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# PERSPECTIVES FROM THE COMMISSION TABLE: SUPERVISION

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

Perspectives from the Commission Table: Supervision

Having heard John Phelan and "Stretch" Gardiner exhort you to ever-higher efforts at saving

- the individual customer,
- the firms,
- the securities industry,
- the financial services sector and
- American capital markets generally,

it doesn't seem to me there's anything left for me to exhort you to save. Having heard a variety of panelists try to teach you the ever-more-intricate details of Congressional, SEC, SRO and Firm requirements seeking to achieve

- customer protection,
- firm profits,
- industry revival and
- national redemption,

it doesn't seem to me there's anything left for me to preach in the area of compliance. Besides, it's the third day of this Compliance and Legal Division Annual Conference -- and, after two days and three nights of seminars and social-time discussions, with the annual Fitz-and-Phil-show (reviewing the year's litigation results) that concludes the Conference only three hours away, it's time to begin putting things into perspective. So let's call this presentation "Perspectives from the Commission Table", and let's start with the Trujillo 1/ opinion dealing with supervision requirements.

Trujillo is one of those few cases that was actually argued before the Commission -- not simply briefs and papers but oral argument. And it was argued by an excellent barrister who understood that he had to cut through the several inches of paper and the plethora of issues to get the Commissioners to recognize and react favorably to the core of his argument.

[Remember that requirement if you ever have a matter to be presented to the Commission:

1. The matter wouldn't be there if there wasn't some person or some entity -- you, your client, your colleague, or your firm -- that had failed two or three times before to persuade Staff and Commission, or Administrative Law Judge, that the charges were unjustified as to that particular "alleged perpetrator".

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1/ In the Matter of Louis R. Trujillo, Securities Exchange Act Release 26635, 43 SEC Docket (CCH) 735 (1989).

2. The legal arguments are various, detailed and lengthy, with a real likelihood that at least some of the charges alleged will stick to the wall -- and that's all the prosecuting staff needs.
3. So, you've got to awaken, surprise and persuade the Commissioners, and I think you've got to do it in the first five minutes.]

You know the facts of Trujillo: Victor Matl was a rogue broker; Louis Trujillo was neither the registered representative nor the branch manager; he worked for the branch manager, with duties that required him to review daily transaction runs and made him responsible for detecting problems, but with authority that stopped short of the ability to discharge or suspend a salesperson or censure a salesperson's activities. The branch manager alone could choose, or choose not, to act. The branch manager had been prosecuted (and had settled) long before. 2/ Louis Trujillo, with the backing of his firm, fought the prosecution through the A.L.J. decision right up to the oral argument. And Bob Romano, Trujillo's lawyer, did get his message through. He put it all in one phrase: if the Commission holds Louis Trujillo liable for failing to supervise Victor Matl, the case will stand for a new principle, respondeat inferior. (That phrase was not quoted in the opinion, but it really should have been.)

There are three other points about the Trujillo opinion that deserve notice. First, footnote 8 (that both The Wall Street Journal 3/ and some very prominent brokers' attorneys have publicized):

> "In circumstances such as those presented here, a supervisory employee with even limited authority must, and we think it is significant that Trujillo eventually did, go beyond his limited authority to contact the firm's national headquarters concerning a rogue broker's activities." 4/

I must say I think, as Loren Schecter said yesterday, that that statement reflects only common sense. It is elicited by the facts of the Trujillo case; its potential significance evokes generalization, but (as was said several times at seminars during this Conference) these cases are fact-intensive. I've had pointed out to me during these seminars that going up the chain

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2/ In the Matter of Victor Matl, Merrill Lynch, Pierce, Fenner and Smith, and Robert M. Fischer, Securities Exchange Act Release No. 22395, 33 SEC Docket (CCH) 1352 (1985).

3/ Ricks, SEC Overturns Censure of Merrill Aide, Seems to Boost Supervisor Obligations, Wall St. J., March 24, 1989, at C5, col. 5. Correction printed March 27, 1989, at A5, col. 1.

4/ Trujillo, 43 SEC Docket (CCH) at 737-738.

of authority to the regional supervisor would have been better; I agree, although that's not what Louis Trujillo did. But it would be fair, in my view, to read footnote 8 as if it said "go beyond his limited authority to contact the firm's national headquarters or to take action of similar tenor concerning a rogue broker's activities".

> Second, don't forget footnote 4:
> "To the extent that Trujillo's arguments may be read to contend that Matl was not 'subject to his supervision' because of the limited function Trujillo performed . . ., we need not and do not rule on that contention. Rather, we assume for purposes of this opinion that Trujillo had a supervisory relationship vis-a-vis Matl." 5/

Again, that statement is permitted by the facts of the Trujillo case. To me, this argument (that the "subject to his supervision" requirement has not been met) has to be made whenever it's germane, but the Commission properly deferred its decision until the point is argued in some other fact-intensive inquiry where the result turns on its determination.

Finally, the statement of why the Commission reached its conclusion:

> "While we believe that Trujillo could and perhaps should have taken such steps sooner, our standard is that a manager (of any stripe) 'must respond reasonably when confronted with indications of wrong-doing.' Trujillo's responses as 'administrative manager' were not unreasonable . . . ." 6/

The citations here are to Vieira 7/ and Boccella, 8/ the recent Orders concerning two former Hutton managers.

Vieira and Boccella both involved brokers' misappropriation of customer funds by means of procedures specifically violative of the firm's compliance manual. So, first and foremost, the two cases should drive home the point that, when the manual (or guide, or whatever it may be called in the firm) sets out a procedure, that procedure will be the very first standard against which the supervisor's actions are measured. I don't believe that every failure to comply with a firm's manual is unreasonable but repeated failure will certainly be unreasonable,

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5/ Id. at 736.

6/ Trujillo, 43 SEC Docket (CCH) at 738.

7/ In the Matter of William L. Vieira, Securities Exchange Act Release No. 26576, 42 SEC Docket (CCH) 1392 (1989).

8/ In the Matter of Nicholas A. Boccella, Securities Exchange Act Release No. 26574 42 SEC Docket (CCH) 1388 (1989).

and there may be contexts, or particular provisions of the manual, where almost any failure raises serious questions.

A corollary, of course, is KNOW YOUR MANUAL. A compliance director who hasn't read his or her own manual is like a character in a child's TV cartoon, sitting on a branch that's been sawed off but won't fall until the fact that it's already been sawed off dawns on the little critter.

What both Vieira and Boccella will be cited for is the paragraph common to them both:

> "As part of his or her supervisory responsibilities, a branch manager must respond reasonably when confronted with indications of wrong-doing . . . . In appropriate circumstances, a reasonable response may require increased supervision . . ., additional training, the imposition of restrictions . . . or even termination of employment." 9/

In Boccella the paragraph concludes that the manager "must implement a response reasonably designed to detect and prevent improper activity." 10/ You say, "Of course!". After all, the statutory standard itself is "failed reasonably to supervise". But what's new here is that the Staff has drafted, and the Commission has blessed, a clear statement that, together with the Wedbush 11/ restatement last year, should tell the world that the 29-year-old Reynolds 12/ standard is no more. And let me suggest why Reynolds is (and should be) history: because no standard for "reasonable" conduct that itself is phrased beyond the likely capability of everyday mortals to achieve is either reasonable or effective to stimulate the desired effort toward achievement. The notion of "utmost vigilance whenever even a remote indication of irregularity" arises may be fine for counterespionage, but it exceeds the capacities of managers, be they line or staff, in the everyday hurly-burly world. So I think Reynolds is good riddance -- and I think Wedbush, along with Vieira and Boccella, comport

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9/ 42 SEC Docket (CCH) at 1391, 42 SEC Docket (CCH) at 1395-1396.

10/ 42 SEC Docket (CCH) at 1391.

11/ In the Matter of Wedbush Securities, Inc., 48 SEC 963 (1988).

12/ In the Matter of Reynolds & Co., et al., 39 SEC 902 (1960). In Reynolds, the Commission, reiterating its long-held position that brokers and dealers are under a duty to supervise their employees, went on to state, as the standard for implementation of supervisory responsibilities, that brokerage personnel in authority must "exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention." 39 SEC at 916.

with what the members of the SEC Staff actually do: that is, look to see how a supervisory system is supposed to function, how it actually functioned in a particular set of facts, and whether the supervisors' responses were reasonable.

Several panelists said in seminars yesterday that they were worried about "the regulators looking over my shoulder". I don't believe that's a real concern, at least vis-a-vis the SEC. The standard is reasonableness, with a range of reasonable responses, and the standard doesn't require perfection -- Trujillo shows that. In the context of 10,000 transactions a day, reasonableness must allow some questionable transactions to slip through undetected, and must allow some of last week's or last month's concerns to slip out of the forefront of one's memory. Reasonableness is fact-intensive; generalizations are difficult. Reasonableness does apply as well to staff personnel as to line personnel -- the question is, how?

And that brings me to Prudential-Bache, 13/ handed down in early 1986 just after I got to the Commission (but without my participation since it had been argued and decided well before). Pru-Bache itself builds on Tallman 14/ sixteen years earlier:

> "Broker-dealers have a responsibility to take effective measures to insure compliance with statutory standards and requirements. That responsibility is not discharged by the setting up of a compliance program . . . which does not confer the authority . . . to accomplish its objectives . . . . Persons who are assigned to positions of Compliance Directors should be accorded powers to initiate and implement steps required to achieve compliance." 15/

Pru-Bache applied that principle to a set of facts in which the compliance person's recommendations were disregarded, and Pru-Bache suggests that authority for direct contact with customers and power to break trades, among other matters, should reside in the Compliance Department. 16/

In one of yesterday's seminars Saul Cohen urged that Pru-Bache is wrong on that point, and Saul quoted from Stu Sindell's insightful comments "From the President" to the membership of this Compliance and Legal Division: "In these turbulent times, it is particularly essential that compliance be recognized for

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13/ In the Matter of Prudential-Bache Securities, Inc., 48 SEC 372 (1986).

14/ In the Matter of Alfred Bryant Tallman, Jr., 44 SEC 230 (1970).

15/ Id. at 233.

16/ Prudential Bache, 48 SEC at 380-381, 401.

what it is -- and what it is not." 17/ Ray Vass has written eloquently on the same theme and I have circulated Ray's paper to all the other Commissioners, drawing attention to this particular argument. 18/ But, while wanting (myself) to agree, I think even I have yet to be persuaded. Perhaps it's because what emerged even before Pru-Bache was a mixed role in many firms, advisory in some respects and authoritative in others -- and the exercise of authority (where it existed) belied the assertion of mere advice even where only advice could be given.

As an example of more recent date, let me read you a sentence or two out of the Commission's Check 19/ opinion late last year:

> "Check was uniquely positioned to exercise effective supervisory control in the specialized area of mutual fund sales, and, as indicated above, he did exercise control on certain occasions when he received inconsistent information on sales orders . . . . It was Check who . . . had the power and obligation to see to it that customers received the benefit to which they were entitled, and Check who had,

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17/ Sindell, From the President, C & L News and Notes 1-2, Compliance and Legal Division - Securities Industry Association (June 20, 1988). The quotation goes on as follows:

> Compliance professionals are advisers, not supervisors. They are staff personnel, not line management. They provide support, guidance, and systems to those charged with the responsibility for the management and supervision of others. They do not have the authority to order managers to manage or supervisors to supervise. Nor do they have the authority to hire and fire or reward and punish persons involved in sales, trading and other financial services. Such authority is the exclusive province of managers and supervisors. And that is how it should be in order to maintain the independence and thereby the effectiveness of compliance as a vital element in the process of self-regulation.

18/ Vass, The Compliance Officer in Today's Regulatory Environment, SIA Compliance and Legal Seminar Outlines 124, 136-138 (1988) (Initially presented at the Practicing Law Institute "Broker-Dealer Institute", Nov. 12-13, 1987).

19/ In the Matter of Robert J. Check, Securities Exchange Act Release No. 26367, 42 SEC Docket (CCH) 651 (1988).

and sometimes exercised, the power to reject mutual fund orders." 20/

If you've got it, and flaunt it, it's tough to deny you ever had it at all.

Now, I picked Pru-Bache for a reason, both because it did precede my arrival at the Commission and because I think it's vintage John Shad. How can one overstate the extraordinary influence that Chairman Shad had on the development of the law in this area? His understanding of firm operations based on a lifetime's experience, his insistence on regulatory compliance, and his feel for the reality of the line and staff supervisory functions, were unmatched. I think that an understanding of Commission actions between 1981 and 1987 can only be achieved with the recollection that John Shad was then at, and at the head of, the Commission table. Succeeding cases have built on Pru-Bache, assuming the correctness of John Shad's understanding, but each has been carefully molded to its own facts -- and I would dispute the legitimacy of the paranoia which (according to a number of panelists and questioners yesterday) is prevalent among industry compliance and legal people generally.

I came to Washington 3-1/2 years ago concerned that, in the dynamics of Staff and Commission consideration of discrete cases, every alleged supervisory failure was grounded in a res ipsa approach: (1) if anyone in the firm violated a statutory or regulatory requirement, there must have been a supervisory failure, and (2) where supervisory procedures were in place and were reasonable, there must have been a failure of implementation -- a kind of presumption against the supervisor. Some of that approach -- or presumption -- must still characterize Staff dealing with suspected failure-to-supervise cases, but twice yesterday Bill McLucas addressed that concern -- and twice he said it wasn't warranted. That's what you came to Orlando to hear: the fact that the most senior, and responsible, Staff officials on the enforcement side are alert to allay any such presumption says more than the opinion of any single Commissioner.

There is a parallel development, going more to substantive standards than to measures of compliance, to which I also want to draw your attention.

In the Hamilton Grant 21/ opinion two years ago, the Commission addressed the obligations of an underwriter and, despite the opportunity to repeat a familiar litany of so-called due diligence obligations derived from Section 11 of the

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20/ Id. at 654.

21/ In the Matter of Hamilton Grant & Co., Inc., 48 SEC 788 (1987).

Securities Act of 1933, 22/ limited itself to the Section 17(a)-oriented 23/ statement that an underwriter must fulfill the obligations of any broker-dealer, i.e., must have a reasonable basis for the key recommendations made in the prospectuses it circulates, and must act with sufficient responsibility to attain that reasonable basis for recommending. Then last year, the Commission addressed municipal underwriter responsibilities on a going-forward basis 24/ and, despite the opportunity simply to repeat the old Walston 25/ formula that

> "it is incumbent on firms . . . to make diligent inquiry, investigation and disclosure . . . . It is, moreover, essential that dealers . . . make certain that the offering circulars and other selling literature are based upon an adequate investigation . . . .", 26/

the Commission circumscribed Walston within its own factual context while asserting as a general standard that broker-dealers recommending securities imply by doing so that they have an adequate basis for their recommendation -- that they have not withheld facts they know, and have researched those facts that are reasonably ascertainable. 27/

As in the supervision area, "the reasonableness of a belief in the accuracy and completeness of the key representations in the final official statement, and the extent of a review . . . necessary to arrive at this belief, will depend on all the circumstances." 28/ That is the standard that underlies all brokerage relations with customers. It's reasonable, it's familiar, it's achievable, and I'm glad it has won Commission recognition for its applicability in capital-raising transactions as well as in the trading markets. Again, the fact that the most senior, and responsible, Staff officials on the Market Regulation side are willing to accept that standard and to recommend it to the Commission, for application in wider contexts, says more than the opinion of any single Commissioner.

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22/ 15 USC 77k (1988).

23/ 15 USC 77q(a) (1988).

24/ Securities Exchange Act Release No. 26100, Municipal Securities Disclosure, 54 FR 28799 (1988), 41 SEC Docket (CCH) 1131 (1988), 1141 et seq.

25/ In the Matter of Walston & Co., Inc., 43 SEC 508 (1967).

26/ Id. at 512.

27/ Municipal Securities Disclosure, supra n. 24, 41 SEC Docket (CCH) at 1147-1149.

28/ Id. at 1147.

In the spring of 1989 it is obvious that I have to close with some reference to the Manning 29/ case.

How broker-dealers handle over-the-counter limit orders will be a matter of esoteric knowledge five years from now, as it was five years ago. What will stay with us -- what the case will stand for -- is Chairman Ruder's ringing concurrence, based on longstanding common law principles of agency (which the Chairman strongly believes permeate and shape the broker-customer relationship):

> "[O]ur capital markets depend upon holding securities professionals, who operate as the gateway to those markets, to higher legal standards than those which govern other facets of commerce." 30/
> "In this case, Hutton's peers at the NASD asked no more . . . . This Commission should ask no less." 31/

It's you to whom the Chairman of the SEC is speaking -- you act as the arbiters and interpreters of legal standards within the broker-dealer community.

It's you for whom the Chairman of the New York Stock Exchange flew to Orlando for a one-night stand -- that's a measure of how far the Compliance and Legal function has come.

So it should not be paranoia that's penetrating through this conference, but pride. Pride in all that's been accomplished in the quarter century since the likes of Fitzpatrick, Hoblin, Rauschman, Rae, Del Duca, Cione and Hammerman first began to mold a compliance and legal function within the firms. Pride in the insight that allowed Mal Frankhauser's original 1971 manual 32/ to serve as the backbone for an evergrowing compliance program all these years, and in the sophistication that is reflected in Ray Vass' unceasing efforts to deploy new tools, to perform even more effectively, and to convey to line management (and to regulators) an articulate perspective on the profitability of compliance. Pride in the responsibility that is and must be the concomitant of the position you've achieved.

Let me tell you that one for-the-time-being SEC Commissioner views it that way, that he's not reticent in sharing that view

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29/ In the Matter of E.F. Hutton & Co., Inc., n/k/a/ Shearson Lehman Hutton Inc., 41 SEC Docket (CCH) 413 (1988).

30/ Id. at 419.

31/ Id. at 421.

32/ Frankhauser, Mahlon, Legal and Compliance Directives, Hayden Stone Inc. (1971-1974).

with others, and that your toughest taskmaster today is not the SEC, not the team of Marcus & Doherty at the NYSE nor the team of Wilson & Clendenin at the NASD, not even the modern-day successors to Stretch Gardiner in management of the Firms. Your toughest taskmaster -- from everything I've heard these last three days -- is yourselves. And that's the best sign of success in compliance; that's exactly how things should be.