THE DILIGENT CHIEF COMPLIANCE OFFICER

What to Do When the Firm Disagrees

By J. Michael Dryton

The Securities and Exchange Commission (SEC or Commission) Office of Compliance Inspections and Examinations (OCIE) staff recently summarized its views regarding the qualities investment advisors should expect in a chief compliance officer (CCO). Echoing the Commission’s statements in the Adopting Release for Rule 206(4)-7 (the “Compliance Rule”), the staff observed that a CCO should be competent and knowledgeable regarding the Advisers Act and ... empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm [and] have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.

Shortly after Rule 206(4)-7 was adopted, the Commission’s staff spoke publicly about the qualities examiners would expect of a CCO. Technical competence regarding the securities laws and regulations was a given; so, Lori Richards, then director of OCIE, described what she believed were the personal qualities necessary for an effective CCO:

• Perhaps above all, a CCO must maintain a skeptical attitude—continually assuming that individuals will try to subvert the rules and act with their own interests in mind.
• A CCO should be motivated by an innate curiosity about how firm employees and others might be trying to circumvent the law or firm policies and procedures.
• Finally, a CCO must be persistent, even relentless, when investigating issues; and unwilling to be stonewalled or derailed, even by senior management, important producers, or portfolio managers.

As Richards put it, “Compliance is not and never was a haven for passive box-checkers.” Of course, expectations are a two-way street. If these are the expectations that firms and the Commission have for a diligent CCO, what are the reasonable expectations that CCOs should have for their firms?

An Independent and Adequately Supported Compliance Department

Richards emphasized the Commission’s expectation that compliance would be independent of business units and would be able to operate on its own initiative, without improper influence from other parts of the firm, with access to and direct reporting to the board or senior management. As she explained, examinations had revealed situations where compliance was sometimes captive to a business unit. Under the Compliance Rule, compliance should have unimpeded and unfiltered access to information and sufficient resources and tools to perform its responsibilities. OCIE recently reiterated these principles in the Outsourced CCO Risk Alert.

Assessing a Firm’s Culture of Compliance

Like the Commission’s examination staff, CCOs should reasonably expect their firms to demonstrate real commitment—not mere lip service—to a culture of compliance. A diligent CCO should periodically evaluate this commitment by reviewing the following factors:

• Is the CCO actively supported by senior management and the board? Is this support substantiated and documented?
• Is there an appropriate tone at the top in which senior management has demonstrated a robust compliance program that proactively seeks to prevent, detect, and address violations of applicable federal securities laws and regulations? Or, is turning a blind eye or willful ignorance of the facts how matters are handled when it is in the economic interest of the firm, an important client, executive, or producer to do so?
• Does the CCO report regularly and directly to senior management and the board about compliance problems, including emerging issues?
• Is compliance adequately provisioned with the tools it needs? Is there adequate documentation of compliance's request for resources?
• Does the CCO have unfiltered, unimpeded access to information, records, and firm personnel? If not, why not or what restrictions have been imposed?
• If the compliance staff is embedded in a business unit, how does the CCO make sure these personnel do not become captive to (i.e., dependent on) the business unit?
• Does the CCO have the ability to confirm that his or her concerns have been appropriately addressed?
• Is the CCO's compensation or ability to move substantiated and documented?
• If the firm has one or more important executives, producers, or portfolio managers, is compliance empowered and supported to perform its responsibilities?
with respect to these individuals? In other words, are there limitations on compliance’s access to information or authority with respect to these individuals? Can any of these individuals bring pressure to bear, directly or indirectly, that will cause compliance to back off a review, investigation, or other performance of their responsibilities with respect to any of these individuals?

• Does the firm give too much deference in compliance issues to any important executives, producers, or portfolio managers?

Based on this review, a diligent CCO will assess the need for (1) revisions to the firm’s compliance policies and procedures, (2) changes in the firm’s supervisory or organizational structure, or (3) recommendations for additional resources to support compliance. Fortunately, at the great majority of firms, these types of changes will be sufficient to address any shortcomings.

Is Capitulation a Viable Option?

When discussing a CCO’s challenges, we usually focus on persistence in the face of push-back from executives, producers, and portfolio managers. But what if, for example, a firm refuses to implement a satisfactory culture of compliance, or worse (every CCO’s nightmare), it refuses to stop a transaction the CCO believes violates the securities laws, and the CCO chooses to capitulate—that is, says nothing knowing that the action is not in compliance? What are the consequences then?

Below is a compelling story of a woman who was a professional in a public company. Although not a compliance officer, her position gave her similar authority to say no to a particular transaction involving her employer. Once you hear the story of how, despite serious misgivings, she decided not to say anything about the transaction, I think you’ll agree that sticking to your guns—doing what a diligent CCO would do—is definitely the better way to go.

Helen Sharkey’s Story

At the Regulatory Compliance Fall 2015 National Compliance Conference, we had the good fortune of having Helen Sharkey as a speaker. With refreshing candor, she recounted the events that led her from a promising professional career as an accountant in a dream job with Dynergy—an up-and-coming energy trading company in Houston (think Enron)—to a guilty plea to one felony count of conspiracy to commit securities fraud, 28 days in a maximum-security federal prison, and a fine.

To fully appreciate her story, a few of the underlying facts are necessary. The matter that eventually led to her undoing was a tax-motivated transaction code named “Project Alpha,” which stood to enhance Dynergy’s cash flow by $300 million and provide a tax benefit of $79 million. Sharkey was a staff accountant working on the Project Alpha “deal team.” The successful closing of Project Alpha was strongly backed by her direct manager and by Dynergy’s chief financial officer (CFO). In the weeks leading up to the deal closing, Sharkey had misgivings about the deal. When she reported these doubts to her manager and then to the company’s CFO, she was disheartened to find her concerns were not taken seriously.

When she arrived in New York for the closing, Dynergy’s attorneys and outside accountants all agreed the deal could proceed. As she laid out the scene, here she was, the lowest person on the totem pole, potentially holding up a $300-million deal that was supported by her boss, and by his boss. The lawyers didn’t have a problem with the deal; neither did the accountants. Everyone at the table, most very senior to her, was saying yes to the deal, and yet her stomach was in knots—but then, what did she know anyway? So, swallowing hard, she said yes and the deal closed.

As she admits, she could have—should have—said no. It was that decision for which she would see her reputation tarnished in the press, ultimately plead guilty to securities fraud, go to jail, pay a fine, lose her accountant’s license, and endure the lifelong stigma of being a convicted felon.

After Sharkey’s presentation, a small group gathered to ask her a few more questions and thank her for sharing her very personal story. I was struck by how differently the presentation had been received by individuals in the group. Some focused on the lack of legal protection Sharkey had when following her manager’s instructions and being a team player. For others, the take-away was how the Commission goes after the little fish because high-ranking executives either insulate themselves from liability or have high-priced legal teams or both. This stems from the fact that in Dynergy’s case, no senior executive was pursued by the Commission in connection with Project Alpha.

However, others recognized the more significant message of her tale, “Listen to your instincts,” Starkey said. “Have the courage of your convictions, notwithstanding the pressures of management or outside professionals who may be vastly more senior.”

She said when she finally decided to tell her story, it was to help people avoid the pitfalls she experienced and recognize how easy it is to commit securities fraud without realizing it. “What I hope to convey is that if by chance the activity that you’re choosing to go along with is illegal, this is what you have to look forward to,” she said.

It requires tremendous personal courage, integrity, and conviction to push back against the pressures of upper management, $1,000/hour outside attorneys, and accountants. Fortunately, most of us will never have the courage of our convictions tested like Sharkey did—when we’re the only impediment to a $300-million deal from which your employer will realize a $79-million tax benefit.

But as compliance professionals, we make critical decisions, virtually on a daily basis, about the conduct of our firm and its employees, including senior executives, portfolio managers, important producers, and others with whom the firm may have important business relationships, such as subadvisors, broker–dealers, and custodians.

If we discover wrongdoing, we have an obligation to our firm—and, if they are affected, our clients—to ensure the wrong-
doing is promptly addressed, the responsible parties are educated or disciplined, and steps are taken to prevent recurrence. Depending on the circumstances, regulatory self-reporting may be warranted.

What If the Firm Takes No Action?
But what if you are only an assistant compliance officer and the chief compliance officer disagrees with your findings and recommendations? What if you are the CCO and the chief executive officer or board disagrees with your findings and recommendations?

What if you have thoroughly researched the matter, are technically knowledgeable about the issues, and believe your findings and recommendations have been rejected to avoid embarrassing one of the firm’s key executives, starting a lawsuit by clients, triggering a regulatory inquiry, or all of the above?

There are many answers, and they all depend on the specific facts and circumstances. In many cases, you may need to seek the advice of counsel. Below is one approach you may wish to consider:

Be sure you know the facts and understand applicable laws and regulations. First, it must be emphasized, above all you have to be completely prepared with all available information and completely conversant in the applicable laws and regulations. It would be a terrible mistake to take a drastic action only to find out later that you did not have the facts or did not understand some technical point. Preparation is paramount (see below for further information). Helen Sharkey did not suggest or imply that a junior or subordinate employee ordinarily should act contrary to the direction of his or her supervisor. It must be remembered that she was already a licensed Certified Public Accountant when she was hired by Dynergy, and although she was a junior employee, she had considerable expertise in tax-motivated transactions. Although she was the most junior person on the deal team, it was self-doubt, not a lack of knowledge, that ultimately led to her downfall.

Gather the evidence. First, be sure to document the facts and gather records related to the potential wrongdoing you believe you have discovered. Gather the records that led you to find the matter, not just those that support your position. If there are records that are inconsistent with your position, you should be prepared to explain them. It could be that you have not fully accounted for their significance, which may change your findings.

Ensure acts or failures to act violate literal terms of firm policies and procedures. Review firm policies and procedures to ensure any alleged acts or failures to act violate the literal terms of the firm’s policies and procedures. It is remarkable how often we believe we know what the firm’s policies and procedures require only to find out the literal words actually require something different. Violations of the policies and procedures should be quoted directly from the policies and procedures manual. If the conduct doesn’t violate the literal words found in the manual, perhaps the problem is that the procedures should be revised.

Ensure acts or failures to act violate applicable laws or rules. Before alleging a violation of a law or rule, be sure you have performed sufficient research to know your allegation is well-founded. Unfortunately, many laws and rules can be complex, and years of court and regulatory interpretations must be considered. (See the sidebar for resources for the text of key federal securities laws, rules and regulations, SEC staff guidance and interpretative materials, and U.S. Department of the Treasury Financial Crimes Enforcement Network (FinCEN) anti-money laundering (AML) programs information).

Report the matter to the appropriate supervisor or management. Generally speaking, compliance officers are not supervisors, except with respect to the employees assigned to the compliance department. Although compliance officers often are assigned more than one job title or function, their supervisory responsibilities result from those additional responsibili-

bilities, not because they happen to be compliance officers. In fact, it is for this reason that it is very important to clearly delineate in the firm’s policies and procedures the difference between any supervisory responsibilities related to an additional job title and an employee’s responsibilities as a compliance officer.

Once a compliance concern has been identified with respect to the firm or an employee, in most firms the compliance officer generally should report the issue to the appropriate supervisor or, depending on the nature of the issue, senior management, in-house counsel, or an audit committee for appropriate action.

But what recourse is available if the matter has been reported and the supervisor, senior management, in-house counsel, or audit committee fails to take appropriate action, particularly, if the conduct is continuing, or is causing or risks potential harm to clients?

Whistleblower Reporting and Protection against Retaliation
The Dodd-Frank Act amended the Securities Exchange Act of 1934 to add Section 21F, “Securities Whistleblower Incentives and Protection.” Section 21F provides a series of incentives and protections for individuals to report possible violations of the federal securities laws. Generally speaking, these incentives and protections take three forms: (1) monetary awards for providing information about violations, (2) heightened confidentiality assurances, and (3) enhanced employment retaliation protections.

The Commission is authorized to provide monetary awards to eligible individuals who come forward with original information that leads to a Commission enforcement action in which more than $1 million in sanctions is ordered. The range for awards is between 10 percent and 30 percent of the money collected.

The Office of the Whistleblower was established to administer the SEC’s Whistleblower Program (http://www.sec.gov/about/offices/
Whistleblower Program is subject to numerous requirements and prerequisites. Certain categories of employees and contractors, including attorneys, accountants, compliance staff, outside compliance consultants, and auditors, among others, typically are excluded from the whistleblower award provisions unless they first report to the appropriate supervisor, senior manager, or committee unless: (1) disclosure to the Commission is necessary to prevent substantial injury to the firm or investors or (2) they have reasonable basis to believe that conduct is occurring that will impede investigation of the misconduct. Additionally, reporting to the SEC must be made no later than 120 days after reporting to the firm.

Pursuant to the anti-retaliation provision, even if a whistleblower does not qualify for an award, no employer may discharge, demote, suspend, threaten, harass directly or indirectly, or in any other manner discriminate against a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower

- in providing information to the SEC in accordance with Section 21F;
- in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or
- in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.), the Exchange Act, including section 78j–1 (m) of this title, section 1513 (e) of title 18 (prohibition against retaliation for providing information to law enforcement), and any other law, rule, or regulation subject to the jurisdiction of the SEC (this includes the Investment Advisers Act and other statutes and rules subject to SEC jurisdiction).

address the conflicting decisions from courts around the country, the SEC issued interpretative guidance stating that although reporting to the Commission is a requirement for the granting of a whistleblower award, it is not a requirement for protection against retaliation.

Although a whistleblower’s original submission may be made anonymously, the Commission will disclose the individual’s identity, as necessary, during the enforcement action in which the SEC obtains the award against the firm from which the whistleblower will receive a share, and in a variety of other circumstances. Consequently, notwithstanding the anti-retaliation protections of Section 21F, a whistleblower likely will find it difficult to remain at the firm against which the whistleblower report is filed. Some also have speculated that whistleblowers may have difficulty finding future employment in the financial services industry, regardless of the legitimacy of their reports.

It’s important to understand that the Whistleblower Program is subject to numerous requirements and prerequisites. Certain categories of employees and contractors, including attorneys, accountants, compliance staff, outside compliance consultants, and auditors, among others, typically are excluded from the whistleblower award provisions unless they first report to the appropriate supervisor, senior manager, or committee unless: (1) disclosure to the Commission is necessary to prevent substantial injury to the firm or investors or (2) they have reasonable basis to believe that conduct is occurring that will impede investigation of the misconduct. Additionally, reporting to the SEC must be made no later than 120 days after reporting to the firm.

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Nonetheless, compliance professionals who discover serious compliance violations, when their firms refuse to address continuing issues or remedy injuries to clients, may be left with few other effective remedies.

J. Michael Dryton is a senior consultant with the recently merged firms National Compliance Services (NCS) and Regulatory Compliance, LLC. He has more than 25 years of experience serving the financial services industry, which includes serving as outside counsel and then as general counsel (and anti-money laundering CCO) for a dually registered investment advisor and broker-dealer. Contact him at mdryton@regulatory-compliance.com.

Endnotes