PUBLICATIONS

DC Circuit Affirms Disciplinary Action Against Compliance Chief

SRZ Private Funds Regulatory Update

November 2020

On Oct. 23, 2020, the United States Court of Appeals for the District of Columbia upheld two disciplinary orders by the SEC, finding there was "substantial evidence" that the former chief compliance officer of a broker-dealer had missed clear "red flags" and had failed to ensure review of electronic correspondence.[1]

Although this case involved a disciplinary action pursuant to the Securities Exchange Act of 1934, the same standard of review applies to federal judicial review of SEC disciplinary actions under the Investment Advisers Act of 1940.[2]

The former CCO initially was found to have violated Financial Industry Regulatory Authority ("FINRA") rules related to disclosure and monitoring, including failure to report a relationship with a statutorily disqualified individual, to develop written supervisory procedures ("WSPs") for review of electronic correspondence, to conduct review of electronic correspondence consistent with the firm's existing policies and to enforce WSPs. At his disciplinary hearing, the former CCO had defended his actions, in part, saying "all email review is boring."[3]

Before review by the federal courts, the SEC had upheld FINRA's disciplinary action in separate decisions in 2018 and 2019. In the 2018 decision, the SEC offered insights into how it thinks about CCO liability, saying it is guided by "the principle that, in general, good faith judgments of CCOs made after reasonable inquiry and analysis should not be

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second guessed. In addition, indicia of good faith or lack of good faith are important factors in assessing reasonableness, fairness and equity in the application of CCO liability."[4]

In both decisions, the SEC questioned whether FINRA should have also charged the firm (which was no longer registered): "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 compliance failures — that it is in their interest to have effective, diligent compliance officers to help them remain in compliance with their obligations."[5]

The SEC also suggested an action against the CEO might have been warranted: "It is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention. . . . Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised."[6]

The case outlines the principles guiding the SEC on decisions regarding CCO liability and reinforces the SEC's view that compliance failures are not solely the responsibility of the compliance department. In the appropriate case, the firm and/or principals may be held responsible for the CCO's actions and inactions.

This article appeared in the November 2020 edition of SRZ's Private Funds Regulatory Update. To read the full Update, click here.

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[1] *North v. SEC,* No. 18-1341 (D.C. Cir. Oct. 23, 2020).

[2] A court must uphold the Commission's decision unless it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A); *see Kornman v. SEC*, 592 F.3d 173, 184 (D.C. Cir. 2010). The Commission's findings of fact are conclusive when supported by substantial evidence. 15 U.S.C. § 80b–13(a).

[3] *In re Thaddeus J. North*, Admin. Proc. File No. 3-17909, Oct. 29, 2018 ("2018 Decision"), at 3.

[4] *Id.* at 12

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[5] *Id.* at 13 (internal quotations omitted); *In re Thaddeus North*, Admin. Proc. File No. 3-18150, Nov. 27, 2019 ("2019 Decision"), at 8 (internal quotations omitted).

[6] 2018 Decision at 13; 2019 Decision at 8.

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