

**MEMO# 4941**

June 30, 1993

## **SEC FURTHER CLARIFIES ROLE OF SUPERVISORS**

June 30, 1993 TO: COMPLIANCE COMMITTEE NO. 13-93 INVESTMENT ADVISERS COMMITTEE NO. 20-93 SEC RULES COMMITTEE NO. 57-93 RE: SEC FURTHER CLARIFIES ROLE OF SUPERVISORS \_\_\_\_\_ As you may know, in administrative proceedings last year against three senior officials of a major broker-dealer firm, the Securities and Exchange Commission amplified its views on who is a supervisor for purposes of the federal securities laws and the responsibilities that this role entails. The Commission has further clarified its views in a recent administrative proceeding against the chief executive officer of a broker-dealer firm. In the order, the Commission found that the officer failed reasonably to supervise the manager of the firm's high yield and convertible bond department (the "HYBD"), with a view to preventing two unrelated schemes to violate the securities laws. In the first scheme, entities controlled by the HYBD manager (the "Partnerships") allegedly purchased securities that were being underwritten by the firm and (after the HYBD had made a market in the securities) sold their holdings back to the HYBD at a premium to the offering price. The Commission found that the HYBD manager thereby violated Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rules 10b-5 and 10b-6 thereunder. The Commission also found that the HYBD manager told the chief executive officer that the Partnerships were willing to purchase unsubscribed portions of the offerings, and found that the chief executive officer approved the Partnership purchases. The second scheme involved an off-shore fund organized by the securities firm. The firm paid trailing commissions to the its salespersons who sold the fund shares and charged the HYBD a fee to recoup the trailing commissions. In order to recover the charge, the HYBD manager required the fund manager to designate the securities firm to receive selling concessions on the purchase of newly issued securities by the fund and other clients of the fund manager. The fund manager also adjusted the prices of trades made for the fund and the fund manager's other clients, in favor of the securities firm. Neither the designation of selling concessions nor the adjustment of trading prices was disclosed to the fund investors or the fund manager's other clients. The Commission found that the HYBD manager thereby violated Exchange Act Section 10(b) and Rule 10b-5, and aided and abetted the fund manager's violation of Section 206 of the Investment Advisers Act. The Commission also found that the HYBD manager had told the chief executive officer about the selling concession designations and "sales credits on trades." The Commission's order states that "reasonable supervision [under the federal securities laws] requires 'strict adherence' to internal company procedures" and that the federal securities laws "impose on supervisors the obligation to respond vigorously even to indications of possible wrongdoing." The order continues: Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and

prevent violations of the federal securities laws. The Commission found that, at a minimum, the chief executive officer should have brought the Partnership purchases to the attention of those persons in the firm primarily responsible for legal and compliance matters, and should have followed-up to ensure that appropriate action was being taken. The Commission also found that the chief executive officer should have acted to prevent the HYBD manager's recovery of the internal fee by means of the selling concession designations. The Commission found that, when the HYBD manager told the chief executive officer that h was recouping a portion of the fee with "sales credits on trades," the officer should have halted the practice if he understood this terminology or, if he did not understand it, "should have recognized it as a red flag and inquired to determine what this method of recouping the fee entailed." The Commission found that the chief executive officer took no action with respect to either scheme (and failed to inquire as to the sales credits), and that he failed reasonably to supervise the HYBD manager with a view to preventing the securities law violations. Without admitting or denying the Commission's findings, the chief executive officer consented to an order barring him from association in a supervisory capacity with any broker-dealer, investment adviser, investment company, or municipal securities dealer, with a three-year right to reapply to become so associated except as chairman, chief executive officer, or president. A copy of the order is attached.

Thomas M. Selman Assistant Counsel Attachment