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The "wholesale Failure" of the Sec's Approach To Chief Compliance Officer Liability

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INTRODUCTION

Chief Compliance Officers ("CCOs") at financial services firms play an essential role in ensuring that the approximately 15,000 firms registered with the Securities and Exchange Commission ("SEC") comply with federal

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securities laws. Such firms include investment advisers, broker-dealers, private equity firms, hedge funds, and others, who collectively manage over $114 trillion in assets on behalf of investors.[1] Rule 206(4)-7 of the Investment Advisers Act of 1940 (the "Advisers Act") became effective in 2004, requiring firms registered with the SEC to designate a CCO to administer its compliance policies and procedures to promote firmwide compliance with SEC regulations.[2] Specifically, the law provides that the CCO must be competent and knowledgable with the full authority to develop and enforce appropriate firm policies and procedures.[3] Accordingly, the CCO should hold a position of sufficient seniority and authority within the firm so that the firm's compliance policies and procedures are imparted to others.[4]

The CCO position is so important to regulators that CCOs can and have been held personally liable for compliance violations of their firms, even when the CCO is not involved in any misconduct nor obstructed or misled regulators.[5] This can result in significant financial penalties and career-ending reputational harm for CCOs and has caused considerable apprehension in the compliance community. This leads to a "chilling effect" of well-qualified professionals, either declining to take on CCO roles or leaving CCO positions for jobs with less personal liability risk.[6]

Regrettably, there is no legal standard for holding CCOs personally liable for violations committed *by their firms* and not themselves. The SEC's attempts to clarify factors that put CCOs in danger of liability have only added

1. *See, e.g.*, Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-7 (2004) [hereinafter "Compliance Programs Rule"]; Luis Aguilar, Commissioner, SEC, Public Statement: The Role of Chief Compliance Officers Must Be Supported (June 29, 2015), https://www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html ("Chief Compliance Officers of Investment Advisers (CCOs) play an important and crucial role in fostering integrity in the securities industry.") [hereinafter "Aguilar Remarks"]; Hester M. Peirce, Commissioner, SEC, When the Nail Fails —Remarks Before the National Society of Compliance Professionals (Oct. 19, 2020), https://www.sec.gov/news/speech/peirce-nscp-2020-10-19 [hereinafter "Peirce Remarks 1"].

2. *See* Compliance Programs Rule, *supra* note 1.

3. *Id.* ("An adviser's chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm.").

4. *Id.*

5. *See, e.g.*, Court E. Golumbic, *The Big Chill: Personal Liability and the Targeting of Financial Sector Compliance Officers*, 69 HASTINGS L.J. 45, 66, 69 (2017) (noting that the SEC brings cases against CCOs based merely on negligence); Marsh Mclennan, *Mitigating Personal Liability Risk for Chief Compliance Officers* (Sept. 2016), https://www.marsh.com/pr/en/services/financial-professional-liability/insights/mitigating-personal-liability-risk-chief-compliance-officers.html (noting that CCOs are at risk of personal liability even if they were not involved in nor aware of the violative conduct).

6. *See, e.g.*, Golumbic, *supra* note 6, at 81-82 (analyzing this chilling effect on compliance officers); Hester M. Peirce, Commissioner, SEC, Chief Compliance Officer Liability: Statement on In the Matter of Hamilton Investment Counsel LLC and Jeffrey Kirkpatrick (July 1, 2022), https://www.sec.gov/newsroom/speeches-statements/peirce-statement-hamilton-investment-counsel-070122 [hereinafter "Peirce Remarks 2"] ("Attracting well-qualified people to the profession is important, and fears of facing liability for someone else's missteps can dissuade excellent candidates from seeking compliance jobs.").

to the confusion.[7] These attempts have been inconsistent, and the SEC's enforcement actions against CCOs often ignore the SEC's own stated liability factors or promulgate new factors altogether.[8] This legal ambiguity has created a cloud of uncertainty, making CCOs unsure when they will be held personally liable for compliance violations committed at their firms.[9]

This problem is well-documented in the financial services industry, as recent statements by senior SEC officials demonstrate. On October 16, 2023, SEC Commissioner Mark T. Uyeda gave remarks that echoed the compliance community's decade-long calls for the SEC to establish a clear CCO liability standard.[10] As Commissioner Uyeda stated, "[l]eft with only the cursory details set forth in settled enforcement actions, the reasoning behind a particular decision to charge a CCO is often left to the collective imagination."[11] Further, on October 24, 2023, the director of the SEC's Enforcement Division Gurbir Grewal described the scenarios in which the SEC would consider an enforcement action against a CCO. Grewal's statement seemed to contradict the SEC's own enforcement protocol against CCOs, causing more confusion and legal uncertainty.[12]

In its public statements, SEC officials have stated that they will only hold CCOs personally liable in three circumstances: (1) when the CCO is affirmatively involved in misconduct; (2) when the CCO engages in efforts to obstruct or mislead the SEC; or (3) when the CCO exhibits "a wholesale failure to carry out his or her responsibilities."[13] The first two categories are not controversial, as CCOs should be legally responsible for their personal misconduct regarding securities laws, as would any other employee.[14] The third category of "wholesale failure," however, has not been clearly defined and has caused significant controversy. In this third category, the SEC has not clearly defined or consistently applied a "wholesale failure" standard and has

7. *See, e.g.*, NEW YORK CITY BAR ASSOCIATION COMPLIANCE COMMITTEE, REPORT ON CHIEF COMPLIANCE OFFICER LIABILITY (2021) [hereinafter "NYC Bar Report"], https://www.nycbar.org/wp-content/uploads/2023/05/Report_CCO_Liability_vF.pdf.; Mark T. Uyeda, Commissioner, SEC, Remarks at the NSCP National Conference (Oct. 16, 2023), https://www.sec.gov/newsroom/speeches-statements/uyeda-nscp-national-conference-101623 [hereinafter "Uyeda Remarks"] (". . . the reasoning behind a particular decision to charge a CCO is often left to the collective imagination.").

8. *See infra* notes 76-101 and accompanying text.

9. *See, e.g.,* Uyeda Remarks, *supra* note 7.

10. *Id.*

11. *Id.*

12. Gurbir S. Grewal, Director, Division of Enforcement, SEC, Remarks at New York City Bar Association Compliance Institute (Oct. 24, 2023), https://www.sec.gov/newsroom/speeches-statements/grewal-remarks-nyc-bar-association-compliance-institute-102423 [hereinafter "Grewal Remarks"].

13. *See* Andrew Ceresney, Director, Division of Enforcement, Keynote Address at the 2015 National Society of Compliance Professionals, NAT'L CONF. (Nov. 4, 2015), https://www.sec.gov/news/speech/keynote-address-2015-national-society-compliance-profcereseney.htm [hereinafter "Ceresney Remarks"] (stating that the SEC will only bring charges against CCOs under these three scenarios); Peirce Remarks 1, *supra* note 1 (reaffirming Ceresney Remarks).

14. *See, e.g.*, Peirce Remarks 1, *supra* note 1.

often created new standards altogether instead of applying the "wholesale failure" standard applied in prior cases.[15] SEC Commissioner Hester Pierce has noted that, when the SEC charges CCOs, this third category often looks like negligence or even strict liability.[16]

This third category has provided several examples that demonstrate this problem. For instance, CCOs have been held personally liable in ambiguous cases where regulators determined the CCO "caused" another employee of the firm to not disclose a conflict of interest issue because the compliance policies and procedures were not "reasonably designed" to prevent the employee's violative conduct[17]; where the CCO failed to "meaningfully implement" compliance policies and procedures to prevent a member of the firm from engaging in business activities with a statutorily disqualified person[18]; where the CCO failed to "adequately" review the email correspondence of an employee[19]; where the CCO misstated assets under management in regulatory filings in reliance on estimates from the Chief Investment Officer[20]; where the CCO failed to implement "reasonably designed" written compliance policies to detect suspicious anti-money laundering activity at the firm by improperly relying on policies from other departments of which the CCO had no supervisory control[21]; and in cases where the CCO is alleged to have no knowledge of the facts underlying the violative conduct but failed to conduct an adequate compliance review that regulators believe would have led the CCO to discover the violative conduct[22] Importantly, the SEC has also stated that if a CCO takes on "supervisory authority" at their firms, they may be personally liable if they do not undertake those responsibilities in a "reasonable manner"— a standard whose meaning has yet to be clearly defined.[23]

The lack of clarity and consistency for CCO liability has harmed CCOs, firms, and regulators. First, this legal uncertainty has caused considerable confusion and anxiety among CCOs, creating a "chilling effect" where well-

15. *See infra* notes 76-101 and accompanying text.

16. *See* Peirce Remarks 1, *supra* note 1; Daniel M. Gallagher, Commissioner, SEC, Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), https://www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html [hereinafter "Gallagher Remarks"] (". ("Both settlements illustrate a Commission trend toward strict liability for CCOs under Rule 206(4)-7.").

17. Blackrock Advisors, LLC, Investment Advisers Act Release No. 4065, Investment Company Act Release No. 31558 (Apr. 20, 2015), https://www.sec.gov/litigation/admin/2015/ia-4065.pdf.

18. The Application of Thaddeus J. N. for Review of Disciplinary Action Taken by FINRA, Securities Exchange Act Release No. 84500 (Oct. 29, 2018).

19. *Id.*

20. David I. Osunkwo, Exchange Act Release No. 81405, Investment Advisers Act Release No. 4745, Investment Company Act Release No. 32783 (Aug. 15, 2017), https://www.sec.gov/litigation/admin/2017/34-81405.pdf.

21. Windsor Street Capital, L.P., Exchange Act Release No. 80908 (June 12, 2017), https://www.sec.gov/litigation/admin/2017/34-80908.pdf.

22. *See, e.g.*, Brown Bros. Harriman & Co., FINRA AWC No. 2013035821401 (Feb. 4, 2014).

23. *See infra* notes 151-189 and accompanying text.

qualified compliance professionals decline to take CCO jobs or leave their CCO roles for jobs with more protections from personal liability.[24] Second, despite the SEC stating that CCOs are its "essential partners"[25] in supporting its regulatory goals, the SEC's CCO personal liability approach has led to a disconnect between CCOs and the SEC because CCOs feel they are being unfairly targeted.[26] Moreover, the SEC's approach has also harmed the ability of CCOs themselves to develop and implement strong compliance programs that support the SEC's regulatory goals because they have to take on a "supervisory" authority which in turn exposes a CCO to personal liability if the CCO did not "reasonably" supervise.[27] The SEC's current approach incentivizes CCOs to develop a "check-the-box," reactionary compliance program and culture to mitigate personal liability by avoiding taking on supervisory authority. A significant body of research demonstrates this is ineffective for developing and implementing strong firmwide compliance.[28]

Further, the uncertainty around CCO liability harms firms because research has demonstrated that strong compliance cultures require a CCO willing to assume a strong and visible leadership role and who actively engages with the firm's senior leadership and business units.[29] Although such activities by the CCO may be interpreted by the SEC as "supervisory authority" (a questionable proposition in its own right), a CCO undertaking a proactive approach *decreases* the likelihood of compliance violations that cause firms financial or reputational harm. This benefits the firms and the public alike. Without a clear and appropriate CCO liability standard, CCOs are less likely to take on supervisory authority at their firms, and they may be put in the difficult position of balancing their interests against the interests of their firms.[30]

Third, the uncertainty around CCO liability harms regulators, whose mission is to protect investors in financial services firms.[31] These same negative consequences to CCOs and firms noted above hinder this regulatory goal by

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24. CCOs do not have the protections of a "profession" as lawyers do; Professor Jennifer Pacella has explained that because "there is currently no governing body or entity, neither state, federal, nor otherwise, that regulates the professional conduct or actions of compliance officers," this situation "gives rise to a susceptibility to personal liability because clear expectations and guidelines for professional behavior are altogether lacking." Jennifer M. Pacella, *Compliance Officers: Personal Liability, Protections, and Posture*, 14 BROOK. J. CORP. FIN. & COM. L. 23, 30 (2019).

25. Professor James Fanto has asserted that the combination of SEC oversight and internal control from compliance officers is necessary because government officials lack the resources to ensure that the significant number of private organizations and their employees are, in fact, complying with their legal obligations. *See* James A. Fanto, *The Professionalization of Compliance: Its Progress, Impediments, and Outcomes*, 35 NOTRE DAME J.L. ETHICS & PUB. POL'Y 183, 191 (2021).

26. *See, e.g.*, Golumbic, *supra* note 5, at 48.

27. *See infra* notes 151-189 and accompanying text.

28. *See infra* notes 151-223 and accompanying text.

29. *Id.*

30. *Id.*

31. SEC, *Mission* (Aug. 9, 2023), https://www.sec.gov/about/mission (stating the SEC's three-part mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation).

creating obstacles to developing and implementing strong compliance programs. The SEC's current CCO liability approach does not support its stated regulatory goals of deterring and punishing misconduct.[32]

This paper proposes that the SEC promulgate a clear legal standard for CCO personal liability, replacing its "wholesale failure" standard with a standard that requires "recklessness" by the CCO before they become personally liable. Unlike the confusion and inconsistency generated by the SEC's "wholesale failure" approach, "recklessness" is well-established and defined in securities law.[33] Thus, this paper proposes that a CCO only be held personally liable for compliance violations at their firms when they (1) are affirmatively involved in the violative conduct, (2) engage in efforts to obstruct or mislead the SEC related to the violative conduct, or (3) act recklessly in failing to develop or enforce compliance related to the violative conduct.

This paper utilizes a unique approach, not just rehashing existing ideas but utilizing cutting-edge research from organizational studies, compliance, behavioral studies, and information from legal authorities to demonstrate what creates strong organizational cultures that prevent unlawful behavior and promote compliance.[34] In 2021, Gallup, the world's largest multinational analytics and advisory company, conducted the most comprehensive employee study of its kind by interviewing 42.9 million employees on 5.1 million teams in more than 5,000 organizations in 212 countries.[35] Analysis of the results of these studies, provides key insights into policies and behaviors that create strong compliance cultures.[36] These studies and others support the recklessness legal standard advocated by this paper because such a standard would incentivize CCOs to meet the SEC's goals of achieving compliant behavior by the firm. This protects investors and promotes fair and efficient capital markets, rather than the current incentives for a CCO to create a check-the-box, reactionary compliance program to protect themselves from personal liability—an approach that is demonstrably less effective for guarding against employee noncompliance.[37] This legal standard will also remedy other negative consequences of the current standard, such as the chilling effect on knowledgeable and competent CCOs, and reflects both the realities of the CCO position and what is required to build strong organizational compliance cultures. These studies demonstrate that compliance is a firmwide endeavor

32. *See supra* notes 232-246 and accompanying text.

33. *See, e.g.,* David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997); SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1992); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990) (applying recklessness standard to federal securities laws).

34. *See* Fanto, *supra* note 25, at 185 ("compliance is now receiving considerable attention from scholars in a range of fields from law to organizational studies."); D. Daniel Sokol, *Teaching Compliance*, 84 U. CIN. L. REV. 399, 408 (2016) (asserting that an understanding of organizational behavior is necessary to solve complex compliance issues).

35. *See* JIM CLIFTON & JIM HARTER, WELLBEING AT WORK: HOW TO BUILD RESILIENT AND THRIVING TEAMS – FROM GALLUPBASED ON OVER 100 MILLION GLOBAL INTERVIEWS (2021).

36. *Id.*

37. *See infra* notes 151-223 and accompanying text.

requiring the efforts of much more than one person–Simply put, a CCO's efforts are *necessary but not sufficient* to attain firmwide compliance.[38] A CCO's personal liability for actions that do not meet a recklessness standard is misguided because wrongdoing at firms typically involves problems with the organizational culture at large rather than with a few "bad apples,"[39] and senior management should not be able to deflect blame for deficient organizational cultures by passing it to an individual CCO.[40]

Part I of this paper analyzes the history and purpose of the Advisers Act and the purpose and responsibilities of the CCO role as clarified by the SEC. It illustrates how the CCO role has greatly expanded in the past two decades due to SEC regulations and the nature of the financial services industry, reflecting the difficulty of the CCO role and the organizational support a CCO needs to be successful.[41] Part II traces the SEC's inconsistent approach to CCO liability and important recent developments in CCO liability, demonstrating that the SEC's guidance to CCOs is still uncertain, making the need for a clear liability standard all the more necessary. Part III proposes a clear legal standard for CCO liability, where CCOs may only be held personally liable for violations at their firms if they affirmatively engaged in the violative conduct, engage in efforts to obstruct or mislead the SEC related to the violative conduct, or act recklessly in failing to develop or enforce compliance related to the violative conduct.

Part IV illustrates how behavioral studies and related research support and feed into this legal standard, creating outcomes that research demonstrates will lead to stronger compliance programs. It shows the negative consequences of the SEC's current approach to CCO liability in five key areas and how a recklessness standard will positively shape compliance at financial services firms in five areas: (1) the chilling effect" of knowledgeable and competent CCOs due to fears of personal liability; (2) the current incentive for the CCO to implement a reactionary, "check-the-box" compliance program where CCOs take actions to protect themselves from assuming "supervisory authority" and thus personal liability, rather than constructing a proactive, holistic, and pragmatic compliance program that research

38. *Id.*

39. *See, e.g.,* Benjamin Van Roiij & Adam Fine, *Toxic Corporate Culture: Assessing Organizational Processes of Deviancy*, 8 ADMIN. SCIS. 23 (2018) (illustrating that organizational cultural deficiencies are broader than just a few bad apples); Wieke Scholten & Naomi Ellemers, *Bad apples or corrupting barrels? Preventing traders' misconduct.* 24 J. FIN. REGUL. & COMPLIANCE 366 (2016); Kanti Pertiwi, *Contextualizing Corruption: A Cross-Disciplinary Approach to Studying Corruption in Organizations.* 8 ADMIN. SCIS. 12 (2018) (elucidating why the "bad apples" perspective is insufficient).

40. *See, e.g.,* Benjamin Van Roiij & Adam Fine, *Toxic Corporate Culture: Assessing Organizational Processes of Deviancy*, 8 ADMIN. SCIS. 23 (2018); Wieke Scholten & Naomi Ellemers, *Bad apples or corrupting barrels? Preventing traders' misconduct.* 24 J. FIN. REGUL. & COMPLIANCE 366 (2016); Kanti Pertiwi, *Contextualizing Corruption: A Cross-Disciplinary Approach to Studying Corruption in Organizations.* 8 ADMIN. SCIS. 12 (2018).

41. Commissioner Uyeda has recently remarked that the volume and breadth of SEC regulations the CCO must ensure firm compliance with is "staggering." Uyeda Remarks, *supra* note 7.

demonstrates is necessary for firmwide compliance; (3) the failure to understand that firmwide compliance failures are often problems with the larger organizational culture and senior management should not be able to deflect blame for deficient organizational cultures on an individual CCO; (4) the risk of hindsight bias; and (5) the failure to support the SEC's own regulatory goals.

PART I - NATURE AND EVOLUTION OF THE FINANCIAL SERVICES CCO ROLE

Rule 206(4)-7, promulgated by the SEC under the Advisers Act, requires SEC-registered firms to designate a CCO to develop and implement firmwide compliance by administering compliance policies and procedures.[42] The 2004 amendment is commonly known as the "Compliance Programs Rule" and has served as the cornerstone of financial services regulation for the past two decades. The Compliance Programs Rule applies to the approximately 15,000 SEC-registered firms, including investment advisers, broker-dealers, private equity firms, hedge funds, and others, each of whom must designate a CCO.[43]

The Compliance Programs Rule is fundamental to addressing the fiduciary duty that all SEC-registered firms have to their clients and requires three core elements of any adviser's compliance program:

> (1) Adopt and implement written compliance policies and procedures designed to prevent violations of the federal securities laws and the Advisers Act;
> (2) Review those compliance procedures annually for their adequacy and the effectiveness of their implementation; and
> (3) Designate a CCO who is responsible for administering the compliance procedures.[44]

The Compliance Programs Rule was promulgated under the antifraud provisions of the Advisers Act, which holds SEC-registered firms themselves to a negligence-type liability standard. Section 206(2) of the Advisers Act makes it unlawful for a firm to "engage in any transaction . . . which operates

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42. Investment Advisers Act of 1940, 7 C.F.R. § 275.206(4)-7(c) (2020) (requiring a registered investment adviser to have a CCO).

43. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") amended the Investment Advisers Act of 1940 to require private fund advisers (including hedge funds and private equity firms) to registered as investment advisers with the SEC. There are only three exemptions for private fund advisers to avoid registration under the Advisers Act: (1) venture-capital fund advisers, (2) private fund advisers with less than $150 million assets under management, and (3) certain foreign private advisers. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).

44. Compliance Programs Rule, *supra* note 1.

as a fraud or deceit any client or prospective client." This provision does not have a scienter (intent) requirement and has been interpreted to impose liability on the financial services firm for merely negligent acts.[45] Fraud does not require intent to violate the Compliance Programs Rule, nor does the SEC need to demonstrate that any client was harmed due to the firm's violative conduct.[46]

Regarding the third prong of the Compliance Programs Rule, the SEC has reaffirmed the statutory mandate that a firm's CCO must be competent and knowledgeable regarding the Advisers Act and must be empowered with full responsibility and authority to develop and enforce appropriate firm policies and procedures. Accordingly, the CCO should have a position of sufficient seniority and authority within the firm to require others to adhere to the firm's compliance policies and procedures.[47]

The SEC considers CCOs to be essential "gatekeepers" on the front lines of preventing, detecting, and remediating compliance violations at their firms.[48] On a day-to-day basis, the CCO oversees employees of their firm from a compliance perspective and is responsible for the design, implementation, administration, and testing of an adviser's policies and procedures. The SEC has affirmed that the CCO is not a direct supervisor of individuals within the business departments but rather an overall supervisor of compliance firm-wide.[49] Thus, a CCO must identify and mitigate risks to the firm at varying levels throughout the organization and partner with business departments and their heads to make decisions that ensure compliance and mitigate risks.[50]

The Compliance Programs Rule does not specify the elements that must be included in a firm's compliance program and procedures. Instead, the firm must tailor the procedures to its specific business model and operations.[51] However, the rule makes clear that the CCO's responsibilities are broad, covering compliance across the firm's business units. In the Adopting Release of the Compliance Programs Rule, the SEC stated that, at a minimum, the adviser's procedures must address the following ten key areas:

- Portfolio management processes, including allocation of investment opportunities among clients;

45. *See, e.g.*, John J. Sikora, Jr. & Jack M. McNeily, *Mens Rea for Investment Advisers Act Violations,* HARV. L. SCH. F. ON CORPORATE GOVERNANCE (July 11, 2019), https://corpgov.law.harvard.edu/2019/07/11/mens-rea-for-investment-advisers-act-violations.

46. *Id.*

47. *See* Compliance Programs Rule, *supra* note 1; *see also* 17 C.F.R. Parts 270, 275, & 279 (2003).

48. *See, e.g.,* Commissioner Jaime Lizárraga, SEC, *Preventing Fraud and Manipulation in the Swaps Market and Bolstering Gatekeepers* (June 7, 2023), https://www.sec.gov/news/statement/lizarraga-statement-security-based-swaps-060723 ("As gatekeepers, CCOs have an important role to play in ensuring compliance with the federal securities laws.").

49. *See infra* Part IV and accompanying notes.

50. *Id.*

51. Compliance Programs Rule, *supra* note 1.

- Trading practices, including best execution, soft dollar arrangements, and trade aggregation;
- Proprietary trading of the adviser and personal trading activities of supervised persons;
- Accuracy of disclosures made to investors, clients, and regulators, including in advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- Creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.[52]

The CCO's responsibilities are substantial because the CCO is the supervisor of compliance firm-wide; these ten areas each involve significant amounts of effort and oversight and are only the "minimum" areas requiring supervision under the Advisers Act. In each of these areas, a firm's compliance program must incorporate many features, including legal disclosures, monitoring and testing, policies and procedures, firm controls, and creating a culture of compliance.[53]

The role of the CCO has become increasingly more complex over the past two decades due to the rapid release of new SEC regulations and the competitive, fast-paced nature of the financial services industry. On April 14, 2021, the Senate confirmed current SEC Chairperson Gary Gensler to a 5-year term through June 5, 2026.[54] Under Chair Gensler, the number of new regulations undertaken by the SEC using its rulemaking powers has been "unprecedented" in speed and volume. Commissioner Uyeda has remarked that the "volume and breadth of [the rules of Chair Gensler's regime] is staggering."[55] During Chair Gensler's term, the SEC is on track to propose and finalize sixty-three new rules by the end of his first four years in office. This is significantly more than the two previous SEC chairs – Chair Mary Jo White (2013 to 2017), who finalized twenty-two rules, and Chair Jay Clayton (2017 to 2020), who finalized forty-three rules in the same period.[56] Many of Chair Gensler's rules have the potential to transform the financial services

52. *Id.*
53. *Id.*
54. Gary Gensler—Securities and Exchange Commission—Nomination, CONGRESS.GOV (Apr. 14, 2021), https://www.congress.gov/nomination/117th-congress/80.
55. Uyeda Remarks, *supra* note 7.
56. Kenneth E. Bentsen, Jr., *The Unprecedented Speed and Volume of SEC Rulemaking*, SIFMA (Sept. 21, 2023), https://www.sifma.org/resources/news/the-unprecedented-speed-and-volume-of-sec-rulemaking.

industry radically and reflect the most substantial overhaul of regulation since the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. The SEC has proposed a significant number of rules across a wide variety of categories, covering diverse areas such as (1) special purpose acquisition companies; (2) security-based swap execution; (3) climate-related disclosures for investors; (4) environmental, social, and governance disclosures by investment advisers and investment companies; (5) shareholder proposals; (6) outsourcing by investment advisers; (7) open-end fund liquidity risk management programs; (8) cybersecurity risk management for investment advisers and investment companies; (9) privacy of customer information; (10) safeguarding client assets; (11) the use of predictive data analytics; (12) registration for index-linked annuities, and (13) amendments to regulatory Form PF.[57]

The SEC's rules create considerable burdens for CCOs, who must interpret and implement each new rule into their firms' compliance programs. As Commissioner Uyeda has recently remarked, "Immense time and resources [are] needed to address even a portion of the changes introduced by the [SEC] in the past two years. Firms are left scrambling to keep pace and compliance professionals are bearing a significant portion of the burden."[58] Moreover, CCOs must train employees to comply with the new rules and inform them how they relate to the day-to-day activities of the firm's business units. Here, CCOs need substantial resources to perform their roles adequately. Yet, most CCOs feel they do not have such resources. According to a recent National Society of Compliance Professionals ("NSCP") survey of over 2,000 CCOs, 70% of CCOs believe the overall compliance function at their firms is under-resourced.[59] Many firms continue to view compliance as a "cost center" rather than a revenue-generating activity and, therefore, limit the resources given to compliance.[60] Based on the growing and significant responsibilities of the CCO role, this is a problematic barrier for promoting firmwide compliance. Adding to the burden CCOs face, most have responsibilities in addition to their compliance responsibilities because most SEC-registered firms are small to mid-size businesses where employees have several responsibilities. As of 2022, the 15,114 SEC-registered firms manage $114.1 trillion in assets under management. 91.7% of these firms employed

57. Twice a year under the Regulatory Flexibility Act, the SEC is required to publish an agenda identifying the legislation it is considering over the next 12 months *See* SEC, Agency Rule List (Spring 2024), https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235 [hereinafter "RegFlex Agenda"].

58. Uyeda Remarks, *supra* note 7.

59. NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS, FIRM AND CCO LIABILITY FRAMEWORK 1 (Feb. 14, 2023) [hereinafter "NSCP Framework"], https://static1.squarespace.com/static/61a9074028e505179c284c97/t/658054b74831a756e126217f/1702909111900/NSCP%2BFirm%2Band%2BCCO%2BLiability%2BFramework%2Bv.2%2B%282-14-2023%29.pdf.

60. *Id.*

100 or fewer employees, 70.2% manage less than $1 billion in assets under management, and 88.5% manage less than $5 billion.[61]

In addition to interpreting SEC rules and implementing firmwide policies and procedures that tailor the rules to their firms, the CCO must communicate the SEC rules to firm employees, almost all of whom are not familiar with compliance or legal professionals and do not have securities regulation backgrounds. This is because the "first line of defense" against noncompliant behavior is ultimately the front-line employees themselves. These employees are directly involved in the daily operations of the firm, and responsible for maintaining compliance and managing risks daily in their respective business units, such as information technology, investor relations, and finance.[62] Employees must understand their roles and responsibilities related to compliance, create and apply internal controls that align with the organization's compliance objectives, and identify and respond to risks that may arise from their work and interactions.[63] The "second line of defense" is compliance, which attempts to detect compliance issues that are not properly addressed by employees.[64]

The following illustrates a typical interaction between these two lines of defense: according to the Compliance Programs Rule, the CCO is responsible for overseeing "marketing practices" to ensure that any of the firm's advertising, marketing activities, and the use of testimonials in marketing materials comply with Rule 206(4)-1, which regulates marketing practices to help reduce instances of market manipulation and protect investors so they

61. INVESTMENT ADVISOR ASSOCIATION, INVESTMENT ADVISOR INDUSTRY SNAPSHOT 2023 7 (June 2023), https://investmentadviser.org/wp-content/uploads/2023/06/Snapshot2023_Final.pdf.

62. *See, e.g., Modernizing the Three Lines of Defense Model: an Internal Audit Perspective*, DELOITTE (Office of Internal Audit: The Three Lines of Defense), https://www2.deloitte.com/us/en/pages/advisory/articles/modernizing-the-three-lines-of-defense-model.html; *The Three Lines of Defense*, THE UNIV. OF MISSISSIPPI (July 2015), https://internalaudit.olemiss.edu/the-three-lines-of%20defense; GEOFFREY P. MILLER, THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE 4 (2d ed. 2017) ("The Three Lines of Defense Line One: operating executives have initial responsibility for implementing internal controls within their own areas. Line Two: risk-management and compliance operations catch problems that are not weeded out at the front line. Line Three: internal audit checks up on everyone, including risk management and compliance, in an attempt to make sure that no problems remain."); Sokol, *supra* note 34, at 411 ("Day to day compliance is . . . the primary responsibility of the business unit heads rather than a compliance officer.").

63. *See, e.g., Modernizing the Three Lines of Defense Model: an Internal Audit Perspective*, DELOITTE , https://www2.deloitte.com/us/en/pages/advisory/articles/modernizing-the-three-lines-of-defense-model.html; *The Three Lines of Defense*, THE UNIV.OF MISSISSIPPI (July 2015), https://internalaudit.olemiss.edu/the-three-lines-of%20defense; GEOFFREY P. MILLER, THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE 4 (2nd ed. 2017); Sokol, *supra* note 34, at 411.

64. *See* KPMG, *The Three Lines of Defense: Making the Transition to a Mature Risk Management Model* (2016), https://assets.kpmg.com/content/dam/kpmg/ca/pdf/2017/01/three-lines-of-defense-kpmg.pdf ("The second line is comprised of the standard setters or risk oversight groups (e.g., compliance functions, legal and enterprise risk management) which are responsible for establishing policies and procedures and serving as the management oversight over the first line (the doers).").

can make informed decisions.[65] Here, the first line of defense is the firm's marketing professionals, who must understand the types of investor communications that are permitted and ensure any communications they have with investors comply with Rule 206(4)-1. As the second line of defense, the CCO ensures that the marketing professionals are trained on Rule 206(4)-1, reviews issues escalated by marketing employees, and conducts periodic testing to ensure employees are complying.[66]

In addition, CCOs operate in financial services, an industry known for its challenging, fast-paced, and competitive nature.[67] Firms must innovate to be competitive, attract investors, and generate attractive returns to survive. CCOs must develop compliance that supports the firm's business objectives. For example, if the firm develops a new investment product or strategy, the CCO must implement compliance that ensures the new product or strategy complies with SEC regulations and develop firmwide compliance for the product or strategy. This is a difficult task, as the SEC has often not directly addressed the compliance nuances of a new product or strategy. The financial services industry is also greatly impacted by rapidly developing technologies, increasing the pace of new products and strategies, and technologies the CCO must implement and monitor.[68]

This difficulty is further exacerbated by the fact that the statutory framework of the Advisers Act itself is susceptible to reasonable disagreement, which creates challenges for CCOs when applying SEC regulations to their firms.[69] The Advisers Act requires that the firm's compliance policies and procedures be "reasonably designed" to prevent and detect violations of the Advisers Act.[70] Each firm must craft its policies and procedures to its unique business model, so what is "reasonably designed" for a firm's business model is open to interpretation.[71] Further, there are procedural and structural barriers at the SEC that hinder the usefulness of its publicly available enforcement actions and settlements. SEC rules are rarely reviewed at the judicial level; instead, the primary mechanism for their interpretation is the

65. Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-1 (2004).

66. *See supra* notes 62-64.

67. *See, e.g.*, Anthony Morris, *The Financial Services Industry Is Changing—Again, And Again, And Again*, FORBES (Oct. 21, 2022), https://www.forbes.com/sites/forbesfinancecouncil/2022/10/21/the-financial-services-industry-is-changing-again-and-again-and-again/ (describing the rapid pace of change and competition in the financial services industry); PwC, *Ahead of the Curve: Confronting the Big Talent Challenges in Financial Services* (2017), https://www.pwc.com/gx/en/ceo-survey/2017/industries/ceo-survey-fs-talent.pdf (discussing the competitive landscape of the financial services industry).

68. *See, e.g.*, Anthony Morris, *The Financial Services Industry Is Changing—Again, And Again, And Again*, FORBES (Oct. 21, 2022), https://www.forbes.com/sites/forbesfinancecouncil/2022/10/21/the-financial-services-industry-is-changing-again-and-again-and-again/; PwC, *Ahead of the Curve: Confronting the Big Talent Challenges in Financial Services* (2017), https://www.pwc.com/gx/en/ceo-survey/2017/industries/ceo-survey-fs-talent.pdf.

69. *See* NYC Bar Report, *supra* note 7, at 7-8.

70. *Id.*; *see also* Compliance Programs Rule, *supra* note 1.

71. *Id.*

SEC's enforcement actions and settlements, issued guidance, and statements.[72] Even when an SEC official makes a speech, they speak on their own behalf rather than speaking to the agency's views.[73] Unlike a judicial opinion, an SEC enforcement action or settlement is typically a result of intense negotiations between the firm or CCOs attorneys and SEC staff, which further hinders their usefulness of providing a clear and consistent interpretation for other firms to look to as guidance.[74] Unlike many other federal agencies, such as the Department of Justice, the SEC does not issue formal policy statements when it issues enforcement actions and settlements.[75] Thus, CCOs face challenges when applying SEC regulations to their firms.

In conclusion, CCOs are saddled with immense burdens to ensure firm-wide compliance amid resource and structural constraints in a competitive, fast-paced, marketplace. Accordingly, the SEC should support and empower CCOs to promote firm-wide compliance to meet regulatory goals. As Part II will illustrate, however, the SEC's current approach to CCO personal liability has generated a cloud of uncertainty.

PART II – SEC'S INCONSISTENT AND PUZZLING APPROACH TO CCO LIABILITY

> "Left with only the cursory details set forth in settled enforcement actions, the reasoning behind a particular decision to charge a CCO is often left to the collective imagination.
>
> - SEC Commissioner Mark T. Uyeda[76]

Without a clear legal standard for CCO liability, the SEC has sent mixed messages about when a CCO may be held personally liable for compliance

72. *See* NYC Bar Report, *supra* note 7, at 7-8. The NYC Bar Framework argues that, "[e]xisting regulatory communications—such as risk alerts, enforcement actions and settlements, and reports of examination activities—can be developed to provide more detailed and specific guidance to compliance officers." *Id.* at 24.

73. *See, e.g.*, *Evolution of a Disclaimer: The SEC Revisits its Approach*, THECORPORATECOUNSEL.NET (June 1, 2023), https://www.thecorporatecounsel.net/blog/2023/06/evolution-of-a-disclaimer-the-sec-revisits-its-approach.html.

74. *See, e.g.*, Daniel M. Hawke, *Settling SEC Enforcement Actions,* LEXISNEXIS (July 2019), https://www.arnoldporter.com/-/media/files/perspectives/publications/2019/07/settling-sec-enforcement-actions.pdf.

75. *See, e.g.*, NYC Bar Report, *supra* note 7, at 24 (recommending that existing regulatory communications should provide more detailed and specific guidance to CCOs). The Department of Justice ("DOJ") sets forth its expectations for compliance in its prosecutorial manual and in guidelines on enforcing specific laws, such as the Foreign Corrupt Practices Act, which it commonly uses to prosecute organizations. See U.S. DEP'T OF JUST., PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS, 9-28.800, at 14–16 (2019) (discussing compliance programs); CRIM. DIV., U.S. DEPT' OF JUST. & ENF'T DIV., SEC. & EXCH. COMM'N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT 56–63 (2012) (setting out the elements of an effective program).

76. Uyeda Remarks, *supra* note 7.

violations of their firms. Here, the third prong of cases when regulators have said a CCO may be charged— "wholesale failure"— presents major problems. First, the SEC has not clearly defined what "wholesale failure" means, does not use this legal standard in its enforcement actions and settlements against CCOs, and has applied the "wholesale failure" standard inconsistently, bringing charges against CCOs when a CCO engaged in conduct that did not rise to what would be a "wholesale failure,[77] often looking like negligence and even strict liability. This uncertainty causes confusion and signals a disparity between what regulators say ("wholesale failure") and what they do (negligence/strict liability).[78] Further, the SEC has not consistently applied a clear, consistent CCO liability standard in its charges against CCOs and sometimes created new standards altogether, causing confusion. The SEC's actions against CCOs often ignore the SEC's stated liability factors or promulgate new factors altogether. Despite calls from regulators and industry groups for a clear CCO liability standard, the SEC has still not promulgated one.

The most direct starting point for this analysis is the 2015 speech by then Director of the SEC Division of Enforcement, Andrew Ceresney.[79] Director Ceresney stated that the SEC may charge individual CCOs in three circumstances: (1) when the CCO is affirmatively involved in misconduct; (2) when the CCO engages in efforts to obstruct or mislead the SEC; or (3) when the CCO exhibits "a wholesale failure to carry out his or her responsibilities." These three categories have been supported and reinforced by industry insiders and numerous SEC officials, including in recent speeches by Commissioner Peirce, Commissioner Uyeda, and Director Grewal. The first two categories are not controversial – CCOs, like any other employee, should face personal liability if they engage in affirmative misconduct that violates the securities laws or obstructs a regulatory investigation. However, the third category of "wholesale failure" has created confusion and concern amongst CCOs.

The *Thaddeus North* case illustrates this point.[80] In *North*, the SEC issued a decision regarding a FINRA disciplinary action against Mr. North, the

77. These cases illustrate that the SEC seems to be applying a negligence-based standard to CCO liability cases. According to Black's Law Dictionary, the legal definition of negligence is "[t]he omission to do something which a reasonable man, guided by those considerations which ordinarily regulate the conduct of human affairs, would do. Or doing something which a prudent and reasonable man would not do." *Negligence*, BLACK'S LAW DICTIONARY (2nd ed. 1910). This reflects the cases against CCOs noted – that the CCO did not act "reasonably" or "adequately" or "should have known" about the firm's violative conduct. Certainly, these cases encompass a broader range of actions than Director Ceresney's 2015 "wholesale failure" standard.

78. Scholars have demonstrated that legal uncertainty is disadvantageous because it reduces the law's efficacy ". . . in guiding the behavior of the people subject to the [law]." RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 543 (Richard A. Epstein et al. eds., 4th ed. 1992).

79. *See* Ceresney Remarks, *supra* note 13; NYC Bar Report, *supra* note 7, at 4.

80. In re Thaddeus J. North, Admin. Proc. File No. 3-17909 (Oct. 29, 2018), available at https://www.sec.gov/files/litigation/opinions/2018/34-84500.pdf.

Chief Compliance Officer of Southridge Investment Group. The SEC upheld FINRA's decision that Mr. North should be personally liable for his firm's compliance failures. As CCO, it found Mr. North had (1) failed to establish a reasonable supervisory system for the review of electronic correspondence, (2) failed to review electronic correspondence reasonably, and (3) failed to report a relationship with a statutorily disqualified person.[81]

Mr. North did not himself engage in wrongdoing nor attempt to cover up the wrongdoing. Instead of defining and applying the "wholesale failure" standard as the third possibility for CCO liability, the *North* opinion simply cited four areas where a CCO may face liability: (1) the CCO engaged in wrongdoing, (2) the CCO attempts to cover up wrongdoing, (3) the CCO "crosses a clearly established line"; or (4) the CCO fails to "meaningfully to implement" compliance programs, policies, and procedures for which he or she has direct responsibility.[82]

Regarding the third and fourth factors, the SEC had never previously stated or applied such standards, nor did it clarify what a "clearly established line" is or what it means to "meaningfully implement." Neither did the *North* opinion apply the facts of the case to such a standard. In fact, the SEC found North personally liable under a fifth category; none of the four areas the opinion says apply to CCO liability – that he "failed to make reasonable efforts."[83] The use of such a "reasonableness" standard broadens the reach of CCO liability past circumstances of a "wholesale failure" and the SEC promulgated new factors altogether.

In the opinion, the SEC states that "good faith judgments of CCOs made after reasonable inquiry and analysis should not be 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."[84] Nevertheless, by using a different, broader standard of CCO liability in the *North* opinion, the SEC, in fact, creates confusion and concern regarding CCO liability rather than alleviating concerns that CCOs have regarding liability.

The SEC has often brought charges against CCOs under a "classic negligence language" reasonableness standard, finding liability in circumstances that would not rise to a wholesale failure.[85] In these negligence-type cases, a CCO is liable for "causing" a firm's violation if the CCO committed "an act or omission the person knew or should have known would contribute" to the violation. Thus, where a firm has committed a violation that does not require scienter—such as failing to have sufficient policies and procedures—a compliance officer can be held to have caused the violation

81. *Id.*
82. *Id.* at 12.
83. *Id.* at 12.
84. *Id.*
85. *See, e.g.*, Peirce Remarks 1, *supra* note 1.

based on her own negligent conduct. Examples of these types of actions include:

- Enforcement action against Blackrock's CCO because he "*caused*" another firm employee to fail to disclose a conflict of interest involving the employee's outside business activity, as the compliance policies and procedures were not "*reasonably designed*" to prevent the employee's violative conduct.[86]
- An enforcement action was taken against a CCO who failed to "adequately" review an employee's email correspondence.
- Enforcement action against a CCO who misstated assets under management in regulatory filings that were based on estimates from the Chief Investment Officer.
- Enforcement action against a CCO where he failed to implement "*reasonably designed*" written compliance policies to detect suspicious anti-money laundering activity at the firm by improperly relying on policies from other departments over which the CCO had no supervisory control.
- Enforcement action against a CCO where he was alleged to have no knowledge of the facts underlying the violative conduct but failed to conduct an "*adequate*" compliance review that regulators believe would have led the CCO to discover the violative conduct.

Further, even in cases where, based on the facts and where there is a strong case for stating that the CCO committed a wholesale failure, the SEC does not use the term wholesale failure to articulate its decision. As an alternative, the SEC has charged CCOs with "aiding and abetting" the firm's compliance violation, which seems to require that the CCO acted recklessly.[87] For example, in the *Southwind* case, the SEC stated that the CCO both "willfully aided and abetted" and "caused" the firm's compliance violations.[88] In the *Sands Brothers* case, the SEC held that CCO Christopher Kelly was liable for aiding and abetting the compliance violation, stating that Kelly was personally liable because he "knew or was reckless in not knowing about" the compliance violations.[89]

86. *In the Matter of Blackrock Advisors, LLC and Bartholomew A. Battista*, Investment Advisers Act Release No. 4065 (Aug. 6, 2015), https://www.sec.gov/litigation/admin/2015/ia4065.pdf.

87. *See e.g., In re Buckingham Research Group, Inc.*, Securities Exchange Act Release No.63323, Investment Advisers Act Release No. 3109, Administrative Proceeding Release No.3-14125, WL 4648468 (Nov. 17, 2010), https://www.sec.gov/files/litigation/admin/2010/34-63323.pdf (CCO found liable for aiding and abetting).

88. *See* In the Matter of Southwind Associates of NJ Inc. (d/b/a Villafranco Wealth Management), William Scott Villafranco, and Anthony LaPeruta, Release No. 82397 (Dec. 22, 2017), https://www.sec.gov/files/litigation/admin/2017/34-82397.pdf.

89. *In the Matter of Sands Brothers Asset Management, LLC, Steven Sands, Martin Sands and Christopher Kelly*, Administrative Proceeding File No. 3-16223 (Nov. 19, 2015), https://www.sec.gov/files/litigation/admin/2015/ia-4274.pdf.

Not only have regulators not defined or applied wholesale failure liability category but recent statements have also caused even more confusion. Director Grewal recently categorized this third category of liability as arising when the CCO engages in "wholesale failures to carry out compliance responsibilities and *conduct even basic inquiry and analysis*" (emphasis added)[90] This seems to denote that a wholesale failure would be extremely rare in the circumstances even more limited than those contemplated by Director Ceresney and others who have endorsed a wholesale failure standard. However, the SEC's charges against CCOs do not apply this standard, and while the SEC states that a wholesale failure is a strict standard, the SEC cases show it is not nearly as high a bar as this language would suggest.

As these cases illustrate, the SEC is unclear and inconsistent regarding the legal standard that applies for CCO liability. To address this problem, several industry groups and SEC Commissioners have continued to advocate for the SEC to establish a clear legal standard for CCO liability. Despite the lack of clarity around what wholesale failure means when assessing CCO liability, these parties have widely endorsed the wholesale failure standard. In June 2021, the New York City Bar issued a report proposing a CCO liability framework (the "NYC Bar framework")[91] The NYC Bar framework adopts the SEC's wholesale failure standard and argues that regulators should first analyze whether there are "affirmative factors" to charge a CCO and then balance these factors against any "mitigating factors." Affirmative Factors include whether charging the CCO helps fulfill the SEC's regulatory goals, whether the CCO made a good faith effort to fulfill their responsibilities, and whether the wholesale failure is related to a fundamental aspect of a well-run compliance program. Mitigating factors include whether structural or resource challenges hindered the CCO's performance, whether the CCO voluntarily disclosed the misconduct or actively cooperated with the SEC, and whether the CCO implemented compliance policies and procedures in good faith. The report concludes that formally utilizing such a framework will help alleviate CCOs' concerns and allow them to focus on their "necessary work."

On July 1, 2022, SEC Commissioner Hester M. Peirce made a formal statement on "Chief Compliance Officer Liability," which advocated for a formalized legal standard for CCO liability and proposed a framework of nonbinding factors for the SEC to consider under which to evaluate whether to bring charges against CCOs for conduct relating to their compliance-related

90. Grewal Remarks, *supra* note 12.

91. The NYC Bar Framework discusses the increasing concerns surrounding enforcement actions against CCOs because such actions are counterproductive by "discourag[ing] individuals from becoming or remaining compliance officers and performing vital functions that regulators stretched too thin would otherwise be unable to perform[.]" The report emphasizes that well-qualified CCOs have and will make decisions to pursue a different path other than as a CCO so that they do not risk "career-ending" enforcement actions that involve great "personal risk." Before charging a CCO, the report urges the SEC to ask itself whether charging a CCO would "help fulfill the SEC's regulatory goals." *See* NYC Bar Report, *supra* note 7.

duties.[92] Here, Pierce supported and applied the NYC Bar Framework factors noted above to determine whether there was a "wholesale failure" to carry out compliance responsibilities. Peirce acknowledged that "the nature of the liability [compliance officers] face in executing [their] responsibilities remains unclear" and noted that "[t]he lack of clarity around CCO liability is problematic" and emphasized that the SEC must do a better job of providing CCOs with information to help them do their jobs properly.[93]

In January 2022, the National Society of Compliance Professionals ("NSCP"), one of the world's largest member organizations for compliance professionals, released a "Firm and CCO Liability Framework" (the "NSCP Framework"), which it said "complements" the NYC Bar Framework.[94] The NSCP Framework does not articulate a complete legal standard for CCO liability but addresses a "framework" of mitigants regulators should consider against CCO liability. The NSCP based its framework on results from multiple industry-wide surveys of thousands of CCOs.[95]

The NSCP Framework looks not only at the CCO's conduct (or omissions) but also focuses on corporate structural issues, such as whether the CCO had the responsibility or authority to perform certain tasks. A "yes" answer to any of the key questions should mitigate against personal liability: these questions include whether firm management failed to delegate to the CCO actual responsibility or authority to affect the violative conduct, whether firm management failed to respond appropriately to the violative conduct after becoming aware of it, whether the CCO escalated the issue or violative conduct to firm management, whether the CCO reasonably relied on

92. Peirce Remarks 2, *supra* note 6.

93. In analyzing Director Ceresney's 2015 speech outlining the three categories of cases for when a CCO may be held personally liable, Pierce emphasized that Ceresney's first two categories are not controversial but that the third category of "wholesale failure" cases "is the one that understandably generates the most controversy and is the most challenging area." *Id.* Importantly, Pierce noted that the actual practices of the SEC in the "wholesale failure" "have looked more like strict liability." Pierce expressed serious concerns about charging CCOs in negligence or strict liability type cases in the "wholesale failure" category for several reasons: (1) the SEC's regulatory goal of promoting compliance will not be met by deterring talented professionals from taking CCO positions for fear of personal liability, (2) it encourages dishonest efforts to cover up failures for fear of personal liability, and (3) wrongfully shifts responsibility for compliance from the firm to the CCO. Accordingly, Pierce urged the SEC to guide CCOs about what a wholesale compliance failure means and how to promulgate a clear legal standard for CCO liability. *Id.*

94. NSCP Framework, *supra* note 59.

95. These surveys focused on "CCO Liability" and "CCO Empowerment." The results demonstrated that a majority of CCOs remained concerned that personal liability would be imposed on CCOs in cases where the CCO acted negligently rather than recklessly (53%), relied on inaccurate data from another employee (66%), and did not participate in the violations caused by the company or other executives (63%). NSCP CCO LIABILITY SURVEY (Dec. 2021), https://nscp.org/wp-content/uploads/2021/12/NSCP-CCO-Liability-Survey-Summary-2021_FINAL.pdf; NSCO CCO EMPOWERMENT SURVEY (Dec. 2021), https://nscp.org/wp-content/uploads/2021/12/NSCP-CCO-Empowerment-and-Resource-Survey-Summary-Final.pdf.

information from others in the firm or firm systems, and whether the CCO acted reasonably.[96]

Next, on October 16, 2023, SEC Commissioner Mark Uyeda urged regulators to "clearly describe the circumstances under which a CCO will be held liable for a firm's violations of the federal securities laws." He noted that the SEC's lack of a CCO liability framework "has been the source of a great deal of concern" for compliance officers, particularly given the plethora of new regulations since the Compliance Programs Rule was promulgated two decades ago. Commissioner Uyeda advocated that "[r]egulators should clearly describe the circumstances under which a CCO will be held liable for a firm's violations of the federal securities laws…and work towards providing more certainty to the hard-working compliance professionals tasked with implementing the [SEC's] expanding rulebook."[97]

Later that same month, on October 24, 2023, SEC Enforcement Director Gurbir Grewal reapplied the three categories of CCO liability described by Director Ceresney in 2015. While Grewal said cases against CCOs are rare, he also stressed that the SEC actively pursues enforcement actions, including against CCOs. Accordingly, CCOs must remain vigilant to guard against personal liability.[98]

To demonstrate CCO liability for their own misconduct, Grewal gave an example of a recent case where the SEC charged a CCO with insider trading. Grewal stated that "when compliance officers violate the securities laws in ways that have nothing to do with exercising their compliance responsibilities, they are held accountable just like anyone else."[99] To demonstrate where a CCO "misled regulators," the second category, Grewal discussed a case where a CCO was personally charged by the SEC for aiding and abetting and causing a firm's books and records violations by providing SEC staff with backdated and factually inaccurate compliance review memos. Here, the CCO engaged in affirmative conduct to thwart an SEC investigation into the firm. As discussed, regarding the "wholesale failure" category, Grewal asserted that this involves cases where the CCO engaged in "wholesale failures to carry out compliance responsibilities *and conduct even basic inquiry and analysis*" (emphasis added)[100]

In conclusion, the SEC has sent confusing messages about when a CCO may be held personally liable for compliance violations of their firms. It has

96. The NSCP summarizes the importance of developing a CCO liability framework because "[i]mposing personal liability on CCOs who have not engaged in misconduct or obstruction has the impact of shifting responsibility from business line personnel and management to the CCOs. This could diminish the culture of compliance within firms and promote indifference from business line employees and management to follow the rules. It could ultimately lead to firm-wide deficiencies being attributed to compliance and benefit management who failed to empower compliance." NSCP Framework, *supra* note 59, at 1.

97. Uyeda Remarks, *supra* note 7.

98. Grewal Remarks, *supra* note 12.

99. *Id.*

100. *Id.*

not promulgated a clear legal standard despite these problems and the urging of industry groups and SEC officials for such a clear legal standard.[101] Here, the third class of cases when regulators have said a CCO may be charged—"wholesale failure"— presents major problems. Part III of this article proposes a recklessness legal standard for CCO liability, which, unlike wholesale failure, applies to many other federal securities laws and provides more legal clarity and consistency with significant benefits for firmwide compliance.

PART III – PROPOSED LEGAL STANDARD FOR CCO PERSONAL LIABILITY

This paper advocates that CCOs should only be held personally liable for compliance violations at their firms when they (1) are affirmatively involved in the violative conduct, (2) engage in efforts to obstruct or mislead the SEC related to the violative conduct, or (3) act *recklessly* in failing to develop or enforce compliance related to the violative conduct. Part II demonstrated that the SEC's current wholesale failure approach to CCO liability is hopelessly flawed. The phrase lacks clarity, is rarely used by the SEC in its charges against CCOs, and has been interpreted in myriad ways, including in situations less significant than wholesale failures, making the standard appear to be grounded in mere negligence or even strict liability.[102]

A wholesale failure to carry out responsibilities is most analogous to when a CCO acts recklessly, a standard regulators and courts have substantially defined and interpreted in enforcing various federal securities laws.[103] Unlike wholesale failure, the recklessness standard applies to many other federal securities laws, providing more legal clarity and consistency.[104] It also has significant benefits for CCOs, firms, and regulators and is supported by research demonstrating that it will positively benefit firmwide compliance.[105]

The proposed legal standard for CCO personal liability defines recklessness like it is defined throughout federal securities law. In federal securities law, scienter is "a mental state embracing intent to deceive,

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101. Professor Jennifer Pacella has recently proposed a novel liability standard that would be applicable across industries, not solely financial services, based on a modification of the business judgment rule from agency law. Professor Pacella stresses the need for an appropriate standard of care for CCO personal liability in all contexts and industries. Pacella, Jennifer M., *The Conundrum of Compliance Officer Liability* (Summer 2023). BERKELEY BUS. L.J., 2024, (forthcoming, available at SSRN): https://ssrn.com/abstract=4581752.

102. *See infra* notes 76-101 and accompanying text.

103. *See, e.g.,* James R. Carroll, Eben P. Colby, Michael S. Hines, Alisha Q. Nanda & Rene H. DuBois, Skadden, Arps, Slate, Meagher & Flom LLP, *Scienter Defenses in Securities Fraud Actions*, PRACTICAL GUIDANCE (Nov. 2022), https://www.skadden.com//media/files/publications/2022/11/scienter_defenses_in_securities_fraud_actions.pdf.

104. *Id.*

105. *See infra* notes 151-223 and accompanying text.

manipulate, or defraud."[106] Recklessness satisfies the scienter requirement[107] because reckless conduct is conduct which is "*'highly unreasonable' and . . . represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.*'"[108] The "highly unreasonable" conduct entailed by recklessness is more than "even inexcusable negligence";[109] the evidence must show that there was "a danger so obvious that the [individual] must have been aware of the danger."[110]

A recklessness standard is found throughout the federal securities laws and applies to other provisions of the Advisers Act.[111] For example, a violation of Section 206(1) of the Advisers Act requires recklessness. Here, the law states that, "It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud any client or prospective client."[112] Recklessness is also required by other federal securities laws, such as Section 10(b) of the Securities Exchange Act of 1934 and accompanying Rule 10b-5, which prohibit material misrepresentations and misleading omissions in connection with the purchase and sale of securities.[113] Further, recklessness has been applied in certain SEC enforcement actions against CCOs: for example, in *Sands Brothers,* the SEC charged a CCO because he "knew or was reckless in not knowing about" the compliance violation at issue.[114]

In contrast, a wholesale failure liability standard has not been applied to other areas of the federal securities laws. Though the SEC has not defined wholesale failure clearly, attempting to define it here is useful. When used as an adjective, "wholesale" is defined as "extensive; broadly indiscriminate."[115] A "failure" is defined as "nonperformance of something due, required, or expected."[116] For purposes of CCO liability, this "something" is the CCO's responsibility under the Advisers Act to develop and administer firmwide compliance. Therefore, to have committed a "wholesale failure," the CCO

106. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); Aaron v. SEC, 446 U.S. 680, 686 n.5, 695-97 (1980); SEC v. Steadman, 967 F.2d 636, 641 (D.C. Cir. 1992).

107. *See* David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997); *see also*, *Steadman*, 967 F.2d at 641-42; Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990).

108. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978) (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)) (emphasis added).

109. Sundstrand Corporation v. Sun Chemical Corporation, 553 F.2d 1033, 1045 (7th Cir. 1977).

110. Howard v. SEC, 376 F.3d 1136, 1143 (D.C. Cir. 2004).

111. Scienter is not required to establish a violation of Section 206(2) of the Advisers Act; a showing of negligence is adequate. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); *see also* SEC v. Steadman, 967 F.2d at 643 & n.5; Steadman v. SEC, 603 F.2d 1126, 1132-34 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981).

112. Investment Advisers Act of 1940, 17 C.F.R. § 275.206(1) (2004).

113. 17 C.F.R. § 240.10b-5 (1951).

114. Sands Brothers, *supra* note 89.

115. *Wholesale*, RANDOM HOUSE UNABRIDGED DICTIONARY (2023 ed.).

116. *Failure*, RANDOM HOUSE UNABRIDGED DICTIONARY (2023 ed.).

must have extensively failed to perform Advisers Act compliance responsibilities. Here, this extensive nonperformance is not analogous to negligence; instead, for there to be a wholesale failure, the CCO's failure to perform would need to be extensive, which is a far-heightened standard compared to a simple negligence standard based on "reasonableness."[117]

The closest analogy to this definition of wholesale failure in securities law is reckless conduct. Here, reckless conduct is "highly unreasonable" and an "extreme" departure from ordinary care, so much so that the CCO must have known that their conduct was an extreme departure from ordinary compliance responsibilities or that it was so obvious their conduct was an extreme departure that the CCO must have been aware of it, even if actual knowledge is not proven.[118] This extreme departure from ordinary care is analogous to the extensive nonperformance required for a wholesale failure because both involve extremely inexcusable conduct.

Based on this definition of recklessness, it is beneficial to give examples of a CCO's reckless conduct in practice. Analyzing cases where CCOs were charged and found personally liable is useful. In these cases, the CCO's conduct would meet the legal standard for recklessness. For example, in *In the Matter of Two Point Capital Management, Inc., and John B. McGowan*, the SEC charged Two Point Capital Management and CCO John B. McGowan for "fail[ing] to adopt and implement reasonably designed compliance policies and procedures and to conduct annual reviews of its compliance program."[119] McGowan failed to engage in almost any compliance activities required by the Advisers Act. Over nine years, he did not conduct any compliance training, perform annual reviews of its compliance program, or adopt and enforce a code of ethics, each of which is a fundamental pillar of an SEC compliance program.[120] Accordingly, McGowan did not engage in the most basic tasks of tailoring a compliance program to the Advisers Act and the firm's business model. Further, he adopted compliance policies and procedures from a professional trade organization's compliance handbook as the firm's written compliance policies, intended as a guide for candidates preparing to take the organization's examinations and not tailored to McGowan's firm's client base or investment advisory business. The Handbook "did not purport to set out compliance policies and procedures . . . and did not include any specific mention of the Securities Act of 1933, the Securities Exchange Act of 1934 or the Advisers Act."[121]

117. *See also* Peirce Remarks 1, *supra* note 1 ("To establish that a compliance officer aided and abetted the company's violation, the Commission must show that the compliance officer engaged in reckless conduct. This standard is not simply negligence on steroids; rather, the evidence must show that there was "a danger so obvious that the [compliance officer] must have been aware of the danger.").

118. *See, e.g., id.*

119. In the Matter of Two Point Capital Management, Inc., and John B. McGowan, Admin. Proceeding File No. 3-21249 (Dec. 5, 2022), at 2, https://www.sec.gov/files/litigation/admin/2022/ia-6199.pdf.

120. *Id.* at 3-5.

121. *Id.* at 3.

McGowan's conduct was reckless because his failure to observe the fundamental pillars of a compliance program was "highly unreasonable" and "an extreme departure from the standards of ordinary care." By disregarding nearly every responsibility that the Advisers Act requires of a CCO, McGowan must have been aware of the extent of the danger this posed to firmwide compliance. Accordingly, McGowan's conduct was reckless, and personal liability is appropriate.

Another example is *Marcum LLP*. In this recent enforcement action, the SEC charged Alfonse Gregory Giuglianoa, a partner at Marcum LLP, a public accounting firm, with failing to sufficiently address and remediate numerous deficiencies in Marcum's quality control system.[122] He was responsible for the firm's quality control policies and procedures and supervised all personnel working within Marcum's quality control function. He knew for several years that regulators had identified various deficiencies in the firm's quality control function and that Marcum's own inspections had also revealed several deficiencies.[123] It was Giuglianoa's responsibility to address these "red flags," yet he failed to address these deficiencies, leading to various compliance failures in the firm.[124] Giuglianoa agreed to pay a $75,000 civil penalty to resolve the case and was ordered to have no leadership for three years.

This result would also be appropriate under a recklessness standard, and personal liability is appropriate because Mr. Giuglianoa ignored "red flags" such that the danger to firmwide compliance was known to him, or he must have been aware of the danger. By not responding to numerous identified deficiencies in any manner whatsoever, he engaged in highly unreasonable behavior related to his compliance responsibilities that were an extreme departure from ordinary care, exposing his firm to compliance vulnerabilities. Thus, personal liability against Mr. Giuglianoa would be appropriate under a recklessness standard.

Lastly, in *Southwind*, CCO Anthony LaPeruta's actions would also constitute reckless behavior.[125] Mr. LaPeruta was the CCO of Southwind Associates of NJ, Inc. ("Southwind"). In 2011, Southwind hired a compliance consultant to review its compliance program. Although the consultant identified fifty-nine significant action items that the firm had to fix to comply with SEC regulations, Southwind did not address most of these action items and failed to implement the fundamental pillars of an SEC compliance

122. In the Matter of Marcum LLP, Admin. Proceeding File No. 3-21500, (June 21, 2023), https://www.sec.gov/files/litigation/admin/2023/34-97773.pdf.

123. *Id.* at 4

124. *Id.* at 23 *See also* J. Christopher Jackson, *Seeking to Avoid Chief Compliance Officer Liability*, in MODERN COMPLIANCE: BEST PRACTICES FOR SECURITIES & FINANCE 679, 697-98 (David H. Lui & John H. Walsh, eds., 2015) (discussing what constitutes a red flag).

125. In the Matter of Southwind Associates of NJ Inc. (d/b/a Villafranco Wealth Management), William Scott Villafranco, and Anthony LaPeruta, Admin Proceeding File No. 3-18323, (Dec. 22, 2017), https://www.sec.gov/files/litigation/admin/2017/34-82397.pdf.

program.[126] First, Southwind engaged in violations of the Custody Rule, which requires that a firm take various measures to safeguard client assets, including having a surprise examination by an independent accountant subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB") and distributing audited financial statements. Southwind did not have the required surprise examination nor distribute audited financial statements, violating the Custody Rule. When it ultimately decided to engage in an untimely surprise examination, Southwind chose an independent accountant who was not subject to regular inspection by the PCAOB and thus was not authorized to perform its surprise examination.[127]

Second, Southwind failed to preserve required electronic communications and did not implement privacy safeguards to comply with SEC regulations. At one point, it sent all this highly sensitive information, including personally identifiable information, over Gmail versus a secure firm system, putting sensitive information at great risk.[128] Moreover, LaPeruta never engaged in *any* annual review of Southwind's written policies and procedures, a fundamental pillar of the Compliance Programs Rule. The compliance consultant identified all these violations, but LaPeruta, as CCO, failed to address them.[129]

Here, LaPeruta's conduct would be reckless because his actions in neglecting the fundamental pillars of a compliance program and ignoring most of the fifty-nine important action items were "'highly unreasonable" and "an extreme departure from the standards of ordinary care." By disregarding so many of his compliance responsibilities, including fundamental pillars of the Compliance Programs Rule, LaPeruta's conduct was an extreme departure from ordinary care that was highly unreasonable, and he must have been aware of the extent of the danger this posed to firmwide compliance. Accordingly, his conduct was reckless, and personal liability is appropriate.

Next, regarding the scope of this paper, it is important to note that the legal liability standard proposed by this paper applies to CCOs as *individuals*, not to the organizational entities they work for. Although the legal liability standard for firms as organizational entities is outside the scope of this paper, it is significant that financial services firms will still generally be liable for Advisers Act violations under a negligence standard because the Compliance Programs Rule was passed under the antifraud provisions of the Advisers Act, which holds firms themselves to a negligence-type liability standard.[130] Here, fraud does not require intent to violate the Compliance Programs Rule, nor does the SEC even need to demonstrate that any client was harmed due to the violative conduct. Holding firms themselves to a stricter standard than

126. *Id.* at 3.
127. *Id.* at 6-7.
128. *Id.* at 8.
129. *Id.* at 11.
130. *See* Compliance Programs Rule, *supra* note 1.

individual CCOs makes sense because, as the research in Part IV demonstrates, firmwide compliance requires the efforts of not just CCOs, but also senior management, business line managers, and individual employees. Proactive, organizational-wide steps from multiple organizational actors must be taken to build a strong compliance program. Senior management, which is ultimately responsible for establishing the organization's organizational and ethical climate, should not be able to deflect blame for deficient organizational cultures onto an individual CCO. Further, firms also have significantly more resources than individual CCOs and are better able to navigate the financial and reputational repercussions of an SEC investigation. It is a "cost of doing business" for organizations in any industry to commit the resources they must incur to ensure they adhere to industry regulations.

In conclusion, this section has advocated that CCOs should only be held personally liable for compliance violations at their firms when they (1) are affirmatively involved in the violative conduct, (2) engage in efforts to obstruct or mislead the SEC related to the violative conduct, or (3) act recklessly in failing to develop or enforce compliance related to the violative conduct. In contrast to this legal standard, the SEC's current approach to CCO liability has significant negative consequences. Part IV shows how behavioral studies and related research support and feed into the legal standard proposed by this paper, creating outcomes that research demonstrates will lead to stronger compliance programs. It establishes the negative consequences of the SEC's current approach to CCO liability in five key areas and how a recklessness standard will positively shape compliance at financial services firms in each of these five areas.

PART IV – NEGATIVE CONSEQUENCES OF SEC'S CURRENT CCO LIABILITY APPROACH AND POSITIVE BENEFITS OF PROPOSED LEGAL STANDARD

This section illustrates how behavioral studies and related research support and feed into the legal standard proposed in Part III, creating outcomes that research demonstrates will lead to stronger compliance programs. It also shows the negative consequences of the SEC's current approach to CCO liability in five key areas and how a recklessness standard will positively shape compliance at financial services firms in each of these five areas: (1) the "chilling effect" of knowledgeable and competent CCOs due to fears of personal liability; (2) the current incentive for the CCO to implement a reactionary, "check-the-box" compliance program where the CCO takes actions to protect themselves from taking on "supervisory authority" and thus personal liability rather than constructing a proactive, holistic, and pragmatic compliance program that research demonstrates is necessary for firmwide compliance; (3) the failure to understand that firmwide compliance failures are often problems with the larger organizational culture and senior management should not be able to deflect blame for deficient organizational cultures on an individual CCO; (4) the risk of hindsight bias and (5) the failure to support the SEC's regulatory goals.

A. "Chilling Effect"

> "Regardless of the cause [of CCO personal liability], the resulting 'chilling effect' on financial sector compliance officers should raise an alarm. The level of ensuing 'brain drain' could diminish significantly the efficacy of financial sector compliance programs, and the integrity of the industry more generally."[131]
>
> \- *Court E. Golumbic*

> "Attracting well-qualified people to the profession is important, and fears of facing liability for someone else's missteps can dissuade excellent candidates from seeking compliance jobs."
>
> \- *SEC Commissioner Hester M. Pierce*

In his article "'*The Big Chill': Personal Liability and the Targeting of Financial Sector Compliance Officers*," Court E. Golumbic, Partner and Global Head of Financial Crime Compliance at Goldman Sachs, describes the apprehension among CCOs that they are being "unfairly targeted" by SEC actions in which individual CCOs have been held personally liable for compliance violations of their firms. Although regulators have stated that CCOs are "essential partners" in ensuring compliance with relevant laws, the individual cases brought against CCOs have strained the relationship between regulators and CCOs. The compliance community views individual enforcement actions against CCOs "as unfairly placing the totality of responsibility for the effectiveness of a firm's program on the compliance officer's shoulders."[132]

Golumbic made these arguments in 2018, and despite the subsequent developments discussed in Part II, the SEC has still not promulgated a CCO legal liability standard. As mentioned, a 2023 NSCP survey found that over 70% of CCOs are deeply concerned about the SEC's approach to personal

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131. Golumbic, *supra* note 5, at 92-93.

132. *Id.* at 85. Later in his article, Golumbic advances two proposals designed to mitigate the chilling effect of compliance officer liability. First, he says, U.S. regulators should adopt a supervisory scheme like the "Senior Managers and Certification Regime" recently implemented by the U.K. Financial Conduct Authority ("FCA") and Prudential Conduct Authority ("PCA"). Golumbic believes this regime, which assigns personal liability to designated "Senior Managers" in connection with defined standards of conduct, promotes the appropriate degree of accountability for compliance officers and a range of senior business and control-side personnel. Second, he argues the industry should establish an advisory body composed of former industry and regulatory officials to develop guidelines on best practices in cases where the conduct of compliance officers is at issue. He believes this type of group would promote more uniformity and transparency in charging decisions and a sense among compliance officers that their interests are fairly represented. *Id.* at 88-91.

liability.[133] This has and will continue to "chill" knowledgeable and competent professionals from becoming CCOs for fear of personal liability and continue the trend of "increased attrition within the ranks of senior compliance officers in the industry."[134] The SEC continues to emphasize "individual accountability" in its enforcement program, showing that CCOs remain in harm's way. In Fiscal Year 2023, approximately two-thirds of the SEC's enforcement actions involved at least one individual target, which is consistent with data from previous years.[135]

This chilling effect harms CCOs, firms, and regulators. As Commissioner Pierce recently stated and as recent surveys demonstrate, "[a]ttracting well-qualified people to the profession is important, and fears of facing liability for someone else's missteps can dissuade excellent candidates from seeking compliance jobs."[136] First, a compliance professional may be well qualified to take on a CCO job, but the benefits of such a role may be outweighed by potential personal liability. Why not be an outside attorney or consultant instead, where the liability standards are clearer and less onerous? Why risk professional reputation and financial security when even SEC Commissioners have stated that there is a "continue[d] . . . trend toward strict liability for CCOs that unfairly holds them accountable for compliance failures they cannot control"?[137]

In fact, the reputational damage to a CCO who is subject to an enforcement action or even a public settlement with the SEC is likely career-ending, forever after making the CCO a pariah in the financial community. The SEC publishes its enforcement actions and settlements on its public website and typically issues a press release noting the actions. Information about these cases is typically republicized by law firms and other third-party publications that the financial services community reads.[138] In short, there would be no hiding for a CCO who is found personally liable or who settles with the SEC. In fact, the SEC prohibits a settling defendant from ever contradicting the SEC regarding the case.[139] It would be nearly impossible to believe that a firm would hire a CCO who has been found personally liable at another firm because it would put both their own firm at risk and the firm's investors would be aware that the CCO was the subject of prior SEC enforcement, putting investor funding, the money required for a financial services firm to operate, at grave risk.

133. NSCP Framework, *supra* note 59.

134. Golumbic, *supra* note 5, at 48.

135. Press Release, SEC, *SEC Announces Enforcement Results for Fiscal Year 2023* (Nov. 14, 2023), https://www.sec.gov/newsroom/press-releases/2023-234.

136. Peirce Remarks 2, *supra* note 6.

137. Aguilar Remarks, *supra* note 1.

138. *See, e.g., infra* notes 142-146 and accompanying text.

139. *See* 17 C.F.R. § 202.5(e); *see, e.g., SEC v.* Farha, No. 8:12-CV-47-T-23MAP, 2018 WL 11354497, 2018 U.S. Dist. LEXIS 244839, at *7 (M.D. Fla. May 1, 2018).

Further, even if the SEC initiates a regulatory investigation against a CCO that does not result in any enforcement against the CCO, such an investigatory process would still be stressful and costly for a CCO, which would cause an additional chilling effect. During a regulatory investigation of a firm and its CCO, the interests of the CCO and the firm would diverge, and the CCO would need to hire their own attorney. In fact, CCO insurance products have been created because of the significant costs associated with CCOs defending themselves in a regulatory investigation. Numerous articles, seminars, and speeches have addressed how CCOs can protect their professional reputations in this challenging environment, illustrating the seriousness of this problem.[140] Thus, the mere prospect of a regulatory investigation into CCO liability also causes a chilling effect on CCOs.

Second, the chilling effect also harms firms. Firms need strong CCOs to implement robust compliance programs because the firms themselves face great reputational and financial risk if they are subject to an enforcement action or settlement with the SEC. As noted, the SEC publishes its enforcement actions and settlement agreements and issues press releases to generate publicity surrounding its actions against firms and individuals.[141] For example, a search of one month (May 2024) of the SEC's public "Press Releases" reveals titles such as "SEC Charges Advisory Firm Mass Ave Global and Co-Founder and CEO Winston Feng with False Statements and Undisclosed Conflicts[142]," "SEC Charges Intercontinental Exchange and Nine Affiliates Including the New York Stock Exchange with Failing to Inform the Commission of a Cyber Intrusion[143]," "SEC Charges Hudson Valley Wealth Management Advisory Firm and Founder for Failing to Disclose Conflicts of Interest[144]," "SEC Charges Pennsylvania Resident with Insider Trading in Dick's Sporting Goods Securities[145]," and "SEC Charges Audit Firm BF Borgers and Its Owner with Massive Fraud Affecting More Than 1,500 SEC Filings[146]" Accordingly, in addition to the fines firms must pay for compliance

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140. *See, e.g.,* Amii Barnard-Bahn, *CCO liability: How To Protect Your Compliance Career*, COMPLIANCE WEEK (May 1, 2024), https://www.complianceweek.com/regulatory-enforcement/cco-liability-how-to-protect-your-compliance-Career/34715.article.

141. *See infra* note 142 and accompanying text.

142. Press Release, SEC, *SEC Charges Advisory Firm Mass Ave Global and Co-Founder and CEO Winston Feng with False Statements and Undisclosed Conflicts* (May 29, 2024), https://www.sec.gov/newsroom/press-releases/2024-64.

143. Press Release, SEC, *SEC Charges Intercontinental Exchange and Nine Affiliates Including the New York Stock Exchange with Failing to Inform the Commission of a Cyber Intrusion* (May 22, 2024), https://www.sec.gov/newsroom/press-releases/2024-63.

144. Press Release, SEC, *SEC Charges Hudson Valley Wealth Management Advisory Firm and Founder for Failing to Disclose Conflicts of Interest* (May 14, 2024), https://www.sec.gov/newsroom/press-releases/2024-55.

145. Press Release, SEC, SEC Charges Pennsylvania Resident with Insider Trading in Dick's Sporting Goods Securities (May 10, 2024), https://www.sec.gov/newsroom/press-releases/2024-53.

146. Press Release, SEC, *SEC Charges Audit Firm BF Borgers and Its Owner with Massive Fraud Affecting More Than 1,500 SEC Filings* (May 3, 2024), https://www.sec.gov/newsroom/press-releases/2024-51.

violations, firms are at great reputational risk caused by these violations, which would jeopardize their ability to raise money from investors if they do not build compliance programs that detect and prevent unlawful behavior. To accomplish this task, a firm needs a strong CCO who understands the regulatory landscape and how to effectively partner with other leaders within the firm to implement a strong compliance program. The chilling effect caused by the SEC's current approach to CCO liability thereby also harms firms.

Lastly, this chilling effect harms regulators themselves. The SEC has stated that CCOs are its "essential partners" in achieving its regulatory goals. The CCO has been considered the eyes and ears of regulators and one of the first lines of defense to ensure regulatory violations do not occur within firms.[147] A key pillar of the SEC's mission statement is to protect investors of financial services firms by "force[ing] federal securities laws to ensure fairness and truth, and provide resources to help investors protect themselves from fraud and evaluate their investment choices."[148] Protecting investors requires strong compliance programs to detect and prevent unlawful conduct. Therefore, the SEC's mission is harmed by deterring knowledgeable compliance professionals from taking on CCO roles or causing those CCOs to leave their roles.

In contrast to the negative consequences of the SEC's current approach to CCO liability, the recklessness legal standard this paper proposes will prevent this chilling effect and its harm because a recklessness legal standard provides CCOs the legal clarity they have been seeking and is unlikely to deter them from taking or staying in CCO positions. Most CCOs do not fear committing reckless behavior but are concerned about liability when regulators claim they are negligent.[149] Reckless behavior is a high bar, requiring "highly unreasonable" behavior and an "extreme" departure from ordinary competence: a knowledgeable and competent CCO would not need to have concerns regarding this standard. The data backs up these sentiments. In the NSCP survey of CCOs, CCOs were most concerned about liability when they faced liability for negligence-type behavior rather than intentional or reckless behavior.[150]

As such, the SEC's current approach to CCO liability has had a chilling effect on knowledgeable and competent CCOs, who fear personal liability. This results in harm to CCOs, firms, and the SEC. In contrast, the legal standard this paper proposes will alleviate these problems.

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147. *See, e.g.,* Michael Asaro, Barry Greenberg & Nathaniel Botwinick, *Managing CCO Risk Without A Liability Standard From SEC*, LAW360 (Dec. 17, 2020), https://www.akingump.com/a/web/7NGaoPUs7ZQiT6DZPzqYpx/2ePMSp/managing-cco-risk-without-a-liability-standard-from-sec.pdf.

148. SEC Mission, *infra* note 231 and accompanying text.

149. *See* NSCP Framework, *supra* note 59.

150. *Id.*

B. Proactive and Holistic Compliance vs. Reactive and "Check-the-Box" Compliance

> "The Corporate scandals of recent years have clearly shown that the plethora of laws of the past century have not eliminated the less-savory side of human behavior. Rules cannot substitute for character."[151]
>
> \- Alan Greenspan, Former Chair of The Federal Reserve

> "Some firms take the "check-the-box" approach to the CCO requirement, merely looking at it as a way to satisfy the rule as opposed to thinking of the role as an essential component of running an advisory or fund business."[152]
>
> \- Peter B. Driscoll, Former SEC Director, Office of Compliance Inspections and Examinations

> "A good CCO expertly weaves compliance into all of a firm's activities."[153]
>
> \- SEC Commissioner Hester M. Peirce

The SEC's current approach to CCO personal liability incentivizes the CCO to implement a reactionary, "check-the-box" compliance program where the CCO takes actions to protect themselves from personal liability rather than constructing a proactive and holistic compliance program in which the CCO actively engages with the firm's business units and provides visible, hands-on leadership across the firm's departments. This is because the SEC has stated that a CCO may be liable for actions of firm's employees when the CCO takes on "supervisory authority" at the firm and then "the CCO [fails] to discharge those responsibilities in a 'reasonable manner.'"[154] The SEC's broad and subjective supervisory authority standards expose the CCO to liability and incentivize inaction because if CCOs do not take on supervisory authority, they are significantly more protected from personal liability.

Behavioral studies and related research demonstrate that a proactive and holistic approach to compliance by the CCO and firm leaders is essential to

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151. Alan Greenspan, Former Chair, The Federal Reserve Board, Remarks at the 2004 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia (Apr. 16, 2004), https://www.federalreserve.gov/boarddocs/speeches/2004/20040416.

152. Peter B. Driscoll, Former Director, Office of Compliance Inspections and Examinations, SEC, The Role of the CCO – Empowered, Senior and With Authority, Opening Remarks at National Investment Adviser/Investment Company Compliance Outreach (Nov. 19, 2020), https://www.sec.gov/newsroom/speeches-statements/driscoll-role-cco-2020-11-19 [hereinafter "Driscoll Remarks"].

153. Peirce Remarks 1, *supra* note 1.

154. *See, e.g.,* Susan Lorde Martin, *Compliance Officers: More Jobs, More Responsibility, More Liability,* 29 NOTRE DAME J.L. ETHICS & PUB. POL'Y 169, 189 (2015); Pacella, *supra* note 101, at 13.

establishing an effective firmwide culture of compliance. As demonstrated in this section, this effective approach to compliance would more likely be interpreted as supervisory authority and expose a CCO to potential personal liability, whereas a reactive, check-the-box approach to compliance would better protect a CCO from personal liability but be ineffective in promoting firmwide compliance.

i. Supervisory Authority

The SEC's current approach to CCO liability incentivizes CCOs to create a reactionary culture by saying "no," reciting rules, and "checking the box" on compliance requirements without considering pragmatic and creative approaches that require active engagement and visibility throughout the firm's business units. The SEC has stated that a CCO does not attain supervisory authority by mere title alone but rather by having the "requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue."[155] Notably, this definition of "supervisor" is broader than the definition of "supervisor" in other areas of law: for example, the United States Supreme Court recently defined "supervisor" for the purpose of vicarious liability under Title VII of the Civil Rights Act of 1964 as an employee with the power to take "tangible employment actions" against another employee, i.e., actions that cause a "significant change in employment status, such as hiring, firing, failing to promote, reassignment with significantly different responsibilities, or a decision causing a significant change in benefits."[156] Thus, an employee who merely has the authority to direct another employee's work without the authority to take tangible employment actions against the employee is not a supervisor under Title VII but, in contrast, under the SEC's definition of supervisor, such an employee would likely be a supervisor because the CCO can affect the employee's behavior by directing their work.

Importantly, the SEC definition of supervisor is also broader than the common law definition of supervisor, which is reflected in "master and servant" legal terms, where the general rule is that a master, analogous to a supervisor, is liable to an injured third party on a tort committed by a servant if the servant was acting within the scope of employment when the tort occurred. Black's Law Dictionary defines this relationship as follows:

155. *See, e.g.*, Lorde Martin, *supra* note 155, at 190.

156. Vance v. Ball State University, 570 US 421, 431 (2013). *See also* Lorde Martin, *supra* note 155, at 195 (advocating that SEC should adopt Justice Alito's definition of "supervisor" in Vance for CCOs); In re Theodore W. Urban, Initial Decision, Securities Exchange Act Release No. 402, Administrative Proceeding Release No. 3-13655, 2010 WL 3500928 1, 42 (ALJ Sept. 8, 2010), https://www.sec.gov/litigation/aljdec/2010/id402bpm.pdf ("[D]etermining if a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.").

The relation of master and servant exists where one person, for pay or other valuable consideration, enters into the service of another and devotes to him his personal labor for an agreed period. The relation exists where the employer *has the right to select the employee, the power to remove and discharge him and the right to direct both what work shall be done and the manner in which it shall be done* (emphasis added).[157]

Accordingly, like Title VII, the SEC definition of supervisor is broader than the common law definition. Whereas under the SEC definition, one is a supervisor if they can "affect the conduct of the employee whose behavior is at issue, " under the common law, to be considered a supervisor, that person must be able to (a) take tangible employment actions against an employee (e.g., the power to discharge) and (b) have the ability to direct both the end goal of the employee's work and the means used to accomplish that end goal. Thus, the SEC definition of supervisor is also broader than the common law definition.

Further, the SEC's definition of supervisory authority is open to subjective interpretation: some SEC experts have even argued that "a person who gets involved in a compliance problem becomes a supervisor." In one such case, the SEC asserted that CCOs are supervisors if they play a "significant, even if shared, role in the firm's supervisory structure [even if their] authority [is] subject to countermand at a higher level."[158] In the *Urban* case, the SEC offered an expansive definition of supervisory authority. Professor Jennifer Pacella observes that in *Urban,* "the SEC appears to have expanded 'supervisory liability' to cover a situation where the officer neither committed illegal acts nor aided or abetted them and did not directly supervise the actual wrongdoer, thereby creating secondary liability and causing the burden to shift to the supervisor to prove that supervision had been adequate."[159]

A CCO who takes a proactive, holistic approach to compliance needs to engage with the firm's business units actively and have the "responsibility, ability, or authority to affect the behavior of the [firm's employees]," the SEC's definition of supervisory authority. Accordingly, these CCOs expose themselves to negligence-type personal liability if the SEC does not find their actions "reasonable." This is a troubling consequence because some of the very types of behaviors CCOs need to take to promote compliance are the ones that expose them to personal liability. In this way, the SEC's broad and subjective definition of supervisory authority exposes the CCO to liability and incentivizes inaction.

The potential liability for taking on supervisory authority may discourage CCOs from taking strong, initiative-taking measures to promote compliant

157. *Master and Servant*, BLACK'S LAW DICTIONARY (2nd ed. 1910).

158. *See, e.g.*, Urban*, supra* note 156, at 46, In re Gutfreund, Exch. Act Rel. No. 34-31554, 51 SEC 93 (Dec. 3, 1992).

159. Pacella, *supra* note 101, at 14.

behavior for fear of appearing to be a "supervisor" and then being liable under a subjective "reasonableness" standard.[160] Without the benefit of hindsight, it is extremely challenging for CCOs to know if they are supervisors for purposes of personal liability.[161] Unfortunately, in these circumstances, the path of least resistance for a CCO is likely to be inaction to avoid personal liability by not engaging in proactive compliance that may be interpreted to trigger supervisory authority, instead engaging in "check-the-box" behavior to protect themselves from personal liability.

ii. The Activities of the CCO: Proactive and Holistic vs. Reactive and Check-the-Box

The phrase "reactive compliance" describes how firms respond after a compliance violation occurs: this resembles the *ex-post* function of law, where the legal system responds to past behavior.[162] In "proactive compliance," regulations shape the behavior of employees at firms such that violations do not ever occur; this is the *ex-ante* function of law, where the law comes before the behavior.[163] Proactive compliance describes a firm's actions to establish an organizational culture of compliance so that violations can be prevented.[164] In recent years, there has been a significant trend of increased investment in proactive compliance (traditionally viewed as a "cost center") because firms recognize that this investment protects them from significant financial and reputational harm.[165]

Research demonstrates that firmwide compliance is significantly more likely when a firm establishes an organizational culture of compliance.[166] In such a proactive compliance program, a CCO must be knowledgeable and resourceful regarding *both* SEC regulations and the firm's business processes and initiatives. Financial services firms are fast-paced, competitive environments seeking to generate significant returns for their investors. In this regard, compliance can be viewed as a "foundation" of a house that allows the firm to grow. As the firm grows bigger, the compliance foundation must also grow deeper and stronger to support it. In these environments, a skilled CCO is pragmatic by supporting the firm in achieving its business objectives while

160. *See, e.g.*, Deborah A. DeMott, *The Crucial but (Potentially) Precarious Position of the Chief Compliance Officer*, 8 BROOK. J. CORP. FIN. & COM. L. 56, 77 (2013).

161. *See infra* Part IV(4).

162. *See, e.g.,* Miriam A. Cherry, *A Global System of Work, A Global System of Regulation?: Crowdwork and Conflicts of Law*, 94 TUL. L. REV. 1, 57 (2019) (defining reactive compliance as attempting to comply with laws but doing "little beyond that").

163. *See, e.g.,* Sokol, *supra* note 34, at 407 (stating that compliance requires "identification of risk and *ex-ante* preventive action."); Benjamin Van Rooij, *Behavioral Jurisprudence: The Quest for Knowledge About the Ex-ante Function of Law and Behavior*, JRSLM. REV. LEGAL STUD. 22, 57-77 (2020).

164. *See, e.g.,* Van Rooij, *supra* note 163.

165. *See, e.g., What's the Difference Between Proactive and Reactive Compliance?*, MINUTEBOX (Apr. 9, 2024), https://www.minutebox.com/blog/2024-04-09-difference-proactive-reactive-compliance.

166. *See, e.g.,* Jennifer Robison, Alex Power & Dan Grafstein, *Compliance Is a Culture Issue,* GALLUP (Sep. 20, 2019), https://www.gallup.com/workplace/266828/compliance-culture-issue.aspx.

also adhering to the evolving regulatory landscape. In this type of structure, the CCO must possess the knowledge and resourcefulness to provide advice to the business units to ensure that the firm factors compliance considerations into its decision-making. A proactive CCO is holistic in engaging with employees throughout the organization, facilitating their ability to problem-solve and propose innovative solutions to issues the business is facing.[167]

To be effective, a CCO must thoroughly understand the business operations of their firms: "[a] thorough understanding of business operations is the foundation for building a compliance program focused on the sticky issues that can prevent a company from meeting its goals. A top CCO knows that to find, fix, and prevent misconduct, he/she must first understand how the business works."[168] Here, the CCO's pragmatism, armed with a thorough understanding of the business, allows her to find the "middle ground" while ensuring compliance with regulatory requirements and supporting the firm's business needs. This pragmatism will gain a CCO credibility and respect in an organization, providing visibility to the firm's business units and most senior management to ensure compliance has a "seat at the table" when decisions are made, which promotes firmwide compliance.[169]

In contrast to this proactive approach, a reactionary compliance culture is characterized by a CCO reciting rules, saying "no," and likely being viewed by firm employees as an intimidating or ineffectual "umpire" who does not understand the firm's business.[170] As a result, compliance is isolated, not taken seriously, and not consulted in decision-making, exposing the firm to compliance liability. Most employees of a firm are not compliance professionals and are focused on their day-to-day responsibilities of meeting their business objectives.[171] When a CCO recites incomprehensible rules or legalese to employees without clearly and pragmatically explaining what the rule means and how it applies to the employee's responsibilities, employees are less likely to speak to the CCO, further isolating the CCO within the organization. If the CCO says "no" to every employee request and does not attempt to creatively problem-solve issues by providing alternative solutions, the reactive compliance culture is exacerbated where decisions are made

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167. *See, e.g.,* Sokol, *supra* note 34.

168. *See, e.g.,* Shelly Scott, *Take a Seat at the Table: How to Realize Your Potential as a Strategic CCO*, BARKERGILMORE (June 2021), https://www.barkergilmore.com/wp-content/uploads/2021/06/Take-a-Seat-at-the-Table-How-to-Realize-Your-Potential-as-a-Strategic-CCO.pdf.

169. *Id.*

170. Professor Sokol notes that "[t]oo much monitoring reduces the ability of agents to perform their jobs and might chill legal risk taking. Such risk taking may serve to benefit the firm. Therefore, effective compliance mitigates risk while it maintains freedom for the firm to undertake its business objectives." Sokol, *supra* note 34, at 412.

171. A comprehensive study conducted by the Cato Institute recently found that the average U.S. firm spends between 1.3 and 3.3 percent of its expenses on regulatory compliance. *See* Francesco Trebbi, Miao Ben Zhang & Michael Simkovic, *The Cost of Regulatory Compliance in the United States,* CATO RSCH. BRIEFS IN ECON. POL'Y (Jan. 24, 2024), https://www.cato.org/sites/cato.org/files/2024-01/research-brief367.pdf.

without compliance input. Gallup has found that employee engagement is essential for a strong compliance culture. A reactionary approach where employees do not engage with the CCO is the antithesis of an engaged compliance culture and makes compliance violations more likely to occur.[172]

Employee training is a key example that demonstrates the difference between proactive and reactive compliance. When any new SEC regulation is passed, a CCO must undertake many steps that go well beyond "checking the box" if they want to promote effective firmwide compliance. One of the fundamental responsibilities of a CCO is to conduct compliance training on the firm's policies and procedures and have the employees attest that they understand and will comply with them.[173] Having employees complete training and attest to reading and understanding compliance policies and procedures would "check the box" on the SEC requirement for CCOs, even if the compliance training was not helpful to employees.[174] Conducting effective training is difficult: studies have found that the way most compliance training is currently conducted is ineffective. Gallup's survey of over 40 million global employees, the largest ever conducted, found troubling results that fewer than one in four employees (23%) who have participated in a compliance or ethics training session within the past 12 months would rate that training as "excellent."[175] Even more troubling it has been found that, among employees who have participated in ethics and compliance training, only one in ten strongly agrees that she learned something that has changed how she does her work after participating.[176] These concerning results are exacerbated by several empirical studies showing that employees' knowledge of legal regulations is limited and that they will be less likely to comply without understanding the regulations.[177] Since most compliance training does not increase most employees' compliance knowledge, most compliance training is therefore ineffective.

Further, academic studies regarding compliance training support Gallup's findings. Research suggests that simply asking employees to read and attest to the firm's policies and procedures is unlikely to increase their

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172. *See, e.g.,* Robison, Power & Grafstein*, supra* note 166.

173. As part of regulatory examinations, the SEC request documentation of compliance training and employee attestations. *See, e.g.,* SEC Examination Brochure (Mar. 2023), https://www.sec.gov/files/exam-brochure.pdf.

174. *See* Driscoll, supra note 152 ("Some firms take the "check-the-box" approach to the CCO requirement, merely looking at it as a way to satisfy the rule as opposed to thinking of the role as an essential component of running an advisory or fund business.").

175. Nate Dvorak, *4 Hard Truths About Ethics and Compliance Training*, GALLUP (Nov. 10, 2021), https://www.gallup.com/workplace/357113/hard-truths-ethics-compliance-training.aspx.

176. *Id.*

177. *See*, *e.g.,* Benjamin van Rooij, *Do People Know the Law? Empirical Evidence about Legal Knowledge and Its Implications for Compliance*, CAMBRIDGE HANDBOOK OF COMPLIANCE, 467-88 (Benjamin van Rooij & D. Daniel Sokol eds., 2021) (demonstrating that for law to shape behavior, people whose conduct the law tries to influence must know the law).

understanding of them or promote more compliant behavior.[178] A more proactive and pragmatic approach is needed to foster *ex-ante* compliance effectively. To be effective, the CCO must train employees, the firm's first line of compliance defense, thoughtfully and strategically regarding the firm's compliance policies and procedures. The following illustrates the importance of employee training and the implications of these studies. When any new SEC regulation is passed, a CCO must undertake many steps that go well beyond "checking the box" if she wants to promote effective firmwide compliance. As an example, one of the many SEC rules proposed by Chair Gensler is the SEC's August 2023 Private Funds Adviser Rule.[179] This rule is 656 pages long and has diverse, detailed requirements regarding private funds areas, including preferential treatment, restricted activities, quarterly statements, annual audits, adviser-led secondaries, recordkeeping, and policy annual reviews.[180] It would greatly increase firms' compliance requirements and require strategic coordination between compliance and other firm departments, including accounting, information technology, legal, and marketing. If the rule is finalized, compliance would be required within 12-18 months, depending on the business model and size of the firm.[181] Here, as with any new SEC rule, the minimum steps that a CCO would need to take to promote firmwide compliance (rather than just "check the box"), the key compliance activities that are an "established part" of organizations[182], include the following:

a. Review the 656-page rule to ensure an understanding of both the regulation and how it applies to the firm's business lines.

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178. *See, e.g.,* Nils Köbis, Sharon Oded, Anne Leonore de Bruijn, Shuyu Huang, & Benjamin van Rooij, *Is Less More? Field Evidence on the Impact of Anti-bribery Policies on Employee Knowledge and Corrupt Behavior,* UC IRVINE SCHOOL OF LAW, LEGAL STUDIES RESEARCH PAPER SERIES No. 2020-22 (April 6, 2023), https://ssrn.com/abstract=4255148 (demonstrating that simply asking employees to read policies and procedures does not improve rule knowledge or reduce corrupt behavior).

179. Private Fund Advisors; Documentation of Registered Investment Adviser Compliance Reviews, 88 Fed. Reg. 63206 (Aug. 23, 2023) (to be codified at 17 C.F.R. pt. 275) [hereinafter "Private Funds Rule"]. Although the future of Private Funds Rule is unclear because the US Court of Appeals for the Fifth Circuit vacated it on June 5, 2024, experts believe that firms "should be prepared for an ever increasing focus on a lot of the same topics that the rules were trying to address, in the examination process and in enforcement investigations. That is how the SEC seeks to informally impose new requirements on [firms], and in that respect many aspects of the rule could be revisited." Claire Coe Smith, *Legal advisers on the future of funds regulation*, PRIVATE FUNDS CFO (Aug. 4, 2024), https://www.privatefundscfo.com/legal-advisers-on-the-future-of-funds-regulation/. Moreover, the SEC's Regulatory agenda contains many complex rules that, similarly to the Private Funds Rule, will require CCOs to undertake multifaceted and timely steps to ensure compliance. *See* RegFlex Agenda, *supra* note 57 (listing the significant amount of proposed and final SEC rules).

180. Private Funds Rule, *supra* note 179.

181. *Id.*

182. See, e.g., James A. Fanto, *The Professionalization of Compliance: Its Progress, Impediments, and Outcomes*, 35 NOTRE DAME J.L. ETHICS & PUB. POL'Y 183, 196-200 (2021) (describing compliance activities); *see also* GEORFFREY P. MILLER, *The Law of Governance, Risk Managment, and Compliance* 157 (2d ed. 2016) (defining compliance activities).

b. Communicate with other CCOs, regulators, law firms, and industry insiders to learn more about the rule and how it may apply to their businesses.
c. Draft firm policies and procedures in coordination with the firm's business units by becoming "intimately familiar"[183] with the firm's affairs so that the policies and procedures accurately reflect the new rule as applied to the firm's business.
d. Conduct both firmwide and targeted compliance training to ensure that firm employees understand and comply with the new rule.
e. Advise the firm's business units on how to conduct themselves in accordance with the policies and procedures, engaging with them frequently.
f. Monitor how the SEC interprets and enforces the rule in its formal and informal guidance and examinations, which are not always clear.
g. Monitor the firm's employees to ensure they are following policies and procedures and follow up on any "red flags" to see if a violation has occurred.
h. Actively monitor any legal or business developments affecting the organization that may require amending the policies and procedures.[184]

If a CCO wanted to "check the box," rather than engage in these proactive steps necessary for effective compliance, she could summarize the rule for employees in compliance training and require each employee to read the 656-page rule and sign an attestation that each employee understands and will comply with it. Rather than actively engaging with the business units to understand how the new rule applies to the firm's unique business model and implement the rule accordingly, potentially exposing the CCO to supervisory authority, the CCO could draft a generic policy that places compliance requirements on the firm's employees. This would be wholly ineffective because most employees are not trained in legal analysis and interpretation and could not understand how the policies apply to their day-to-day activities. Moreover, employees are extremely busy with their day-to-day activities outside of compliance and would likely view reading and understanding a massive SEC rule as an unmanageable burden. Employees will be less likely to come to the CCO with questions or concerns when the CCO engages in this type of "rule reciting" rather than the active engagement described above. To mitigate personal liability, a CCO could also limit the responsibilities delegated to the CCO herself by drafting policies and procedures with fewer duties applicable to her.[185] Further, Commissioner Gallagher argues that there

183. Fanto, *supra* note 181, at 196.
184. *See* Fanto, *supra* note 24, at 198.
185. Commissioner Gallagher commented that CCOs may be perversely incentivized to check the box on the "minimum" compliance responsibilities and adopt procedures with fewer specified compliance responsibilities "to avoid liability when the government plays Monday morning quarterback." Gallagher,

is a "significant risk" at such firms that by taking ownership of the implementation of the policies and procedures, CCOs could unwittingly also be taking ownership of business functions, thereby "subjecting them to strict liability whenever there is a violation of the securities laws."[186]

A "check the box" approach likely would protect a CCO from personal liability because the CCO would state that employees were "trained" and required to read the rule and attest to compliance with the rule, as required by the letter of the law.[187] Any non-compliance by employees was not the result of deficiencies from the CCO; a CCO could even argue that the employees "should have known better." Once a violation occurs, a CCO would *ex-post* report the violation and refer the wrongdoer for punishment. However, this would not ***prevent*** the violation from occurring in the first place, countering the regulatory goal of protecting investors as compliance violations put investor money at risk.

In contrast, if a CCO takes initiative-taking and holistic steps to promote compliance, such as attending meetings of various business units, actively engaging with business units on projects, and taking on oversight of projects, she has ironically exposed herself to more liability by potentially taking on "supervisory authority" for purposes of SEC compliance. An effective CCO must be an effective risk manager who understands the business[188] so that she can seek out potential problems before they occur, not someone who avoids learning about potential problems. Under the SEC's current approach to CCO personal liability, CCOs who attempt to seek out and remediate violations expose themselves to liability when their efforts are viewed as incomplete or unsuccessful by the SEC. For example, in *Blackrock*, the CCO was found personally liable even though he became involved in a potential compliance disclosure conflict of interest issue by participating in multiple meetings regarding the issue and coordinating with outside counsel for legal advice. The SEC disagreed with the CCO's conclusion regarding the conflict of interest and found him personally liable, claiming he somehow *caused* the violation.[189]

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supra note 16. Professor D. Daniel Sokol demonstrates that "compliance that is only cosmetic in nature does not lead to better compliance." Sokol, *supra* note 35, at 413.

186. Gallagher, *supra* note 16.

187. *See, e.g.*, James M. Lager, *Overcoming Cultures of Compliance to Reduce Corruption and Achieve Ethics in Government*, 41 MCGEORGE L. REV. 63, 73–74 n.58 (2009) ("In some organizations, employees are required to sign a statement acknowledging that they have read or received the code of conduct, presumably to provide evidence in a future employment-related dispute. Whatever value obtaining a signed receipt might have outside government, public employees are charged with knowledge of the rules regardless of whether they have even heard of them. Therefore, requiring a government employee to sign, as proof that he or she has read the code, adds nothing except a useful contrivance for prosecutors").

188. *See, e.g.*, JAMES LAM, ENTERPRISE RISK MANAGEMENT: FROM INCENTIVES TO CONTROLS 23 (2nd. ed. 2014)., at 23 (noting that the number one lesson of risk management is to "know your business" and that this "is an integral component of risk management.").

189. *See* In the Matter of Blackrock Advisors, LLC & Bartholomew A. Battista, *supra* note 17.

The recklessness legal standard proposed by this paper will hinder the negative consequences discussed in this section. It solves the "reasonably supervise" issue—classic negligence language—when a CCO takes on supervisory authority because a CCO would *only* be liable when she has taken on supervisory authority and then acted recklessly. Recklessness is a high bar that is unlikely to deter CCOs from engaging in the type of proactive and holistic compliance activities required to be successful. Under a recklessness standard, a CCO's activities must be highly unreasonable and an extreme departure from ordinary care. A CCO who tries to understand the firm's business, seeks out potential problems, and becomes involved in challenging issues would not be deemed reckless. This is beneficial because the behavioral studies demonstrate that firms are helped by a strong CCO who proactively engages with the firm's business units to develop a culture of compliance, making it less likely that employees at the firm will engage in violative conduct. Deterring CCOs from taking on supervisory authority creates unnecessary and potentially insurmountable roadblocks to promoting firmwide compliance.

C. Firmwide Compliance Requires Organizational Efforts Larger Than Any One Individual: An Effective CCO is Necessary but Not Sufficient for Firmwide Compliance

> "Formal ethics systems will have little influence on behavior unless they are coupled with cultural systems supporting ethical conduct."[190]

- *James M. Lager, Deputy Ethics Counsel of the U.S. Government Accountability Office*

> *"While it is critical for managers with responsibility for oversight and approval to know their businesses, it is also important for **all** employees to understand how their individual accountabilities could affect the risks of the organization, and how their functions and responsibilities relate to others in the company."*[191]

- *James Lam – Enterprise Risk Management: From Incentives to Controls*

Next, the SEC's current approach of charging CCOs individually under a nebulous negligence-based standard is misguided because it fails to recognize that compliance operates in a much larger organizational cultural framework; where to promote firmwide compliance, an effective CCO is ***necessary but not sufficient***. The SEC's current approach to CCO liability does not reflect the reality that firmwide compliance requires the efforts of not just CCOs, but

190. Lager, *supra* note 188, at 72 n.53.
191. LAM, *supra* note 188.

also senior management, business line managers, and individual employees.[192] A significant body of research, described in this section, has demonstrated that proactive, organizational-wide steps from multiple organizational actors must be taken to build a strong compliance program. Senior management, which is ultimately responsible for establishing the organization's organizational and ethical climate, should not be able to deflect blame for deficient organizational cultures onto an individual CCO.[193] Under a recklessness legal standard, which reflects these realities, a CCO would not be unfairly held individually responsible for deficiencies in an organization's culture.

The reservoir of empirical knowledge illustrates that organizations do not act as individuals but rather, "organizations consist of a range of humans within a set of structures, values, and practices that shape the overall conduct within the organizational setting."[194] Research has demonstrated that the "tone at the top," which describes an organization's general ethical climate as established by its senior management, profoundly influences compliant behavior throughout an organization.[195] It has been referred to as the "first ingredient in a world-class ethics and compliance program" that is a foundation that "sets an organization's guiding values and ethical climate" and "the glue that holds an organization together."[196] Without a strong tone at the top, a CCO's effectiveness in promoting firmwide compliance is severely limited. A CCO must be supported by senior management that emphasizes the importance of compliance throughout the firm and exemplifies those values (e.g., integrity and transparency) because how an organization's leaders communicate and represent the organization's values impacts if employees also exhibit those values. For example, an organization's values may state that it acts with "integrity." For the value to permeate throughout the organization, senior leaders must communicate that value as well as themselves act with integrity to

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192. *See, e.g.*, Van Roiij & Fine, *supra* note 39 (illustrating that organizational cultural deficiencies are broader than just a few "bad apples"); Scholten & Ellemers, *supra* note 39; Pertiwi, *supra* note 39 (elucidating why the "bad apples" perspective is insufficient).

193. As James M. Lager, Deputy Ethics Counsel of the U.S. Government Accountability Office argues, "[f]ormal ethics systems will have little influence on behavior unless they are coupled with cultural systems supporting ethical conduct." Lager, *supra* note 187, at 72 n.53 (citing Klebe Treviño & Michael E. Brown, *Managing to be Ethical: Debunking Five Business Ethics Myths*, 18 ACAD. MGMT. EXECUTIVE. 69, 73 (2004)).

194. *See, e.g.,* Van Rooij, *supra* note 163 at 11 (citing E.H. SCHEIN, ORGANIZATIONAL CULTURE AND LEADERSHIP (4th ed, 2010)).

195. *See, e.g.*, *Tone at the Top: The First Ingredient in a World-Class Ethics and Compliance Program*, DELOITTE (2015), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/risk/us-aers-tone-at-the-top-sept-2014.pdf. [hereinafter "DELOITTE"] (describing the tone at the top as the foundation upon which the culture of an enterprise is built); Martin Lipton, John Savarese, & Sarah K. Eddy, *Risk Management and the Board of Directors*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 30, 2023), https://corpgov.law.harvard.edu/2023/09/30/risk-management-and-the-board-of-directors-9/ (explaining that the tone of the top is key to effective risk management).

196. DELOITTE, *supra* note 195.

demonstrate this commitment.[197] The tone at the top reinforces an organization's social norms, what employees see senior management doing (descriptive social norms), or what employees think (consciously or not) senior management believes they should do (injunctive social norms).[198] Empirical studies demonstrate that a strong tone at the top aligns social norms with the law's behavioral objectives and strengthens it.[199] Professor D. Daniel Sokol notes that "[i]f top management shows an active and sincere embrace of compliance activities, this will change firm culture to one that is more pro-compliant."[200] Accordingly, a strong tone at the top is essential to promote firmwide compliance. If senior management "says one thing and does another," a firm's compliance culture will be deficient.[201]

Troublingly, most employees do not feel that there is a strong compliance tone at the top of their firms: Gallup finds that only 36% of United States employees think their employer "would do what is right" if they raised a concern about ethics and integrity, only 23% strongly agree that they can apply their organization's values to their work, and only 27% strongly agree that they "believe in" these values.[202] These disturbing findings illustrate that many firms have a deficient tone at the top, making compliance violations both more likely to occur and less likely to be reported. Here, personal liability against CCOs is misguided when they do not engage in or cover up misconduct nor act recklessly because a CCO is severely limited in authority without a strong tone at the top.[203] In these types of situations, CCO liability is not appropriate if firm management does not support a CCO with resources and authority and where firm management has failed to respond appropriately to violative conduct after becoming aware of it. A firm's compliance program should not be "window dressing" to protect top management from blame.

Next, Gallup has found that an organization's internal structure must support its desired culture to support the CCO in achieving their responsibilities.[204] The CCO should be in a structural position of visibility and seniority to promote compliance. The CCO is best supported by reporting to a firm's CEO and, if applicable, its Board of Directors, which signals the importance of the CCO's role to firm employees and gives compliance direct access to promote compliance considerations into important firm decisions.[205]

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197. For example, an extensive Deloitte study found that effective compliance requires senior leaders to communicate that compliance is a responsibility of every employee and an integral part of the company's culture, as well as adhere to the firm's compliance policies in the same way that each employee does. *Id.*

198. Van Roiij, *supra* note 39, at 66.

199. *Id.; see also* ROBERT E. FREDERICK, A COMPANION TO BUSINESS ETHICS 405 (1999).

200. Sokol, *supra* note 34, at 413.

201. *Id.*

202. Louis Efron, *Are Your Company Values More Than Just Words?,* GALLUP (Dec. 14, 2022), https://www.gallup.com/workplace/406418/company-values words.aspx.

203. *Id.*; *see also* Van Roiij & Fine, *supra* note 39.

204. *See What is Organizational Culture? And Why Does it Matter?,* GALLUP, https://www.gallup.com/workplace/327371/how-to-build-better-company-culture.aspx.

205. *See* Fanto, *supra* note 25, at 203 (describing the recommended organizational reporting structure).

Further, if the CCO does not report to the CEO, they may receive tardy responses to important compliance issues, and communications between the parties may get "lost in translation."[206]

In addition, to build a strong firmwide compliance program, business line managers and firm employees must support the tone at the top, demonstrating that the CCO cannot promote firmwide compliance alone. Skilled managers are essential to firmwide compliance by fortifying the first line of defense, employees, against noncompliance by helping shape employee behavior. Here, "[b]ecause managers translate cultural expectations to employee behaviors, the manager is the conduit of culture."[207] Managers can most effectively promote compliance to employees in several ways. There, managers should describe the compliant behavior they want to see, emulate that behavior, and reinforce it. For example, managers could track examples of ethical actions by employees and announce them firmwide. Further, managers should not ignore the problematic behavior of employees; "if bad behavior is met with a shrug, nothing leaders say about their culture or values will be taken seriously."[208] Senior leaders and managers must set values that set and reinforce how they expect employees to interact with others when representing the organization. The key to effective compliance is the alignment of organizational values with legal requirements; a CCOs efforts are necessary (understanding and applying the legal requirements and how they apply to the firm's business) but not sufficient (a CCO alone cannot effectively set organizational norms).[209]

Moreover, organizational studies have demonstrated that ongoing employee dialogue and feedback, requiring efforts much greater than an individual CCO, are essential to a strong compliance culture. Research demonstrates that employees feel they are being treated more fairly when employers (senior management and managers) listen to them, positively influencing employee behavior, including compliance.[210] Firms should utilize employee surveys and conversations to generate feedback about their compliance culture and analyze whether their professed compliance values align with employee perspectives. Surveys could be done confidentially or by third parties to promote honesty. These efforts will allow the firm to determine weaknesses in its compliance program and engage in the dialogue and actions needed to make improvements. Problematically, Gallup surveys have found that only 27% of U.S. employees strongly believe in their

206. *Id.*
207. Robison, Power & Grafstein, *supra* note 166.
208. *Id.*
209. *See, e.g.*, *id.*
210. Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 975-76 (2017) (demonstrating that employees feel they are treated more fairly when employers listen to them, which positively influences behavior).

company's values, which exposes firms to compliance liability.[211] Active engagement and employee feedback are essential for a firm to assess its compliance program, make enhancements where needed, and address potential problems. This requires efforts from both the CCO and management throughout the firm.

Further, to effectively promote firmwide compliance, senior management and managers must create a sense of "psychological safety," without which an organization exposes itself to compliance liability. Psychological safety occurs when employees "feel[ ] safe to take interpersonal risks, to speak up, to disagree openly, to surface concerns without fear of negative repercussions or pressure to sugarcoat bad news."[212] When there is psychological safety, employees feel comfortable speaking to other employees with ideas or concerns, including providing constructive feedback to firm leaders about suggestions for improvement or changes. Psychological safety is extremely important to promote compliance because the more psychological safety there is in a firm, the more secure members of that team feel about using formal channels to report issues.[213] This is imperative for compliance because the firm can proactively correct the behavior and make changes if concerns are expressed.[214] Firms may not know about compliance issues if concerns are not expressed until it is too late. A CCO can certainly help create a sense of psychological safety by being open to feedback and questions and promoting a positive compliance culture, but the actions of the CCO alone cannot create the psychological safety required for an overall organizational culture of compliance. On a day-to-day basis, employees most often interact with their coworkers and managers, and it is the management's responsibility to create this sense of psychological safety among managers and coworkers.

Research has demonstrated a correlation between psychological safety and how valued an employee feels in an organization. When employees feel they are being listened to and their contributions matter, they have a stronger commitment to their organizations and are more likely to detect and speak up about compliance concerns proactively.[215] Problematically, most organizations

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211. Nate Dvorak & Bailey Nelson, *Few Employees Believe in Their Company's Values*, GALLUP (Sept. 13, 2016), https://news.gallup.com/businessjournal/195491/few-employees-believe-company-values.aspx.

212. *See, e.g., What is Psychological Safety?,* MCKINSEY & CO. (July 17, 2023), https://www.mckinsey.com/featured-insights/mckinsey-explainers/what-is-psychological-safety (describing psychological safety); *see also* Antoine Ferrère, Chris Rider, Baiba Renerte, & Amy Edmondson, *Fostering Ethical Conduct Through Psychological Safety*, MIT SLOAN MGMT. REV. (June 7, 2022), https://sloanreview.mit.edu/article/fostering-ethical-conduct-through-psychological-safety/.

213. *See* Rider, et. al., *supra* note 212.

214. Langevoort, *supra* note 210, at 968 ("one dominating message from the behavioral ethics literature is that perceived fair treatment of managers and other employees is important to good behavior."); *see also* Tom Tyler et al., *The Ethical Commitment to Compliance: Building a Values-Based Culture*, 50 CAL. MGMT. REV. 31, 36–40 (2008).

215. *Id.*

have not created a sense of psychological safety. In a recent Gallup study of the U.S. working population, 24% of respondents reported seeing or being aware of unethical behavior in their workplace in the past 12 months, yet only 47% chose to report the issue, potentially exposing their firms to significant liability.[216] When firms create a sense of psychological safety, it improves the likelihood that employees would "speak up" to report issues, thus giving firms the opportunity to address compliance issues proactively.[217]

Lastly, the ultimate lifeblood of an organization's compliance culture, and the biggest risk to compliance, are the employees themselves; an organization's compliance culture is no stronger than its employees. Indeed, "one mistake in hiring can bring down an entire company."[218] A CCO must be supported by an organization that selects and develops employees who align with her organizational values. This involves efforts from human resources, senior leaders, and others. A firm should emphasize its compliance values when recruiting employees and only hire employees it believes align with this culture. This can be accomplished by utilizing skills and behavioral interview questions, posing ethical questions to candidates, and conducting comprehensive background checks.[219] Moreover, research suggests that people are driven by what they think is right and by what they think others think is right: accordingly, creating a firmwide compliance culture where employees know that their firm is an environment where people "do the right thing" helps attract ethical employees.[220] To promote firmwide compliance, firms must make it clear that compliance is everyone's responsibility and that ethical behavior will be part of an employee's performance review. For example, if employees have demonstrated integrity in their interactions with clients and coworkers, such behavior should be documented in formal performance reviews and considered a factor in salary and promotion decisions. Problematically, under the SEC's current approach to CCO liability, CCOs can be held responsible for the actions of unethical employees and employees they cannot control, and in organizations that do not undergo the activities necessary to recruit and develop employees who align with the organization's values. Holding a CCO personally liable for the actions of unethical or ill-advised employees does not make sense if the CCO did not

216. Nate Dvorak & Alex Power, *Culture Drives Your Ethics and Compliance Reporting Ratio,* GALLUP (Sept. 2, 2020), https://www.gallup.com/workplace/318197/culture-drives-ethics-compliance-reporting-ratio.aspx.

217. *See supra* notes 145-148.

218. LAM, *supra* note 191, at 160.

219. Eric Friedman, *How To Hire For Integrity And Why It's Important*, FORBES (Sept. 29, 2021), https://www.forbes.com/sites/forbeshumanresourcescouncil/2021/09/29/how-to-hire-for-integrity-and-why-its-important.

220. Hui Chen & Zach Coseglia, *Skin in the Game? Dr. Caitlin Handron Discusses How Compliance Incentives Might Work in Practice*, There Has to be a Better Way Podcast, ROPES & GRAY (Mar. 29, 2023), https://www.ropesgray.com/en/newsroom/podcasts/2023/march/skin-in-the-game-dr-caitlin-handron-discusses-how-compliance-incentives-might-work-in-practice (summarizing cultural psychology research).

participate in the violative conduct, help cover it up, or act recklessly. Under a recklessness legal standard, this will no longer be a concern because the CCO will only be liable if her own actions were extremely unreasonable in departing from ordinary care.

Additionally, the compliance obligations of a firm are a team effort requiring synergies among departments. CCOs must rely on information from others at their firms to meet their compliance obligations, such as regulatory filings. Problematically, CCOs have been found liable in cases where they have incorrectly relied on information from others with significant authority at their firms. For example, in the case of *David I. Osunkwo*, a CCO overstated the firm's assets under management in its regulatory Form ADV filing. The CCO had relied on information from the firm's Chief Investment Officer to obtain the amount of the firm's assets under management[221] The SEC fined the CCO $30,000 and suspended him claiming he violated the Advisers Act by making an untrue statement in its Form ADV Amendment.[222] CCOs do not operate in a vacuum; to adequately conduct their jobs, they ***must*** rely on information from other firm employees: it is ill-advised to impose personal liability in such a case where a CCO relied on information from others if the CCO did not act recklessly.

As this section demonstrates, CCOs operate in a broader organizational culture in which their actions are necessary to promote firmwide compliance but are far from sufficient alone. CCOs require support from senior management, managers, and employees in building a compliant organizational culture. Without such support, a CCO is limited in effectiveness, and the firm will be exposed to compliance liability. Under a recklessness standard, reflecting these organizational realities, if a CCO is not supported by senior management or faces structural barriers such as an indirect reporting structure or toxic organizational culture, the CCO would (correctly) not be held personally liable for the actions of others at the firm because even the strongest CCO's effectiveness will be significantly limited by other factors in the work environment. The SEC has stated that CCOs are its "essential partners"[223] in promoting compliance and supporting its regulatory goals and will improve trust and transparency between itself and CCOs by clearly adopting a legal standard reflecting the CCO position's realities within the context of a broader organization. This will send the appropriate message that corporate wrongdoing more often involves problems with the organizational culture rather than with a few bad apples. A recklessness standard will not allow the use of a CCO as "window dressing" or a "fall person" to protect senior management from the responsibility of building a strong organizational culture.

221. In the Matter of David I. Osunkwo, *supra* note 20.

222. *Id.*

223. *See, e.g.,* Ceresney Remarks, *supra* note 13 ("We rely on [CCOs] as essential partners in ensuring compliance with the federal securities laws and we will do all we can to help you perform your work.").

D. Hindsight Bias

> ". . . the [SEC] plays Monday morning quarterback."
>
> - *Former SEC Commissioner Daniel M. Gallagher*[224]

> "A conflict between your judgment and ours, which is always informed by hindsight, should not result in an enforcement action against you."[225]
>
> - *SEC Commissioner Hester M. Peirce*

Under the SEC's current approach to CCO liability, there is a serious risk of hindsight bias when evaluating whether compliance procedures or the CCO's actions were "reasonable" only after a violation has occurred.[226] Hindsight bias occurs when one perceives past events as having been more predictable than they were. Numerous empirical studies have demonstrated that when viewing past events with present knowledge, people are overconfident that they would have foreseen past events.[227] Frequently, the SEC seems to believe it could have predicted the outcome of the CCO's actions (or inactions) when the CCO made decisions before the violations occurred. This is problematic because CCOs operate in a broader firmwide organizational framework where they must make routine "real-time judgments" in demanding environments, often with constrained resources and limited information while managing numerous responsibilities.[228] Even the Advisers Act itself acknowledges that CCOs make real-time judgment calls. Thus, the SEC has stated that the CCO should tailor a compliance program to the firm's particular business model to best detect and prevent violations. Here, each firm's compliance program will be unique. As the NSCP has stated, decisions to charge compliance officers under a "reasonableness" standard "unduly places compliance officers in harm's way for real-time judgments of a type that they must routinely make."[229] What the SEC views as

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224. Gallagher Remarks, *supra* note 185.

225. Hester M. Peirce, Commissioner, SEC, Costumes, Candy, and Compliance: Remarks at the National Membership Conference of the National Society of Compliance Professionals (Oct. 30, 2018), https://www.sec.gov/newsroom/speeches-statements/speech-peirce-103018 [hereinafter "Peirce Remarks 3"] ("A conflict between [the CCOs] judgment and ours, which is always informed by hindsight, should not result in an enforcement action against you").

226. *See* NYC Bar Report, *supra* note 7, at 8 (noting the risk that hindsight bias will make a CCO's actions that seemed reasonable at the time appear unreasonable after a violation); Peirce Remarks 3, supra note 225.

227. *See, e.g.*, Neal J. Roese & Kathleen D. Vohs, *Hindsight Bias*, 7 PERS. ON PSYCH. SCI. 411 (2012).

228. *See, e.g.,* NYC Bar Report, *supra* note 7, at 7-9 (describing that CCOs must often make decisions quickly and with incomplete guidance).

229. Letter from National Society of Compliance Professionals to Andrew Ceresney, Director of Enforcement, SEC (Aug. 18, 2015), https://www.mfdf.org/docs/default-source/fromjoomla/uploads/blog_files/nscpceresneyletter.pdf.

"reasonable" is often vague, and the SEC frequently uses its enforcement actions or settlements to introduce a new rule or clarify how a current rule is to be interpreted, exposing CCOs to personal liability with limited notice that the act or omission would be deemed illegal.[230]

In contrast, a recklessness legal standard mitigates the risk of hindsight bias. When a CCO engages in an extreme departure from ordinary care of her compliance responsibilities, the risk is obvious. In fact, the CCO's behavior presents a risk so obvious that the CCO knew about the danger or must have been aware of it because it was so obvious. Accordingly, there is little risk of hindsight bias because the CCO knew at the time of her actions that she was engaging in highly risky behavior, putting the firms and investors at great peril.

E. SEC's Regulatory Goals for CCO Liability

> "We protect investors by vigorously enforcing the federal securities laws to ensure truth and fairness. We deter misconduct, hold wrongdoers accountable, and provide resources to help investors evaluate their investment choices and protect themselves against fraud."[231]
>
> \- SEC Mission Statement

The SEC's current approach of bringing negligence-type enforcement actions, (far short of a "wholesale failure") against individual CCOs is misguided, in part, because it does not promote the SEC's regulatory goals of deterring misconduct, preventing fraud, and punishing wrongdoing.

The SEC's approach to CCO liability does not promote the SEC's regulatory goals. In announcing its fiscal year 2023 enforcement results, the SEC reiterated that "[i]ndividual accountability remains a pillar of the SEC's enforcement program."[232] Approximately two-thirds of the SEC's cases in fiscal year 2023 involved charges against one or more individuals.[233] The SEC has made numerous statements regarding the regulatory purpose of individual accountability charges, including against CCOs. The SEC's key regulatory goals in doing so appear to be: (1) deterring misconduct, (2) preventing fraud, and (3) punishing wrongdoing.[234] However, the SEC's current approach to CCO personal liability does not meet these objectives. Further, even if the

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230. *See* NYC Bar Report, supra note 7, at 8; Peirce Remarks 3, supra note 225 at 64..

231. SEC, Mission (Aug. 9, 2023), https://www.sec.gov/about/mission.

232. Press Release, SEC, *SEC Announces Enforcement Results for Fiscal Year 2023* (Nov. 14, 2023), https://www.sec.gov/newsroom/press-releases/2023-234..

233. *Id.*

234. *See, e.g.*, SEC ENFORCEMENT MANUAL 4 (Nov. 28, 2017), https://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

SEC's current approach does promote these objectives in some capacity, the benefits of such an approach are far outweighed by the costs.

First, the deterrence regulatory goal holds that if the CCO is punished for misconduct, other CCOs will be deterred from committing similar offenses in the future.[235] However, in the nebulous cases brought against CCOs in negligence-type scenarios, the CCO neither committed the misconduct nor was in a difficult, if not impossible, position to prevent it. Thus, the deterrence motive is not effective because the misconduct resulted from actions taken by people other than the CCO and likely could not have been prevented by the CCO.[236] As discussed, CCOs operate in a larger organizational framework that presents constraints. Unlike the SEC's individual liability cases against individuals who committed the misconduct, CCOs may be charged because of what someone else at their firm did. Consequently, the SEC's approach designates CCOs as individually responsible for compliance that is determined by other members of the CCO's firm whom the CCO ultimately cannot control. Moreover, the "letter of the law" does not promote deterrence because the SEC often uses enforcement actions, "sweep examinations," issued guidance or settlements to clarify its rules.[237] It is often unclear to CCOs how the SEC will interpret its own rules: unlike many other federal agencies, the SEC does not issue formal policy statements when it issues enforcement actions and settlements.

As an extension of this deterrence goal, the SEC has also stated that individual accountability prevents fraud.[238] This regulatory goal is unlikely to be met in most CCO personal liability enforcement cases because it is extremely difficult for CCOs to know what actions to take to prevent fraud by analyzing the SEC's current enforcement approach against CCOs. Instead of clarifying the behavior it wants to see from CCOs, the SEC has confused CCOs by not clarifying a legal standard for CCO liability and imposing liability in cases where the CCO was not involved in misconduct.

Third, the SEC has stated an individual enforcement action may be appropriate to punish individual misconduct when the behavior "involves particularly egregious or extensive misconduct."[239] This goal reflects a retributive justice approach where punishment is warranted because the CCO's behavior deviates from what society deems morally acceptable and

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235. *See, e.g.*, Aguilar Remarks, *supra* note 1 (stating that the SEC brings actions against CCOs to punish behavior and deter misconduct); SEC ENFORCEMENT MANUAL, *supra* note 234, at 4 (noting the deterrence objective).

236. *See, e.g.,* NYC Bar Report, *supra* note 7, at 20. Utilitarian justice calls for punishment as a form of deterrence to prevent the individual criminal, and society in general, from engaging in the prohibited conduct in the future; stating that individual accountability "deters future illegal activity; it incentivizes changes in corporate behavior; it ensures that the proper parties are held responsible for their actions; and it promotes the public's confidence in our justice system." OFF. OF THE DEPUTY ATTORNEY GENERAL, Individual Accountability Policy, https://www.justice.gov/archives/dag/individual-accountability.

237. *See, e.g.*, NYC Bar Report, *supra* note 7, at 8.

238. *See, e.g.*, SEC Mission Statement, *supra* note 231.

239. SEC ENFORCEMENT MANUAL*, supra* note 234, at 4.

serves as a form of retaliation.[240] This regulatory goal is also not met when there is no clear legal standard, and the CCOs themselves are not participating in the misconduct; here, CCOs are being punished for conduct that is not egregious and does not warrant retaliation. Thus, the SEC's retributive justice approach has led CCOs to believe they are being unfairly targeted and created a disconnect between regulators and CCOs, which creates negative consequences for compliance.

Moreover, even if some aspects of the SEC's regulatory goals are met under its current approach to CCO liability, the costs far outweigh any benefits. The most powerful deterrence that occurs is not the deterrence described in the SEC's regulatory goals, but rather the deterrence of well-qualified individuals accepting CCO roles or leaving them to take other jobs where they have better liability protections.[241] Further, CCOs are disincentivized from taking the hands-on, proactive approach needed to build compliance because such actions may be interpreted as supervisory authority and subject them to liability.[242] Both costs significantly harm the SEC's regulatory goals and far outweigh any benefits.

In contrast, a recklessness legal standard will promote regulatory goals. First, the SEC's deterrence goal is appropriate where a CCO acts recklessly. It is appropriate for the SEC to signal that where a CCO engages in an extreme departure from ordinary care related to compliance, they will be punished, which will deter other CCOs from committing similar offenses in the future. Recklessness is egregious behavior that places investors at risk for compliance failures at the firms they invest in.[243] CCOs play a fundamental role in protecting investors through designing and implementing firmwide compliance; tolerating reckless behavior from CCOs sends a troubling message and places investors in harm's way.

Further, although some have argued that CCOs should not be subject to any personal liability unless they affirmatively engage in misconduct or obstruct a regulatory investigation, implementing a recklessness standard will help promote regulatory goals of deterring misconduct and preventing fraud because a recklessness standard will deter unqualified employees who do not have the requisite experience and knowledge from taking on the CCO role because the role entails potential personal liability, signaling its importance. Unlike certain regulated professions and positions, anyone can be the firm's CCO, including a firm employee or even an outside consultant.[244]

240. *See, e.g.*, Ronen Perry, *The Role of Retributive Justice in the Common Law of Torts: A Descriptive Theory* (2005). 73 TENN. L. REV. 177, 180-83 (2006).

241. *See supra* notes 131-150 and accompanying text.

242. *See supra* notes 151-189 and accompanying text.

243. *See, e.g.*, Christy Bieber & Adam Ramirez, *What Is Recklessness? Legal Definition & Examples*, FORBES (Jan. 4, 2023), https://www.forbes.com/advisor/legal/personal-injury/recklessness/ ("A reckless defendant doesn't just act less carefully than a reasonable person would have under the same circumstances. A reckless defendant behaves more egregiously, with an added level of dangerous disregard for safety.").

244. *See, e.g.,* Fanto, *supra* note 25 at 203.

Problematically, an unqualified CCO would be more likely to become a "yes CCO" due to this lack of expertise. Here, like the CCO who always says "no" for fear of personal liability, thereby creating a reactionary culture, the "yes CCO" also harms firmwide compliance. Such a CCO reflexively says "yes" to ideas the firm presents for fear of being disliked or proven wrong. If a CCO does not have knowledge, she will not understand the firm boundaries that sometimes need to be set to comply with regulations. Further, a personal liability standard for CCOs signals to firms that they need someone knowledgeable and competent to protect them from the financial and reputational risk that comes with compliance violations. Moreover, regulators will benefit from this recklessness standard because it increases the likelihood that a firm hires a knowledgeable CCO, which promotes regulatory goals.

Lastly, a recklessness standard promotes the SEC's regulatory goal of punishing individual misconduct because reckless behavior "involves particularly egregious or extensive misconduct."[245] Recklessness is the type of behavior where punishment is warranted because the CCO's behavior deviates from what is acceptable and serves as a form of appropriate retaliation.[246]

CONCLUSION

> CCO liability should be evaluated through a framework that appropriately recognizes the efforts of individuals acting in good faith. The [SEC's] enforcement authority should not be used as an opportunity for 'gotcha' or to be an easy way to boost enforcement statistics. In light of this wave of rulemaking, the [SEC] and its staff should recognize that honest, earnest, and dedicated compliance professions can be one of our most useful allies in protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.[247]

- *SEC Commissioner Mark T. Uyeda*

Despite bringing individual charges against CCOs, this paper has demonstrated that the SEC has not clearly defined a CCO personal liability standard. This approach has caused concern and confusion, adversely affecting CCOs, firms, and regulators. This paper proposed a new legal standard for CCO personal liability, replacing the SEC's "wholesale failure" approach with a standard requiring "recklessness" by the CCO before personal liability may attach. This proposed standard will bring positive benefits for firmwide compliance in five crucial areas, in contrast to the negative consequences of the SEC's current approach to CCO liability in these

245. SEC ENFORCEMENT MANUAL, *supra* note 234, at 4.
246. *Id.*
247. Uyeda Remarks, *supra* note 7.

areas. Behavioral studies and related academic research support this proposed legal standard, demonstrating that it will lead to more robust compliance programs.

This paper has significant implications for compliance, business law, and legal scholarship more broadly. First, as the conscience of firms managing trillions in assets on behalf of investors, including individuals, pensions, and universities, CCOs play an integral role in promoting behavior that protects these investors and promulgating the legal standard proposed will benefit these investors and the U.S. economy.[248] Second, this paper applies novel research regarding the *ex-ante* function of law, where CCOs and other organizational actors must take proactive, preventative actions to ensure violations do not occur in the first place. The far majority of legal scholarship focuses on the *ex-post* function of law, where the legal system responds to past behavior; however, as demonstrated, such an approach is ineffective in promoting an organizational culture of compliance, which has important consequences for organizations across industries.[249]

CCOs have challenging jobs in fast-paced, competitive environments where they play a critical role in promoting compliance in the securities industry. It is time for the SEC to support them by promulgating a clear legal standard for CCO personal liability that reflects the challenging nature of CCO roles and their organizational environments. The legal standard proposed by this paper will both support CCOs and promote regulatory goals. The author hopes that this paper will lead to positive changes in this area.

248. *See supra* notes 151-223 and accompanying text.
249. *Id.*