COMPLIANCE MISTAKES
FOR INVESTMENT ADVISERS AND FUNDS TO AVOID

Outline
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The regulatory landscape has changed dramatically for investment advisers and funds in the last few years. During that time, there has been a virtual onslaught of regulations adopted at an unprecedented rate, which have had more far-reaching and profound effects than ever before. This onslaught of new regulation has occurred simultaneously with an increase in enforcement activity and litigation being undertaken with remarkable ferocity. Much of this has been a reaction to recent industry scandals that have put advisers and funds under increased scrutiny, such as the scandals involving allegations of late trading and market timing in mutual funds.

The first section of this paper describes the current compliance landscape and outlines the major areas of legal exposure for advisers and funds resulting from compliance violations. The second section of this paper covers a list of compliance mistakes that all advisers and funds should avoid and provides a practical perspective on how they might be avoided.

I. THE CURRENT COMPLIANCE LANDSCAPE

A. The SEC Compliance Program Rules

Among the numerous rules recently adopted by the SEC are Rule 206(4)-7 under the Investment Advisers Act of 1940 ("Advisers Act") and Rule 38a-1 under the Investment Company Act of 1940 ("Company Act"). These might be considered the most salient to a discussion of compliance because they require, for the first time, that SEC-registered investment advisers and registered investment companies establish and implement compliance programs, meaning written policies and procedures designed to prevent violations of the federal securities laws.[1] Failure to establish and implement such a compliance program now constitutes an independent regulatory violation, regardless of whether or not an underlying violation has occurred.

B. Legal and Practical Exposures for Compliance Violations

Most compliance violations expose advisers and funds to potential legal liability on a number of levels, among them:

1. Regulatory liability

Compliance violations can result in regulatory liability in a number of ways, including:

- Direct violation of a specific regulatory requirement (for example, failing to keep books and records called for by applicable SEC rules)

- Failure to adhere to disclosed policies, which operates as a fraud against clients or investors (for example, disclosing in the prospectus a fund's policy prohibiting market timing and then arranging for undisclosed exceptions to the policy for certain investors)

- Breach of fiduciary duty, which falls within the ambit of Section 36(a) or (b) under the Company Act (breaches of duty involving personal misconduct or for excessive fees) or Section 206 of the Advisers Act (which has been interpreted to embody a federal fiduciary duty between an adviser and its client[2])

Regulatory liability can occur at either the federal or state level, regardless of where an adviser or fund is registered or, in cases, whether it is registered at all. Although enactment of the National Securities Markets Improvement Act of 1996 (NSMIA)[3] made some headway in dividing the regulatory universe between federally-registered entities subject to SEC jurisdiction and state-registered entities subject to the jurisdiction of state regulators, NSMIA made it clear that all entities must adhere to at least some regulatory provisions at both the federal and state levels,[4] most notably, the regulatory provisions aimed at protecting against fraud.

Of course, the various anti-fraud provisions of the federal securities laws generally apply to unregistered as well as registered persons.[5] At the same time, several provisions in NSMIA expressly avoid preempting or limiting a state's ability to investigate and enforce its own anti-fraud laws with respect to fraud and deceit, regardless of whether an entity is federally registered, state registered or not registered at all.[6]

Regulatory violations can exposure wrongdoers to both civil and criminal liability. Perhaps not surprisingly in the wake of recent industry scandals, there has been an increase in the number of actions that are being brought as criminal cases in lieu of or in addition to civil cases. [7] Moreover, regulators have a wide array of remedies and sanctions available to them to redress violations, including monetary fines, penalties, censures, cease and desist orders, suspensions of licensing and bars from the industry, as well as jail time or prison sentences in a criminal case.

2. Private plaintiff liability

In addition to regulatory liability, compliance violations expose advisers and funds to potential liability to private plaintiffs -- typically clients or shareholders -- who may be able to sue for compliance violations that cause them harm, regardless of whether the regulators are pursuing claims simultaneously for the same violation.[8] Among others, compliance violations may serve as the basis for private claims under the federal or state securities laws,[9] or for state law claims for breach of fiduciary duty or breach of contract.

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3. Personal liability and organizational (vicarious) liability

Whenever an individual officer, director or employee of an adviser or fund commits a compliance violation, both the individual and the adviser or fund may be exposed to legal liability for that violation.[10] In the past, a common response to individuals being named as defendants along with their firm was to "circle the wagons" and mount a joint defense, with the firm providing legal counsel and covering litigation costs for named individuals in addition to the firm. In appropriate cases, individuals were often reimbursed, indemnified or insured for amounts they were required to pay in settlement of or upon conclusion of cases pressed against them individually.

Recently, however, instead of circling the wagons, firms are more often terminating individuals implicated in wrongdoing and turning over their records to regulators in an effort to "cooperate" with the investigation and mitigate adverse effects for the firm, often at the expense of the individuals.[11] Moreover, there is a new phenomenon occurring in the regulatory arena, where regulators are requiring individuals who settle their cases to forego any right they may have to indemnification, insurance coverage, tax write-offs or other similar protections that would mitigate the "sting" of them having to pay *personally* any monetary penalty or other amounts assessed against them in the settlement.[12] This places individuals' personal assets at risk for compliance violations in a way not seen in the past.

4. Primary and secondary liability

Since case law limits the ability of private plaintiffs to impose secondary liability on defendants under certain securities laws, [13] plaintiffs' lawyers have become increasing "gymnastic" in recharacterizing conduct as primary or secondary, depending on what most benefits their claim. Similarly, regulators are becoming increasingly adept at holding "secondary" wrongdoers liable, by relying on claims such as failure to supervise (discussed more below). This has had the effect of broadening the scope of potential defendants who might be held liable for any given compliance violation.

5. Reputational risk

Compliance violations also risk damaging the reputation of all firms and individuals implicated or named in the violation, regardless of the outcome. The "indirect" impact of clients and shareholders who leave a firm as the result of a compliance problem, or who never engage or invest with the firm in the first place, can be as damaging as the "direct" impact of the violation itself (fines, damages, etc.), even if more ephemeral and difficult to measure.

This reputational risk is greater than ever in today's world, where self-appointed "scandal watch" groups will publicly steer investors away from organizations implicated in matters, sometimes before charges are brought and before any liability is established.[14]

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II. COMPLIANCE MISTAKES TO AVOID

Caveat: This is not an "official list" from any regulatory or other source. It is based on historical experience, statements by regulators, news reports and a fair amount of sheer prediction of what the future may hold in the new compliance regime. The list is not in any particular order.

MISTAKE #1 FAILURE TO INTEGRATE

Compliance is best approached as a "system" or "program" with considerable effort aimed at ensuring that the various parts of the system are integrated. Great risk results when compliance procedures are adopted in a haphazard, uncoordinated fashion, without a clear idea of what the system is intended to do and how the component parts fit into an integrated whole.

Fundamental to a properly integrated compliance system is ensuring that is has the appropriate scope, meaning that it addresses the right areas of activity. To determine what areas their compliance system should address, firms are expected to undertake a "risk-based analysis" to identify where their compliance risks are the greatest and where risks for conflicts of interest with clients or shareholders exist.[15] Policies and procedures should then be designed to address those risks. As a result, the policies and procedures appropriate for one organization may not be the same as those that are appropriate for another organization, due to differences in size, clientele, business operations and other characteristics that cause the risk factors to vary between them.

A well-integrated compliance system should also have appropriate depth, meaning that it should do more than restate applicable legal requirements. Rather, the system should include methods for:

- preventing compliance violations (which might include education and training, as well as appropriate checks and balances)
- detecting violations (which might include auditing, monitoring and "forensic" testing) and
- correcting violations (which might include spelling out internal lines of reporting, chains of command and checklists that are triggered in the event problems are detected)

in each area of activity covered.

Even a well-designed compliance system should be reviewed at least once a year and more often if developments warrant.[16] In addition, the system should be designed so as to mesh and coordinate to the extent relevant with other service providers serving the adviser's clients and fund's shareholders. This is particularly true for investment companies, which are now required to oversee the compliance of their "service providers" under Rule 38a-1.[17]

MISTAKE #2 FAILURE TO "DO WHATCHA SAY"

Advisers and funds should take all precautions against failing to adhere to their own policies and procedures. In certain cases, it can actually be worse legally if a policy is adopted and then not followed than if the policy had never been adopted at all. This is because material policies – even policies adopted voluntarily and not legally required -- ought to be disclosed[18] and, once disclosed, create potential anti-fraud liability if not

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followed. This heightens the risk for failing to "do whatcha say you're gonna do."

Here is a hypothetical example to illustrate this point: Mutual funds are not required to adopt a policy restricting their investments to domestic securities. However, if a fund nonetheless voluntarily adopts such a policy it must disclose the policy in its prospectus. If the fund then invests in foreign securities in contravention of both of its investment policy and prospectus disclosure, the fund may not have violated any regulatory restriction on its investments, but may indeed have violated the regulatory prohibitions against securities fraud, by using a prospectus that contains material misstatement or omission.

Failure to adhere to one's own internal policies and procedures is a common theme for SEC enforcement action.[19] All of this suggests that advisers and funds ought to adopt only policies and procedures that they can realistically follow and that actually serve to meet their compliance goals. This is one area where it pays to be proactive rather than reactive.

MISTAKE #3 FAILURE TO "LOOP"

It is important but not always easy to identify everyone who needs to be in the compliance "loop" and then to keep them informed and trained on compliance matters. Nonetheless, education and training of all personnel with compliance responsibilities must be a priority in order to have an effective compliance "system."

In many organizations, responsibility for this task is likely to fall to the chief compliance officer ("CCO"), who under the SEC compliance program rules is charged with the responsibility for administering the organization's policies and procedures.[20] This means CCOs will have to plan for matters such as:

- identifying where specific personnel fit into the compliance "loop"
    - this will require a fairly comprehensive understanding of the organization's business and what activities are undertaken in specific areas
- implementing methods for educating and training personnel on the compliance matters pertinent to their areas of responsibility
    - this may take the form of individualized training plans involving attendance at outside conferences or workshops, attendance at in-house training sessions and/or participation in "dry runs" or drills designed to test compliance outside of a "real time" environment
- finding effective methods for keeping personnel up-to-date on compliance developments affecting their areas
    - this commonly involves periodic internal communiqués and in-house compliance meetings
- keeping themselves and other compliance department personnel up-to-date on compliance developments
    - this might include attendance at industry compliance conferences and subscribing to relevant industry publications, as well as having a close interface with in-house or outside legal counsel.

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Perhaps surprisingly, the challenge of keeping everyone in the compliance “loop” is not limited to small organizations that might lack the resources for training and education. Large organizations too can find it difficult to even identify all the right personnel, let alone keep them effectively in the compliance loop in often far-flung and loosely connected locales. Yet it is imperative to meet this challenge in light of the ever weakening viability of the defense that the right hand didn’t know what the left hand was doing.[21]

MISTAKE #4 FAILURE TO SUPERVISE

Advisers and funds can be held liable for failure to supervise other persons who are deemed to be subject to their supervision. The SEC has long been active in bringing failure to supervise claims against advisers based on the implied obligation to supervise[22] found in Advisers Act Section 203(e)(6).[23] Using a failure to supervise claim is one way regulators can recharacterize “secondary” conduct -- that is, conduct that was not directly responsible for the compliance violation, but was in some way peripherally involved in it -- as “primary” liability. The underlying theory seems to be that a failure to supervise sets up circumstances that allow supervised persons to “get away with” compliance violations[24] and that by imposing on supervisors the responsibility to supervise reasonably, clients and investors are provided with another means of protection from harm.

Most of the SEC’s failure to supervise claims involve supervision of individuals within the same firm or organization. However, supervisory responsibilities do not necessarily stop at organizational boundaries. This point was driven home by a 2001 administrative proceeding brought by the SEC against an adviser for failure to supervise an employee of a sub-adviser based on the facts of that case, where the adviser was found to have a “supervisory relationship” with the sub-adviser’s employee.[25]

Funds too now face this issue squarely under Rule 38a-1, which specifically requires them to adopt policies and procedures that provide for the oversight[26] of compliance by their service providers.[27] It is irrelevant under the rule whether the service provider is part of the fund’s organization or in any way affiliated with the fund or not.

The most effective method for avoiding Mistake #4 is to set up an effective compliance system that includes reasonable measures to supervise those subject to supervision. That way, advisers can take advantage of the affirmative defense to a failure to supervise claim afforded by Section 203(e)(6) when a reasonable compliance system is in place and funds will get whatever defensive advantage is afforded by their compliance with Rule 38a-1.

MISTAKE #5 FAILURE TO FOLLOW UP ON “RED FLAGS”

“Red flags” are evidence or indications that suggest something is awry, that warn about irregularities or about a possible compliance violation. Failure to follow up on a “red flag” warning of a problem can be as damaging as the problem itself. Ignoring “red flags” can be interpreted -- at best -- as sloppy business practices or a lack of reasonable superivision. Worse yet, it can be interpreted as bad faith or wrongful intent or participation in a cover-up. In cases, it may trigger regulatory action where regulators

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might otherwise decline to pursue a formal proceeding, or may prompt them to impose a more severe penalty for the underlying violation.

The SEC has often cited failure to follow up on red flags as a factor in its enforcement actions, particularly in cases involving a failure to supervise.[28] The SEC's view of the matter was summed up as follows: "Remember, in order to counter failure to supervise charges, an adviser must have established procedures and have a system for applying the procedures that reasonably can be expected to prevent and detect securities law violations by supervised persons. Also, supervisors must reasonably discharge their obligation under the procedures. <u>When they see 'red flags' and suggestions of irregularities, they must make inquiries and conduct adequate follow-up</u>."[29]

<u>MISTAKE #6 FAILURE TO "STEP UP"</u>

Failure to "step up to the plate" once a compliance problem has come to light can lead to devastating results. Here are but three of the ways this can occur:

<u>First</u>, failing to act promptly to correct or rectify a problem can cause a relatively minor problem to quickly morph into a major problem. The quintessential example of this might be an adviser who purchases a security into a client's account that is later determined to contravene the investment restrictions on the account. By the time the problem is discovered, market action has caused the value of the security to drop so that if the security were liquidated in order to bring the account back into compliance, the security would have to be sold at a loss. But, instead of acting promptly to rectify the situation, the adviser makes the decision to wait, hoping that the market value of the security will go up and permit it to be liquidated at a gain. The simple decision to wait sets up a high-risk gamble that can quickly get out of hand. If instead of going up, the value of the security continues to go down, the compliance violation will simply continue to get bigger and bigger.[30] Moreover, instead of having caused the violation innocently or merely negligently, the adviser might be faced with allegations that it acted in bad faith, or willfully, recklessly or intentionally, with all the attendant legal consequences.[31]

A <u>second</u> way that failure to "step up to the plate" can lead to devastating results is when those involved in a violation try to avoid responsibility for their actions. This type of conduct can actually create more liability than there otherwise would be. It is not surprising -- human nature being what it is -- that individuals will attempt to shift blame elsewhere or minimize their culpability when things go awry. But those attempts can lead to even bigger trouble and, indeed, amount to crimes if they involve lying to investigators, destroying documents or instructing or coercing others to do so.

In several noteworthy cases, the attempt to avoid blame or hide evidence has resulted in *criminal* convictions where the matter under investigation ultimately did not result in *any* charge at all, or in only a *civil* charge, against the defendant. For example:

- Martha Stewart, who was not indicted for the insider trading that was under investigation following the sale of her ImClone stock. Rather, she was charged with -- and convicted of -- conspiracy, obstruction of justice and making false statements arising from her conduct during the investigation.

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- Arthur Andersen, which was indicted for and convicted of obstruction of justice based on destruction of documents that occurred during the investigation of the Enron matter, and not for work rendered during its engagement as Enron's auditor.
- James P. Connelly, Jr., former Vice Chairman and Chief Mutual Fund Officer of Fred Alger & Company, Inc., who settled a civil administrative action with the SEC over allegations of permitting improper market timing. Although the SEC brought only civil charges, Connelly was also charged criminally by the New York State Attorney General and convicted of tampering with evidence as a result of directing subordinates to delete e-mails called for by a subpoena issued in the investigation and coaching them to falsely report facts relevant to the investigation.[32]

This is not to suggest that these three defendants – or anyone else – should simply "roll over" and not mount a proper defense to accusations, allegations or charges. Rather, it is to emphasize that whatever actions are taken in response to accusations, allegations or charges to avoid "stepping up" can themselves lead to trouble quite independently of the underlying problem.

Moreover, the government has instituted a number of measures to encourage organizations to "step up" and "self-report" wrongdoing and to take other measures to "cooperate" with investigators.[33] The SEC has specifically named "self-reporting" as one factor it uses to determine whether and how to take enforcement action in response to a particular violation.[34] Wrongdoers who get "credit" for self-reporting -- along with self-policing, remediation and cooperation – may get reduced charges, lighter sanctions or less harsh language in the documents used to announce and resolve enforcement actions, or in extraordinary cases, may be able to avoid SEC enforcement action altogether.[35] As a result, organizations face more pressure than ever to "step up to the plate" and not only admit wrongdoing but become an active participant in rectifying it.

A <u>third</u> way that failing to "step up" can be devastating is failing to respond to requests for documents, either in connection with an SEC request or in response to formal process such as a subpoena. If records are stored on electronic media, advisers and funds are required to arrange and index the records to permit easy location, access and retrieval and must provide *promptly* any copies requested by the SEC.[36]

However, perhaps understandably, some organizations seem to be having trouble handing over requested documents that take the form of email. For example, the Bank of America was recently fined a record $10 million for failing to hand over documents requested by the SEC in an investigation, reportedly due in part to the difficulty of retrieving archived email.[37] This should serve as a wake-up call to advisers and funds that failing to "step up" with email can be just as devastating as failing to "step up" with any other type of document.[38] The special features and challenges posed by email need to be considered as firms create, store and make retrievable their electronic records consistent with regulatory expectations.[39]

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III. CONCLUSION

This discussion of the current compliance environment and compliance mistakes that all advisers and funds should avoid will help them to navigate through the dramatically changed regulatory landscape that has developed over the last few years.

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[1] For a more complete discussion of the SEC compliance program rules, *see* the CLEOnline.com seminar entitled "COMPLIANCE PROGRAMS FOR INVESTMENT ADVISERS AND INVESTMENT COMPANIES" and the paper by Schnase, Lorna, entitled "The New and Improved Compliance Environment: A Q&A on the New Compliance Program Requirements for Advisers and Funds" provided as part of the library materials with that seminar.

[2] *See* Securities and Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 18 (1963).

[3] The National Securities Markets Improvements Act, Public Law 104-290, was enacted October 11, 1996, effective July 8, 1997, and, among other things, amended portions of both the Advisers Act and the Company Act.

[4] For a more complete discussion of the federal and state registration and other regulatory requirements as they apply to investment adviser and investment adviser representatives, *see* the CLEOnline.com seminar entitled "RUNNING THE TRAPS: FEDERAL VERSUS STATE REGISTRATION OF INVESTMENT ADVISERS AND INVESTMENT ADVISER REPRESENTATIVES" and the paper by Schnase, Lorna, with the same title provided as part of the library materials with that seminar.

[5] For example, Section 206 of the Advisers Act prohibits "any investment adviser" (not only "registered" advisers) from engaging in the activities prohibited there, and Rule 10b-5 under the Securities Exchange Act of 1934, prohibits "any person" from engaging in fraud in connection with the sale of securities.

[6] *See, for example*, Section 203A(b)(2) and Section 222(d) of the Advisers Act.

[7] *See*, *for example*, In the Matter of James Patrick Connelly Jr., Respondent, SEC File No. 3-11303 (October 16, 2003), a civil administrative action brought by the SEC against and settled by the former Vice Chairman and Chief Mutual Fund Officer of Fred Alger & Company, Inc., a prominent mutual fund firm, for his involvement in allowing selected investors to market time their funds. Connelly also pled guilty to the crime of Tampering with Physical Evidence, a class E felony, for which he was sentenced to 1 to 3 years in state prison on charges brought by the New York State Attorney General's office stemming from its investigation of the same matter. *The People of the State of New York v. James P. Connelly Jr.*, SCI - 5648/03 (N.Y. Sup. Ct.) (2003). SEC press release: http://www.sec.gov/litigation/litreleases/lr18541.htm

[8] For example, it has been reported that there are some 300 private lawsuits pending against certain of the mutual fund companies that have also been pursued by federal and/or state regulators for alleged market timing violations. While the defendant companies may be able to argue that their settlement payments to the regulators have already made shareholders whole, private plaintiffs are expected to claim that the regulatory settlement did not rectify everything. *See* Deane, Stephen, "SOX Leads to Restitution for Investors," Institutional Shareholder Services website at http://www.issproxy.com/governance/publications/2004archived/129.jsp.

[9] Certainly, not all the securities laws support a private right of action, but many do. For a discussion of private rights of action under the securities laws, *see* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

[10] This would generally be the case, for example, through the application of straightforward principles of agency law, with employers exposed to liability on a theory of imputed or vicarious liability.

[11] *See, for example,* the Connelly case, *supra* at note 7. According to an SEC press release, Connelly's former employer, Alger, actually reported the allegations of tampering to the New York Attorney General's office and cooperated in the investigation that culminated in the criminal charges filed against Connelly. New York AG and SEC Bring Criminal and Civil Actions Against Mutual Fund Executive, SEC Press Release 2003-138 at http://www.sec.gov/news/press/2003-138.htm.

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[12] This was confirmed in the remarks of Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute in Chicago, Illinois (April 29, 2004) available at http://www.sec.gov/news/speech/spch042904smc.htm, who stated: "[T]o enhance deterrence and accountability, the Commission recently has adopted a policy requiring settling parties to forgo any rights they may have to indemnification, reimbursement by insurers, or favorable tax treatment of penalties." Also, regulators are more often asking respondents to waive the attorney-client privilege as part of their "cooperation."

[13] For example, the U.S. Supreme Court has held that there is no private right of action for secondary "aiding and abetting" liability under Rule 10b-5. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, et al., 511 U.S. 164 (1994). In the wake of the Enron scandal, legislation was discussed which would "roll back" the effect of the Central Bank decision and restore aiding and abetting claims for private plaintiffs under 10b-5. *See* "Markey Questions SEC on Protections for 'Aiding And Abetting' Investor Fraud; Responsibility for Fraud Should be Shared by Enablers" at http://www.house.gov/markey/Issues/iss_finance_pr020524.htm. However, to date, no such legislation has been enacted.

[14] *See, for example*, Morningstar's recommendations on the fund scandals at http://www.morningstar.com/fii/fundindustryinvestigation.html?fsection=rightspotlight2.

[15] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204 and IC-26299 (December 17, 2003) ("Adopting Release") at Section II.A.1.

[16] The SEC's compliance program rules actually require policies and procedures to be reviewed not less than annually. Rule 206(4)-7(b) and Rule 38a-1(a)(3).

[17] Rule 38a-1 expressly requires oversight of a fund's advisers, principal underwriters, administrators and transfer agents, but the Adopting Release states that this does not lessen a fund's obligation to consider compliance as part of its decision to employ other entities, such as pricing services, auditors and custodians. Adopting Release, *supra* note 15, at footnote 28.

[18] Material adviser policies usually appear in the adviser's Form ADV. Material fund policies usually appear in the fund's prospectus or Statement of Additional Information (SAI).

[19] *See, e.g.*, In the Matter of Fleet Investment Advisors Inc., Advisers Act Rel. No. 1821 (September 9, 1999)(case settled without respondent admitting or denying wrongdoing), in which a substantial portion of the SEC's findings were devoted to a description of the adviser's circumvention of its own internal policies and procedures.

[20] Rule 206(4)-7(c) and Rule 38a-1(a)(4).

[21] Perhaps the most significant undercutting of this defense occurred with the enactment of the Sarbanes-Oxley certification requirements, where certifying officers of registered investment companies (and publicly traded advisory firms) must now certify as to the establishment and maintenance of controls over financial reporting and disclosure and as to the fact that the information contained in certified periodic reports fairly presents, in all material respects, the financial condition and results of operations of the issuer. *See* Section 302 and Section 906 of the Sarbanes-Oxley Act of 2002 and SEC Rules 30a-2 and 30a-3 under the Company Act.

[22] Section 203(e)(6) authorizes and directs the SEC to take certain specified administrative actions against an adviser if it finds the adviser has failed to reasonably supervise another person who commits a violation, if the other person is subject to the adviser's supervision. From this, it is implied that advisers have the duty to supervise.

[23] *See, e.g.*, Fanam Capital Management, Richard J. Ennis and Seth Morgulas, Advisers Act Rel. No. 2316 (Oct. 24, 2004) (officer of unregistered hedge fund adviser failed to supervise another firm officer under his direction, who traded and handled investor money in violation of federal securities laws); Oechsle International Advisors, L.L.C., Advisers Act Rel. No. 1966 (Aug. 10, 2001) (adviser failed to supervise portfolio manager who had manipulated the closing price of certain securities held in advisory accounts); In the Matter of Rhumbline Advisers and John D. Nelson, Advisers Act Rel. No. 1765 (Sept. 29, 1998) (adviser and CEO failed to reasonably supervise CIO with a view to detecting and preventing his securities law violations); First Capital Strategists, Advisers Act Rel. No. 1648 (Aug. 13, 1997), 1997 SEC LEXIS 1646 (adviser and its partners failed to supervise trader who engaged in unauthorized trading, noting that it was insufficient to rely on trustworthiness of trader without independently reviewing positions); Van Kampen American Capital Asset Mgmt., Advisers Act Rel. No. 1525 (Sept. 29, 1995) (adviser failed to supervise because it gave complete control over pricing procedures to portfolio manager). These proceedings were settled without respondents admitting or denying wrongdoing.

[24] This theme seems to underpin a recent failure to supervise claim pressed by the SEC against a broker-dealer firm as well. *See* In the Matter of Knight Securities L.P., Securities Exchange Act of 1934 Release No. 50867 (December 16, 2004) ("Knight"). In that case, the SEC spelled out some of the organizational problems that supported its claim that the firm failed to reasonably supervise its Leading Sales Trader who conducted "best execution fraud." First, the firm failed to maintain an effective review system in the form of exception reports or some other mechanism to reasonably monitor and prevent the violations caused by the Leading Sales Trader. Second, the Leading Sales Trader was directly supervised by his brother, who was the head of the institutional sales desk and who, in addition to being his brother and supervisor, had

a profit-sharing arrangement with the Leading Sales Trader. Their relationship, their positions and responsibilities within the firm and their profit-sharing arrangement created an inherent conflict of interest that, according to the SEC, contributed to a substantial breakdown in the supervision over the Leading Sales Trader.

[25] Western Asset Management Co. and Legg Mason Fund Adviser, Inc., Advisers Act Rel. No. 1980 (Sept. 28, 2001; case settled without respondent admitting or denying wrongdoing). For a more complete discussion of this case and of the obligation to supervise generally, *see* the CLEOnline.com seminar entitled "AN INVESTMENT ADVISER'S DUTY TO SUPERVISE ITS SUB-ADVISERS" and Schnase, Lorna, "Supervision of Sub-Advisers," *The Investment Lawyer* (December 2003 and January 2004).

[26] One may be able to argue that "supervising" another person is somehow substantively different from and more onerous than simply "overseeing" them, but there is no clear indication in any reviewed SEC releases or proceedings that there is an intended distinction in that terminology.

[27] Rule 38a-1(a)(1). *Also, see supra* note 17, for a list of a fund's "service providers" under the rule.

[28] *See, e.g.*, the Western Asset Management case, *supra* note 24, where the failure to follow up on red flags was repeatedly cited as part of the adviser's failure to supervise in that case. *See also*, In the Matter of Rhumbline Advisers and John D. Nelson, *supra* note 23.

[29] Speech by SEC Staff: Meeting the Compliance Challenge, Remarks by Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Before the Investment Counsel Association of America, Scottsdale, Arizona (April 23, 1999) (emphasis added) at http://www.sec.gov/news/speech/speecharchive/1999/spch271.htm.

[30] For a more ludicrous but real-life example of a compliance problem getting out of hand, consider the case of former financier Martin Frankel, who was convicted to more than 16 years in prison for bilking several insurance companies out of $200 million, all after having been previously banned for life from the securities industry by the SEC for conducting a similar scheme in prior years. Believe him or not, Frankel claims he began stealing with apparently benevolent intentions to help his girlfriend's children. When the judge questioned Frankel why he needed $200 million to help the children, Frankel said things just "got out of hand." *See* NBC.com news story posted December 10, 2004 at http://www.wnbc.com/money/3989291/detail.html.

[31] In addition to providing an essential element to legal claims that might not otherwise exist, bad faith or willful, reckless or intentional misconduct can cause insurance and/or indemnification coverage to not apply. *See* Sections 17(h) and (i) under the Company Act.

[32] For more on this case, *see supra* note 7.

[33] This might include terminating or reassigning the responsible individuals, doing an internal investigation and turning over the results to governmental investigators, waiving the attorney-client privilege and other extraordinary measures. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Securities Exchange Act of 1934 Release No. 44969 (October 23, 2001) at http://www.sec.gov/litigation/investreport/34-44969.htm.

[34] *Id*. See also, Remarks of Stephen M. Cutler, *supra* note 12.

[35] *Id*. See also, Chapter Eight – Sentencing of Organizations in the 2004 Federal Sentencing Guideline Manual (as effective November 1, 2004) at http://www.ussc.gov/2004guid/CHAP8.htm, which cites self-reporting as a factor that can potentially mitigate the fine or other sentence imposed when an organization is convicted of a criminal offense.

[36] *See* Rule 204-2(g) under the Advisers Act and Rule 31a-2(f) under the Company Act. Under those rules, advisers and funds must also establish and maintain procedures to safeguard the records from loss and destruction, limit access to authorized personnel and ensure that reproductions are complete and accurate.

[37] *See* Caffrey, Andrew, "Bank of America Fined Record $10 Million," Boston Globe (March 11, 2004) at http://www.boston.com/business/articles/2004/03/11/bank_of_america_fined_record_10m/.

[38] One news source has reported that some firms are spending upwards of $100,000 per month or more to have lawyers cull through archived emails in order to respond to SEC requests for email. Frankie, Chris, "Costs of SEC E-Mail Requests Skyrocketing," posted on the Ignites.com website (December 14, 2004).

[39] In an administrative proceeding brought recently against Knight, a registered broker-dealer firm, the SEC provided an explicit indication of what Knight had done with its email which the SEC found failed to meet the firm's books and records obligations under the federal securities laws: "Knight stored employees' e-mails on a back-up tape drive for a period of only 30 days -- notwithstanding the fact that the federal securities law required the Firm to retain e-mails for a three-year period. After the 30-day period passed, Knight re-used the tape drive and wrote-over the prior e-mails. The e-mail data

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was not otherwise retained. In addition, Knight's backup system only captured e-mails that were present at the time of the backup and thus would not capture any e-mails that might have been deleted during the day." Knight, *supra* note 24.

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