Remarks Of

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"Failure to Supervise Revisited"

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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"Failure to Supervise Revisited"

I. Introduction

I appreciate the opportunity to participate in the National Society of Compliance Professionals ("NSCP") 1993 National Membership Meeting. I view such a meeting as timely since the securities industry is changing rapidly. While I suspect that I will not always agree with the NSCP's views, I am nonetheless interested in those views. I believe that communication with the industry enables me to do a better job as a regulator, and I expect that everyone agrees with the proposition that I need all the help that I can get. I certainly wish to encourage such continued communication between us.

It is my intention today to focus briefly on some of the proceedings that have been instituted by the Commission against legal and compliance professionals under the "failure to supervise" provision of Section 15(b)(4)(E) of the Exchange Act, since the issuance by the Commission of the Salomon Brothers report of investigation pursuant to Section 21(a) of the Exchange Act (the "Report").

II. Failure to Supervise Revisited

Under Exchange Act Sections 15(b)(4)(E) and 15(b)(6), a finding of liability for failure to supervise requires a finding that a person has failed reasonably to supervise another person who has committed violations of the federal securities laws, while subject to that person's supervision, and, insofar as any sanction is concerned, there also must be a finding that it is in the "public interest" to impose the sanction. Unfortunately, the legislative history behind these provisions provides little guidance as to what was intended by the phrase "subject to his supervision." This has led to a great deal of confusion as to just who can be a "supervisor" within the meaning of the failure to supervise liability provisions of the Exchange Act. The Report attempted to clear up this confusion.

Typically, a finding of failure to supervise liability involves two distinct considerations: one, whether the person was the supervisor of a person who violated the federal securities laws and, two, whether the person performed reasonably in discharging his supervisory responsibilities. Both of these questions ordinarily entail a fact specific inquiry, especially in the case of non-line personnel, such as most legal and compliance personnel, where the concept of supervisory responsibility is far less developed than in the case of "line supervisors." The fact specific nature of the past cases involving legal and compliance personnel have made it very difficult to achieve any analytical consistency in this area which, in turn, creates the need for clearer guidance.

In an attempt to clarify the confusion that apparently existed in the area of failure to supervise liability for non-line personnel, such as most legal and compliance personnel, which may have resulted from, among other things, the Huff decision,[1] and to make it clear that there can be liability for such non-line personnel under certain facts and circumstances, not necessarily dependent upon control or even upon hire, fire, reward or punish authority, the Commission addressed this issue in the Report. In my opinion, the key sentence in the Report in this area appears on page 23. "Rather, determining 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."

I continue to hold the view that the guideline for determining a "supervisor" for purposes of Exchange Act Section 15(b)(4)(E), as expressed in the text of the Report on page 23, is considerably broader than the definition of "supervisor" contained in the

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1 In re Arthur James Huff, Rel. Nol. 34-29017 (March 28, 1991).

concurring opinion in Huff and is somewhat broader than the definition of "supervisor" that appeared in most of the prior case law in this area. I believe it is important to make these points since failure to supervise enforcement cases probably will continue to be a high Commission priority in the near future.

I recognize that there has been a great deal of concern, bordering on hysteria, among legal and compliance personnel in the securities industry over the language of the Report. I do not believe that this concern is warranted, and the failure to supervise cases instituted by the Commission recently appear to support my belief. It may be helpful to discuss quickly these cases.

Since the issuance of the Report, there have been three significant proceedings instituted and resolved by the Commission involving an allegation of a failure to supervise reasonably. The first cases are entitled In the Matter of the Nikko Securities Co. Incorporated, Inc., Tsuneo Iida, Masanori Ishikawa, and Susumu Okada.[2] In this matter, a trader at Nikko U.S., a registered broker-dealer, engaged in unauthorized speculative foreign exchange transactions on behalf of the firm, losing over $18 million. The trader acted both as a speculative trader and as a member of the firm's accounting department with authority to make entries on the firm's accounting records. Because he held both positions, he apparently was able to successfully conceal his unauthorized trading. When Iida, the President and Chairman, Ishikawa, the Executive Vice President, and Okada, the Senior Vice President, learned of the unauthorized trading and loss of over $18 million, they also decided to conceal the loss from the Commission, the NYSE and the public. Their concealment resulted in the levy by the Commission of financial reporting and books and records violations.

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2 Rel. No. 32331 (May 19, 1993).

The Commission subsequently entered an order finding, among other violations, that Nikko failed reasonably to supervise the trader involved with a view to preventing violations of the financial reporting and books and records provisions. The three officers also were found to have aided and abetted the firm's financial reporting and books and records violations. Specifically, the Commission was of the view that the fact that the trader also held a position in the accounting department was highly irregular and that this circumstance, when coupled with the fact that the firm failed to separate the functions or to establish procedures reasonably designed to prevent or to detect efforts by the trader to make improper or unauthorized entries in the firm's accounting records, was sufficient to warrant a failure to supervise action against the firm. The Commission censured the firm and ordered it to comply with specific undertakings regarding its compliance policies, procedures, practices, and personnel.

The second case, or cases, that I wish to discuss are entitled In the Matter of Frederick H. Joseph[3] and In the Matter of Edwin Kantor.[4] These are the only two recent cases that I am aware of which rely, in part, on the Commission's language in the Report. These two actions involve the failure reasonably to supervise Michael Milken. Joseph, of course, was the CEO and Vice Chairman of the board of directors of Drexel. As CEO, he was a supervisor of Milken and manager of the firm's High Yield Convertible Bond Department ("HYBD"). Kantor was Senior Executive Vice President of Drexel and was Milken's immediate supervisor and a manager of the HYBD.

These two actions arise out of two schemes conducted by Milken, the first being his use of certain controlled entities (the "Partnerships"). Through the Partnerships,

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[3] Rel. No. 32340 (May 20, 1993).

[4] Rel. No. 32341 (May 20, 1993).

Milken engaged in manipulative trading and caused misrepresentations in connection with 18 new issues of securities Drexel underwrote and distributed through the HYBD. The second scheme was that Milken caused a registered investment adviser, who was fund manager of Finsbury Group, Ltd., an off-shore mutual fund, to make improper payments from fees to Drexel by using client assets for his own benefit. Importantly, Milken, Joseph, and Kantor had frequent conversations. In some of these conversations, Milken advised these individuals of certain activities through which he carried out these two schemes.

The Commission, citing the Report, stated that a CEO has the ultimate affirmative responsibility, upon learning of serious wrongdoing, to ensure that steps are taken to prevent further violations and to determine the extent of the wrongdoing. The Commission found, with respect to the new issues, that Joseph became responsible for ensuring that transactions in new issues did not result in violations when he exercised authority to clear Partnership purchases or otherwise had indications that the Partnerships were purchasing new issues. The Partnership purchases raised significant legal issues because Milken's department was responsible for pricing, allocating, distributing, and maintaining a secondary market for the securities that the Partnerships were purchasing. Joseph had this knowledge, but apparently took no action with a view to preventing the violations that resulted from the Partnerships' transactions in the new issues.

As to the improper payments by the investment adviser, the Commission found that through his discussions with Milken, Joseph should have, at a minimum, recognized red flags and acted to determine if the method of recouping fees was a violation. Again, by failing to act, or failing to conduct an inquiry, Joseph failed reasonably to supervise Milken with a view to preventing violations of the federal securities laws.

With regard to Kantor, the Commission found that he failed reasonably to supervise because he had the authority to affect Milken's conduct and because he was responsible for reviewing daily trading runs and giving prior approval to Milken before engaging in transactions in which he had an interest, such as the Partnership accounts. By Kantor's failure to act, he failed reasonably to supervise with a view to preventing Milken's violations. With regard to the investment adviser, when Kantor first learned that Milken was recovering part of the fee improperly, he took no action to prevent the practice.

Joseph and Kantor were both comprehensively barred from association in a supervisory capacity, with a right to reapply after three years to become associated in such a capacity.

The third case, or cases, that I wish to discuss are entitled In the Matter of PaineWebber Incorporated[5] and In the Matter of Robert A. Gardner.[6] These matters involve the failure reasonably to supervise by PaineWebber of six of its branch offices and the failure reasonably to supervise by Robert Gardner, one of its branch managers. In general, registered representatives at six PaineWebber branch offices made unsuitable recommendations to customers to purchase index options, misrepresented and failed to disclose risks in trading index options, misrepresented to customers the values of their accounts, engaged in unauthorized trades in customer accounts, and falsified customers' new account forms. In addition, one registered representative misappropriated customer funds, and one registered representative engaged in registration violations.

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5 Rel. No. 34-31889 (February 18, 1993).

6 Rel. No. 32273 (May 6, 1993).

The Commission examined the violative conduct charged with respect to each branch office and found that PaineWebber failed reasonably to supervise the registered representatives with a view toward preventing the violations. The Commission was of the view that PaineWebber failed to monitor the registered representatives trading activities, to enforce existing procedures, to make a proper investigation and respond to red flags, to prevent trades which were not approved by the compliance department, to prevent unauthorized trades, to monitor and to enforce existing PaineWebber policies, to design a policy and procedure to prevent registered representatives from cashing customer checks without proper authorization, and to monitor trading in customer accounts to determine if trades were at levels consistent with the customer's objectives and income, among other things. While there were significant compliance breakdowns at the firm's branch offices which PaineWebber failed reasonably to supervise, the case did not involve new or unique legal principles and did not rely on the Report to impose liability on PaineWebber.

The branch manger, Robert A. Gardner, as a direct line supervisor, was found to have failed reasonably to supervise a registered representative who allegedly made misrepresentations, employed strategies not suitable for his customers, engaged in excessive trading, and falsified customers' new account forms, among other violations. The Commission found that Gardner had the duty and responsibility to monitor trading and to follow certain supervisory and compliance procedures, but failed to do so. The Commission also found that he failed to detect or to respond reasonably to red flags.

The Commission censured PaineWebber and ordered it to comply with specific undertakings relating to adopting, implementing, and maintaining new compliance policies, practices, and procedures. Gardner was comprehensively barred from association in a supervisory capacity, with a right to reapply in three years to become associated in such a capacity.

From these aforementioned above cases, I acknowledge that it is premature to predict the ramifications of the Report in the failure to supervise area. The early results indicate, though, that the hand wringing exhibited by legal and compliance personnel concerning a potential flood of cases against legal and compliance personnel, as a result of the issuance of the Report, has not been justified to date.

While I do anticipate that failure to supervise cases will continue to be a high Commission enforcement priority, I am unaware of any attempt to "target" legal and compliance personnel for enforcement attention. Further, while the Report does make it clear that failure to supervise liability can extend to non-line personnel, including legal and compliance personnel, I would submit that such a course of action would not be unreasonable under the appropriate facts and circumstances.

I am of the view that the Commission will continue, "as a matter of course, [to] look at the facts in any given case, and raise the questions of what the compliance procedures were, how the process worked or failed to work, and how the individuals performed. Indeed, even the threshold question of whether to proceed against the firm or any supervisory personnel requires first an assessment [under Section 15(b)(4)(E)] of whether there were '(i) . . . established procedures. . . . which would reasonably be expected to prevent and detect, insofar as practicable, any such violation. . . and (ii) [whether] 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.' Beyond an assessment of whether the firm and/or the supervisory personnel may have 'failed to supervise,' the Commission staff does, in cases where it is an obvious issue, make a judgment as to the system, procedures and performance of the people charged with making compliance actually work.

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[The Report] does not say that with respect to every question and problem fielded by compliance personnel on a daily basis, that an individual's judgment is not only on the line, but also that he or she is exposed if others do not follow the advice and/or the directives given. The Commission did not state that every decision of the compliance and legal departments will now be second guessed. Rather, the [Report] dealt with an underlying violation of a very serious nature by a senior firm employee -- described by the chief legal officer himself as 'criminal' in nature.

. . .

The reaction to the [Report] by the industry has thus far been one of concern and resentment over a level of liability which people in positions of responsibility and authority similar to Feuerstein believe is misplaced. The objective, however, of holding an individual in this type of position to account is not to intimidate responsible compliance personnel into avoiding involvement in solving problems. Nor is the agency trying to set impossible-to-achieve standards of accountability. Rather, the Commission is making it clear that when such personnel are responsible within the firm for responding to very real problems, they are as accountable as others if they fail to respond reasonably."[7]

I view such a course of action as responsible, and cause for vigilance, but not as cause for hysteria. I challenge you today to be vigilant, not hysterical. "[The Report should give] more stature, more influence and more credibility to the input and advice which most legal and compliance personnel now render on a routine basis. [The

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7 McLucas and Hiller, "The Salomon Case and the Supervisory Responsibilities of Lawyers and Compliance Personnel, "Insights (May 1993), at 9, 10 & 11.

Report,] in effect, says as much to the brokerage firms and their management personnel about the gravity of taking a cavalier attitude toward the advice received from the compliance/legal personnel, as it does to those responsible for rendering that advice."[8] Viewed in this manner, I would like to think that the members of this audience would appreciate, rather than condemn, the Report.

III. Conclusion

In its enforcement program, the Commission has attempted to be tough and aggressive on the one hand and fair and reasonable on the other. That is a difficult balance to maintain and often results in actions that are thorough and effective but rather slow. I assure the NSCP that above all, the Commission strives to "do the right thing" in its enforcement program, even with respect to failure to supervise matters.

For almost 60 years, the Commission has attempted to protect investors without unnecessarily impeding the natural progression of market forces. The result to date has been a vibrant, active securities market, second to none. I intend to work with Chairman Levitt and my other colleagues on the Commission, and with the NSCP, among others, to perpetuate that result. While there may be differences in the approach taken from time to time, I know that everyone is committed to such a goal. I look forward to working with each of you in the future toward that objective.

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8 Id., at 12.