* do something . . . does not mean that [it] *should* do it." Peirce, *supra* note 401. It's hard to see how pinning the expectations for an entire organization's supervisory program on a single individual should maximize its potential; meanwhile its effect in limiting it should be obvious. The *Special Study* recommended the designation of senior executives "responsible for internal supervision and regulatory and self-regulatory matters generally," *see supra* note 188, but that focal point for administration and interaction with regulators was not intended to supplant management committees and other mechanisms of company governance that the Commission had identified at the heart of "centralized controls," *see supra* note 174, and that found their way into SRO rules, *see supra* note 422.

428. Initially, when broker-dealers had to rely on branch managers and other business heads to act as supervisors for compliance purposes, arguably sanctions were necessary to discourage them from subordinating their regulatory responsibilities to their pecuniary interests. (The company itself could be expected to discipline someone whose oversight failure contributed to liability without having to consider his or her other business contributions.) Instead of sanctions for what are essentially employment deficiencies, rules might require broker-dealers and investment advisers to appoint supervisors with no competing business responsibilities (in which case aiding and abetting liability should be sufficient to address any wanton misbehavior). *Cf.* Testimony of Charles W. Scharf Before the U.S. H. Fin. Servs. Comm. (Mar. 10, 2020), https://www.govinfo.gov/content/pkg/chrg-116hhrg42866/html/chrg-116hhrg42866.htm (The CEO and president of one of the nation's leading banks with broker-dealer and investment adviser operations reported the company moved to centralized compliance and make it independent of business in response to systemic violations.).

granting it narrowly over the misuse of material, nonpublic information).[429] The deleterious effects of *Reynolds* and its progeny on compliance with those regimes would seem to validate that decision.

Investor wealth, the health of the economy, and the country's well-being depend on the integrity of financial services providers. A large part of it rests on diligent supervision. As the law recognizes, to maximize these efforts, broker-dealers and investment advisers must be rewarded—by dispensing with derivative liability in disciplinary proceedings where oversight was appropriate.[430] By necessity, the standards must come from the industry itself. They rely on processes for establishing, enforcing, inspecting, and reevaluating policies and procedures that provide clear guidance on supervisory roles and assignments. Satisfaction depends less on the merits of methods that inevitably failed, than on genuine adherence to those processes.

Supervision is hard to judge: Success is immeasurable, while failure in the context of isolated misconduct can be deceiving. It is important, therefore, to evaluate statutory liability for it relative to the objective: to encourage broker-dealers and investment advisers to instill in themselves systems and procedures *reasonably designed* to prevent violations; and to extend to their associates supervisory liability only when they failed to do what they promised to do under those programs. Unfortunately, the design was discarded to implement ahead of time the legislation behind it. Formidable obstacles confront its reinstatement today, including a more attenuated SRO regime,[431] purposefully vague legal requirements,[432] and gained acceptance of the misguided notion of corporate

429. Section 15(g) of the Exchange Act and Section 204A of the Advisers Act authorize the SEC to make rules of supervision in the area. *See supra* note 49. In more than thirty years since the laws were passed, the Commission has not promulgated a single rule under them. In 2012, OCIE issued a report evaluating the information barrier procedures of select broker-dealers, *see* U.S. Sec. & Exch. Comm'n OCIE Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices Under Section 15(g) of the Securities Exchange Act of 1934 (Sept. 27, 2012), https://www.sec.gov/about/offices/ocie/informationbarriers.pdf (reporting on observations following the examination of nineteen broker-dealers' programs, identifying concerns and highlighting effective practices). It emphasized the report "*reflects the views of staff and does not represent findings or conclusions of the Commission*," *id.* at 4, adding the list of practices considered effective "is not intended to be prescriptive," is not a "safe harbor," and "other practices besides those highlighted . . . may be appropriate as alternatives or supplements," *id.* at 47. The results suggest the Commission is hard pressed to set intra-company supervisory standards as Congress originally anticipated.

430. This should apply to SRO actions as well. In the *Special Study*, the SEC cited the NASD's practice of dismissing supervisory cases against members that self-reported violations. *See supra* note 185.

431. *See generally* Hester Peirce, *The Financial Industry Regulatory Authority: Not Self-Regulation After All* (Geo. Mason Univ. Mercatus Ctr. Working Paper, 2015), https://www.mercatus.org/system/files/Peirce-FINRA.pdf. Among other things, representatives of member organizations now constitute a *minority* of FINRA's Board of Governors, *see FINRA Board of Governors*, *Composition*, FINRA, https://www.finra.org/about/governance/finra-board-governors#Composition (last visited Oct. 13, 2022), making the SRO less responsible to the industry it purportedly serves.

432. *See, e.g.*, SEC Rule 15*l*-1 (Regulation Best Interest), 17 C.F.R. § 240.15*l*-1 (2022).

> [W]hile we are declining to expressly define "best interest" in the rule . . . we are providing interpretations and guidance regarding the application of the specific component obligations . . . . [C]ompliance with each . . . including the "best interest" requirement . . . will be applied in a principles-based manner.

* * *

illegality.[433] Overcoming them will require rededication to self-government for professional and ethical standards, legal clarity, and renewed understanding of oversight as an institutional responsibility, with greater deference to the decisions made to carry it out, for broker-dealers, investment advisers, and their associates to do more to protect the public from miscreants in their midsts.

> [W]hether a broker-dealer's recommendation satisfies the requirement[] . . . is an objective evaluation that is not susceptible to a bright line test[.]

Regulation Best Interest: The Broker-Dealer Standard of Conduct (Final Rule), Exchange Act Release No. 86031, 84 Fed. Reg. 33318, 33333–34 (July 12, 2019). It is hard to know what to do to prevent an undefined violation.

433. *See* Mary Jo White, Chairwoman, U.S. Sec. & Exch. Comm'n, Speech at New York University School of Law Pollack Center for Law and Business, Program on Corporate Compliance and Enforcement, Entitled "A New Model for SEC Enforcement: Producing Bold and Unrelenting Results" (Nov. 18, 2016), https://www.sec.gov/news/speech/chair-white-speech-new-york-university-111816.html (discussing the SEC's policy, announced in January 2012, and expanded in June 2013, requiring legal entities to admit to wrongdoing in settlements in certain cases); *see also* Robert Khuzami, Dir., SEC Div. of Enf., Public Statement by SEC Staff: Recent Policy Change (Jan. 7, 2012), https://www.sec.gov/news/public-statement/2012-spch010712rskhtm; Edward Wyatt, *S.E.C. Changes Policy on Firms' Admission of Guilt*, N.Y. Times (Jan. 6, 2012), https://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html. Arguably, the idea of corporate illegality—inherently inconsistent—counteracts the tendency in the company to identify and extinguish unlawful conduct. Where it is accepted that a legal entity can behave illegally, it's to be expected that its operatives will promote whatever level of misbehavior the enterprise embraces. Culpability is mutualized, responsibility dissipates, and the risk of punishment for anyone in particular diminishes. "Corporate culture" shields a broad swath of participants from accountability.