GUEST COLUMN

NY City Bar Association Issues Report on CCO Liability: New Recommendations for the SEC

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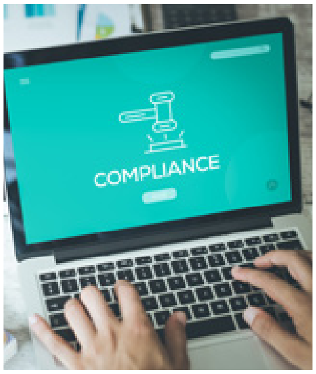
At every financial firm there is at least one person serving as Chief Compliance Officer (CCO) charged with creating and enforcing a compliance manual and ensuring that the firm complies with its legal and regulatory obligations. The functions CCOs serve ultimately protect investors. At large institutions, there can be hundreds or even thousands of people involved in compliance efforts. However, in recent years, these essential gatekeepers have faced increased regulatory focus on holding them personally liable for institutional failures, often arising out of assessments made in hindsight regarding what compliance officers or programs ought to have detected or prevented.

A recent report by the New York City Bar Association (NYCBA) and others – Chief Compliance Officer Liability in the Financial Sector – details concerns about compliance officer liability and calls on regulators to provide limitations and guidance on when a compliance officer can be charged. The concerns in the report are summarized below.

Over the past few years, agencies that regulate the financial sector have chosen to prosecute CCOs at financial firms, alleging that they personally violated securities laws or that they "caused" their firms to violate these laws. While the report is clear that the authors have no sympathy for bad actors, including those that are involved in fraud or obstructing regulators, there is concern that certain of these cases appear to involve compliance officers who have in good faith attempted to ensure compliance and/or remediate noncompliance.

In the absence of more explanation or guidance, these cases appear to be classic "prosecution by hindsight." They also fail to take into account the unique structural obstacles compliance officers face. Compliance officers are required to make decisions with limited guidance in real time on how complex transactions should comply with complex regulatory regimes. Recent regulatory directives have imposed greater duties and requirements on compliance officers, including having to police areas such as privacy and cybersecurity that have not traditionally been the purview of a compliance officer. Despite these greater requirements, compliance officers frequently do not have the ability to unilaterally effect change in their firms. Rather, they depend on the firm's businesspeople to implement initiatives designed to ensure that compliance directives are followed.



"[A] compliance officer can be charged if, among other things, he or she has exhibited 'wholesale failure' to carry out his or her responsibilities. However, this standard has not been clearly delineated from operational failures or missteps that fall short of a 'wholesale failure' to discharge duties."

Without greater guidance, compliance officers are increasingly hesitant, worried that if regulators later disagree with their judgment, their careers may be ruined, or at best, they will be financially harmed by having to defend themselves against costly government investigations. In many cases, compliance officers are leaving the profession for a less risky one.

For their part, regulators have attempted to make clear that they are not "targeting" compliance officers. In a 2016 speech providing some guidance on the topic, then-Director of the Division of Enforcement of the Securities and Exchange Commission (SEC) Andrew Ceresney stated that a compliance officer can be charged if, among other things, he or she has exhibited "wholesale failure" to carry out his or her responsibilities. However, this standard has not been clearly delineated from operational failures or missteps that fall short of a "wholesale failure" to discharge duties. The SEC and the Financial Industry Regulatory Authority (FINRA) in recent years have, to their credit, also offered some additional guidance in recent enforcement actions, but prior enforcement actions remain a concern, SEC [and FINRA] leaders come and go, and enforcement priorities change. More formal, longer-lasting steps must be taken to restore the compliance community's confidence and trust.

As a result, the report calls on regulatory agencies

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to implement several recommendations. First, regulatory agencies should provide formal guidance on what factors would lead them to consider or reject a case of compliance officer liability, including factors such as whether the compliance officer engaged in good faith, and whether structure or resource challenges hindered the compliance officer's performance. Second, agencies can use existing methods of communication, such as FAQs, other informal guidance documents, or settled prosecutions, to explain more fully the circumstances where an enforcement action against a compliance officer is necessary. Third, regulatory agencies and compliance officers should have an ongoing, meaningful and informal method of communications before the fact, to help compliance officers more easily make decisions. Fourth, the regulators should set up a formal advisory board with leaders in the compliance community to discuss issues of mutual concern. In summary, the report notes that compliance officer liability should be considered with significant deliberation.

These reasonable recommendations do not require fundamental regulatory or legislative reform and would be meaningful to the compliance community. With the adoption of some important steps, regulatory agencies, the compliance community, and the investing public can continue working together to achieve the mutual goals of regulatory compliance and fair and efficient capital markets.

Adam Felsenthal is Deputy Chief Compliance Officer and Counsel of Great Point Partners, LLC, a hedge fund and private equity firm focused on the healthcare industry. He is also Secretary of the Compliance Committee of the New York City Bar Association (NYCBA). This article is written in Mr. Felsenthal's capacity as Secretary.