Fall 2015

The Vanishing Supervisor

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This Article begins with two stories that are emblematic of related trends in broker-dealers: the importance of compliance officers and the significance of technology for the oversight of brokers and their activities. The stories also point to the lessening role of the supervisor who is "on the ground" in the branches of these firms. The diminished position of the mid-level supervisor is surprising, even shocking, in the federal regulation of broker-dealers. The history of this regulation reveals that Congress, the Securities and Exchange Commission (SEC), and self-regulatory organizations (SROs) like the Financial Industry Regulatory Authority (FINRA) sought to prevent broker abuses of customers by enhancing the role and competence of mid-level broker-dealer supervisors, best exemplified by the branch manager. Indeed, the Securities Exchange Act of 1934 (Exchange Act) did something that was not in the common law of agency or in the regulation of businesses under corporate or other business organization law: it imposed a direct liability upon broker-dealer supervisors for their failure to supervise those under their control who commit securities law violations. This focus on the intermediate supervisor was both a business and regulatory reaction to the rise of large broker-dealers with numerous employees and multiple offices spread across the entire country that served the growing number of new investors in the post-World War II years. The SEC and the SROs took advantage of the new managerial position to ensure that brokers would follow the law and, through their regulation and enforcement, they sought to "professionalize," and to raise the standards of, this position. Recognizing, however, that the supervisory tasks were too much for typical mid-level supervisors, the SEC, the SROs, and the broker-dealers themselves provided them with the assistance of compliance officers and technology. Yet these aids are now threatening to push intermediate supervisors aside, for business and regulatory reasons: (i) the "flattening" of the managerial hierarchy in broker-dealers, partly made possible by technology, and (ii) the fact that the SEC and the SROs have established, and have more confidence in, compliance officers to assist in the performance of supervisory tasks in broker-dealers. As a result, broker-dealers are pressuring regulators to allow technologically-enhanced compliance officers, generally operating remotely in the main office under the direction of senior supervisors, to conduct the work of intermediate supervisors. This Article contends that to replace, or even to downplay the importance of, this kind of supervisor would remove a key player in effective compliance for broker-dealers. There is considerable value for compliance in maintaining the broker-dealer supervisor who has securities experience, who is close to and even participates in the securities activities of brokers, and who thus understands the pressures that they face. This Article argues that the SEC and FINRA must resist this dangerous trend of the

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elimination of the mid-level supervisor, a process to which they are themselves contributing with their emphasis upon compliance officers, and it offers several steps that they can take to bring these supervisors into the compliance conversation.

I. INTRODUCTION

Let us begin with two stories about the brokerage industry today, which are based on real life events. In the first, a broker-dealer,[1] which earns most of its money from sales of securities products to retail investors, has a head of sales called Louis. Louis is a big man and something of a bully who does not appreciate the people at the firm—call them compliance officers—who remind him of the legal and professional obligations that he and the brokers must follow. He once referred to a former chief compliance officer as a member of "Hitler's Reich" and to one of the compliance officers as "Igor, Frankenstein's assistant." Louis recruits Stephen, in industry parlance, a "big producer," to the broker-dealer. Louis is very friendly with Stephen and gives him free rein to work. Stephen soon comes to the attention of the compliance officers for various reasons: for example, he appears to be doing trading in several of his retail customer accounts that is not in accordance with their investment objectives, and in these accounts he generates a lot of commissions which are high in relation to the value of the accounts. Moreover, one of his institutional accounts appears to be that of a stock manipulator who borrows money from the broker-dealer to do the manipulation (and the stock being manipulated ends up in the accounts of Stephen's retail customers!). Theodore, the current chief legal and compliance officer, wants Louis to put Stephen on a short leash, but Louis resists, and Stephen continues his misconduct. Theodore urges the CEO to fire Stephen, but Louis mollifies Theodore by agreeing to keep an eye on Stephen. This oversight does not stop Stephen, who eventually leaves the firm in the wake of customer complaints and losses, requiring the broker-dealer to pay millions of dollars to abused customers. The Securities and Exchange Commission (SEC) learns of the situation and fines the broker-dealer for allowing the misconduct to occur. Then, in a highly controversial administrative action, it charges Theodore for not having stopped Stephen's misconduct. The administrative law judge finds Theodore (who is in fact a former SEC lawyer and division assistant head) not at fault, but the SEC's Enforcement Division takes the case all the way up to the SEC Commission level. It ends there because three out of the five Commissioners recuse themselves, and the other two are split as to whether Theodore should be liable.[2]

In the second story, a broker-dealer decides to sell alternative investments to retail customers, who make up most of its client base. "Alternative investments" is a catch-all phrase for non-traditional investments—such as investment trusts, partnerships, and hedge funds—that are not publicly traded. Since these kinds of investments are illiquid, highly speculative, and not always easy to value, they are not suitable for retail investors. Even

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1. A broker-dealer is the main kind of financial firm operating in the securities markets. A broker-dealer typically conducts both the functions of a "broker," meaning that it acts as an agent for others in their securities transactions, 15 U.S.C. § 78c(a)(4) (2012), and a "dealer," meaning that it is in the business of making markets in securities (i.e., buying and selling them), 15 U.S.C. § 78c(a)(5). In most circumstances, a person acting as a broker-dealer must be registered with the Securities and Exchange Commission (SEC). 15 U.S.C. § 78*o*. In this Article, "broker" will usually refer to the typical sale-oriented professional working in a broker-dealer.

2. This story roughly follows the predicament of Theodore Urban. *See In re* Urban, SEC Release No. 402, 2010 WL 3500928 (Sept. 8, 2010) (giving the administrative law judge's initial decision). The SEC declined summarily to affirm the judge's decision. *In re* Urban, SEC Release No. 63456, 2010 WL 5092728 (Dec. 7, 2010). The SEC eventually let it stand for the reason stated above. *In re* Urban, SEC Release No. 3366, 2012 WL 1024025 (Jan. 26, 2012).

for those retail investors who are qualified to purchase them, alternative investments should be a small part of an investor's overall portfolio. Large and with many offices, this broker-dealer operates under a model that exists today in a number of national broker-dealers: many of its branches are independently owned and operated by brokers. To help link together all of these branches, to provide them efficiently with products and order execution facilities, and to supervise them, the broker-dealer uses an automated system that, among other things, gathers together all the information about its brokers, customers, and their transactions. As one part of the oversight of customer transactions in alternative investments, the firm runs all transactions through the automated system, which can identify, and even reject, ones that do not comply with its product and customer guidelines. For example, a transaction would be flagged for further investigation by compliance and supervisory staff in the home office if a customer purchasing an alternative investment is not an appropriate investor for it on the basis of the customer's sophistication and size of portfolio, or if the customer already has too large a concentration of his or her portfolio in alternative investments. However, it turns out that, as a result of programming errors and limitations, the automated system often fails to flag or to reject transactions in alternative investments that should not have been made for certain customers. As a result of an enforcement action brought against it by the Financial Industry Regulatory Authority (FINRA)[3] on its sales of alternative investments, the broker-dealer pays a $1 million fine, hires an outside consultant to advise it on revamping its compliance procedures, and undertakes a significant revision as to how it oversees the sale of alternative investments to retail customers, including with respect to its automatic system's failure to identify suspicious or problematic transactions.[4]

These two stories are emblematic of two significant, related trends in the broker-dealer world. The first trend, exemplified by the first story but which also figures in the second, is the important role of a compliance officer in the oversight of brokers. The SEC's enforcement action against Theodore was based on the allegation that he did not go far enough in stopping the misconduct of Stephen, the rogue broker, despite the resistance of Louis, Stephen's nominal supervisor. Even the second story emphasizes the importance of compliance, for compliance officers and supervisory staff at the home office of the broker-dealer are supposed to review the transactions flagged by its automated system. The other trend, highlighted by the second story, is the significant role of technology in the oversight of activities in a broker-dealer and thus in the identification, or even the prevention, of problematic transactions. As shown by the example, technology allows a broker-dealer to keep an eye on brokers in numerous, far-flung offices in an economical way. Moreover, technology becomes a useful tool in the hands of compliance officers who, with its help and from a remote location, use automated systems to review transactions.

But another, less evident message of these two stories, which goes hand-in-hand with

3. FINRA is the union of the former self-regulatory arms of the National Association of Securities Dealers (NASD), FINRA's actual predecessor, and the New York Stock Exchange (NYSE). This union occurred when the stock marketplaces, the National Association of Securities Dealers Automated Quotations (NASDAQ) and the NYSE, respectively, became private companies, rather than member organizations. FINRA, like the NASD before it, is a registered securities association under section 15A of the Exchange Act, 15 U.S.C. § 78*o*-3.

4. This story is based upon a FINRA settlement of an enforcement action with a broker-dealer. *In re* LPL Financial LLC, FINRA Letter of Acceptance, Waiver and Consent No. 2011027170901 (March 24, 2014).

the importance of compliance and technology in the oversight of brokers, is the lessening importance of the supervisor who is "on the ground" in the branches of broker-dealers. It is true that, in his opinion in the first story, the administrative law judge unfavorably portrays the conduct of Louis, who protects the rogue broker Stephen. But Louis is not a branch manager; he is the head of retail sales and thus near the top of the broker-dealer's hierarchy. In the story, the rogue Stephen went his merry way, working in and out of several different branches relatively free of interference or control by the branch managers in them. In the second story, FINRA faulted the broker-dealer for not training its mid-level supervisors adequately so that they could better oversee customer transactions in alternative investments solicited by brokers under their supervision. However, the main emphasis of this settled proceeding, particularly with respect to the remedial measures undertaken by the broker-dealer, involves the firm's commitment to fix its reporting forms for alternative investments, which would be entered into the automated system, and to enhance the oversight of alternative investment sales by a special compliance and supervisory group in the main office.

This outcome of a diminished mid-level supervisor is surprising, even shocking, in the federal regulation of broker-dealers. The history of this regulation, which essentially began with the Exchange Act,[5] reveals that Congress, the SEC, and self-regulatory organizations (SROs)[6] like FINRA sought to prevent brokers from abusing customers by enhancing the role and competence of mid-level broker-dealer supervisors, best exemplified by the branch manager. Indeed, the Exchange Act, as well as other federal securities laws modeled upon it, does something that was not in the common law of agency or in the regulation of businesses under corporate or other business organization law: it imposes a direct liability upon broker-dealer supervisors for their failure to supervise those under their control who commit securities law violations.[7] The creation of this liability, which in essence imposes a duty to supervise on them, was a reaction to a new business reality that came into existence in brokerages during the middle of the last century. From operating primarily as small businesses in partnership form with a few partner owners and a small group of employees who collectively worked out of a handful of offices, broker-dealers became larger organizations with multiple offices spread across a region or even the entire country in order to serve the growing number of investors in the post-World War II years. In these larger organizations, the partner/owners could no longer control and supervise every branch or office. They thus began to hire, train, and rely upon new mid-level supervisors, often drawn from the brokerage ranks, to assist them in the management and supervision of the brokers, particularly in the branches. Recognizing the managerial role of these supervisors, with the help of Congress, which empowered the SEC to impose supervisory liability on them, the SEC and the SROs enlisted these supervisors in the task of ensuring that brokers under their direction followed the law.

However, the SEC worried that these supervisors would come from one of several backgrounds that would make them less than ideal persons to oversee branches. They

5. *See* 15 U.S.C. § 78a (beginning the Securities Exchange Act of 1934).

6. SROs are essentially markets or groups of financial professionals authorized under federal securities laws to regulate their own participants, which are generally broker-dealers operating in these markets, with self-regulation subject to SEC oversight. *See* 15 U.S.C. § 78c(a)(26) (defining a self-regulatory organization).

7. *See infra* Section II.A (explaining the Exchange Act and following statutory framework).

would be either a successful broker with many clients who would be too busy to supervise and also be in need of supervision, or they would be a less successful or no longer active broker not having the authority or the desire to rein in the brokers in the branch, whose success contributed to their own compensation.[8] Although neither the SEC nor FINRA (at the time, it was the still the National Association of Securities Dealers (NASD)) ever banned producing managers from being supervisors, much of their regulation and enforcement, as well as statutory changes, in the latter half of the twentieth century was designed to "professionalize"—and raise the standards of—this position. For example, qualifications were imposed upon brokers and others broker-dealer employees who wished to occupy this middle management position in a broker-dealer. More significantly, SRO rules on supervision went from being general guidelines for broker-dealers to detailed policies and procedures that, among other things, would tell a supervisor exactly how to do the job.[9] In addition, these same rules ensured that the broker-dealers had to have someone watch over the supervisors themselves, with special attention paid to high producing supervisors.[10]

Over the course of this same half century, however, the SEC, the SROs, and the broker-dealers themselves recognized that the supervisory tasks were too much for a typical mid-level supervisor to handle. Since one of the supervisor's main responsibilities is to ensure that brokers do not violate the laws, regulations, and professional standards in their securities activities, as these latter proliferated it became difficult for a branch manager or section chief to keep track of, and to supervise in accordance with, all of them. Thus, a specialized broker-dealer position came into existence to assist supervisors so that they could do their job competently: the compliance officer.[11] Compliance officers, who at first worked under the legal department and later within compliance departments, kept up with all the legal, regulatory, and professional developments, translated them into compliance and supervisory procedures, educated and monitored the brokerage staff for their compliance with these procedures, and investigated any potential violations.

Moreover, just as broker-dealers began to use technology to enhance the securities business itself—as in order execution—they also employed technology for compliance and supervisory purposes. For example, compliance officers use developing surveillance technology to review a broker's communications and transactions with clients. Here, the standard business and regulatory story of specialization of tasks[12] resulted in better functioning supervisors in the industry. Ideally, they could focus attention on the main

8. Supervisors generally receive a part of the commissions made by those under their supervision. *See infra* note 175 (discussing how some compensation structures could create a conflict of interest and discourage adequate supervision).

9. *Infra* Section II.B.

10. For example, FINRA's current rules on supervision provide for the supervision of supervisory personnel. FINRA RULE 3110(b)(6), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1134 (last visited Oct. 20, 2015).

11. For general works on the development of broker-dealer compliance, see SEC. INDUS. ASS'N: LEGAL & COMPLIANCE DIV., WHITE PAPER ON THE ROLE OF COMPLIANCE (Oct. 2005) [hereinafter WHITE PAPER]; SEC. INDUS. & FIN. MKTS. ASS'N, THE EVOLVING ROLE OF COMPLIANCE (Mar. 2013) [hereinafter THE EVOLVING ROLE OF COMPLIANCE].

12. The classic work on this subject is of course ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

supervisory problems, which compliance officers—aided by technology—had both identified and proposed solutions for.

Yet this ideal state of affairs is now changing, as the stories that opened this Article suggest. The two forms of assistance to mid-level supervisors are now threatening to push them aside. No doubt, there is a business explanation to what is occurring, as there was in the appearance of mid-level supervisors in the first place. In the world of large businesses, there is a "flattening" of the historical multi-level business hierarchy as layers of middle management are eliminated.[13] Technology often justifies and facilitates this flattening, as business processes become automated and as upper level managers can do more with fewer subordinates. The same process is occurring in the large broker-dealers that dominate the industry; automated supervisory, compliance, and other processes make some mid-level supervisors superfluous.[14] In a financial world where bottom line profitability is king[15]—and where supervisory and compliance expenses have grown with increasing regulatory demands—broker-dealers often look to consolidate supervision and compliance in a home office that can remotely monitor the branches and other offices through automated technologies, as the second story demonstrates.

There is also, however, an important regulatory explanation for the disappearing mid-level supervisor. As noted above, a longstanding SEC and SRO goal was to make mid-level supervisors more professional, and thus effective in ensuring compliance within their branch or group, even though the supervisor was a successful, profit-driven broker in many cases. But in recent years regulators appear to have relinquished this goal, or at least are less confident of ever achieving it. Put another way, regulators realize that they need not continue down what may be an unattainable path when they have others in a broker-dealer more suited to this task: compliance officers. Through years of regulation and enforcement decisions, the SEC and SROs made broker-dealers give compliance officers their own structure of authority and decision-making that are independent of the business hierarchy.[16] Broker-dealers have also learned that these officers should have a say on every important decision made within them, and that the chief compliance officer (CCO) is expected to have a "seat at the table" with the highest executives and ultimately to report to the top decision-making body. Since the typical compliance officer generally does only the compliance job, in the view of regulators this officer is not faced with the conflicting pressure of sales. Indeed, compliance officers have become the darlings of regulators, who expect them to be their eyes and ears in firms and to report any misconduct occurring in them. As in the case of Theodore, many compliance officers are drawn from the ranks of the SEC and FINRA and thus have professional ties with these regulators. So long as the Exchange Act provision imposing liability on supervisors remains in the statute, the mid-level supervisor always faces liability for the failure to supervise, as the SEC and FINRA would be the first to assert. But the regulatory emphasis on compliance, together with

13. *See infra* note 161 (explaining that this flattening was intended to put decision power lower in the organization, close to those employees dealing with consumers).

14. *See infra* note 163 (discussing technology's role in consolidating the brokerage industry).

15. *See* GERALD F. DAVIS, MANAGED BY THE MARKETS: HOW FINANCE RESHAPED AMERICA 6–8 (2009) (discussing the spread of financial thought from financial intermediaries).

16. *See infra* notes 129–33 and accompanying text (explaining the SEC's expectations for an effective compliance department).

broker-dealers' own desire for cost savings and organizational rationalization, is producing pressure for the elimination of the mid-level supervisor; although this supervisor is a long-time staple of regulation in the broker-dealer world, their shoes could be filled by technologically savvy compliance officers.

This is a dangerous outcome, however, because it will produce more misconduct in broker-dealers, rather than better compliance. There is considerable value for compliance purposes in having broker-dealer supervisors who have experience in the job, who are close to and even participate in the securities activities of their fellows, and who thus understand the pressures faced by broker-dealers. Psychologists tell us that leaders in group settings like that of the typical branch office are most influential in defining the identity—and thus the standard of conduct—of the group if their conduct exemplifies their words of advice.[17] A branch chief who talks about putting customer interests first has ample opportunity to demonstrate whether these words are "for show" or reflect the substance of his or her beliefs. Moreover, according to organizational theorists, an organization's culture that intends to promote legal and professional compliance is most effective when it is not limited to words from senior executives on high (although these words are important), and is embodied in the everyday conduct of mid-level supervisors.[18] To replace, or even to downplay the importance of, this kind of supervisor with a remote supervisory and compliance group would remove a key player in effective compliance and would thus prove disastrous for broker-dealers. Furthermore, it would reinforce the risk that compliance officers already run, which is parodied in Louis's attitude towards them in the first story: that they are divorced from business reality and a "necessary evil" for, and to be ignored if possible by, the brokers.

This is not to downplay the importance of compliance or the inevitable contributions of technology for broker-dealer supervision. In another article, I argued that compliance officers are invaluable for promoting "internal" compliance through the counsel and advice that they offer to brokers and to their supervisors.[19] By "internal" compliance, I mean attitudes and conduct that are based upon the policies and principles of securities regulation, as opposed to "external" compliance, which at its worst involves a formalistic "checking the box" of actions to be taken in a given transaction. Indeed, that article presented compliance officers as indispensable allies to supervisors for the reasons explored above with respect to producing up-to-date supervisory procedures, as well as for promoting internal compliance. However, it is one thing to have a compliance officer as an adviser; it is another thing altogether to have the compliance officer supplant the supervisor. Not only would this threaten the efficacy of that officer's advisory role, but it

17. *See, e.g.*, David M. Mayer et al., *Who Displays Ethical Leadership, and Why Does It Matter? An Examination of Antecedents and Consequences of Ethical Leadership*, 55 ACAD. MGMT. J. 151, 153–54 (2012) (discussing the influence of the example of leaders on a group's values).

18. Joel Gehman et al., *Values Work: A Process Study of the Emergence and Performance of Organizational Values Practices*, 56 ACAD. MGMT. J. 84, 105–08 (2013) (rejecting the view that organizational values come only from the "top down" and are relatively stable, but arguing that they emerge locally and are constantly subject to change and refinement).

19. James A. Fanto, *Surveillant and Counselor: A Reorientation in Compliance for Broker-Dealers*, 2014 B.Y.U. L. REV. 1121, 1174 (2014), http://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=2946&context=lawreview.

would also put a non-business line-person in a supervisory role. At the very least, as seen in the Theodore's case, this would result in the threat of supervisory liability for the compliance officer. The greater danger is that there would be a stark differentiation between broker activity and compliance with the law, which a fruitful collaboration between the compliance officer and the mid-level supervisor would eliminate. Furthermore, while automated and remote surveillance of brokerage activities is likely only to continue to grow, it is not the solution to all supervisory matters—in fact, there are many forms of broker misconduct that automated surveillance cannot detect.[20] In addition, there is always the risk that technologically-enhanced supervision will make senior executives in a broker-dealer overconfident in their ability to identify problems, which will lead them to overlook the gaps in the technology that brokers can exploit.

The SEC and FINRA must thus become aware of and resist this dangerous trend of the gradual squeezing out of the mid-level supervisor, a process to which they are themselves contributing with their increasing emphasis upon compliance. They can take several steps to reverse the trend. First, they need to recognize and push back against industry efforts to eliminate the mid-level supervisor by the use of remote office surveillance effected through compliance and technology. While non-regulated businesses may follow their cost-cutting logic by eliminating middle managers, this cost justification cannot prevail in the brokerage business. Cost-cutting in this business must be done in accordance with public policy goals, such as investor protection, and where the mid-level supervisor is a critical figure in satisfying them. More specifically, while SEC and FINRA officials should continue to champion the significance of compliance (although with more emphasis on "internal" compliance), they must recognize the importance of mid-level supervisors for achieving compliance goals and integrate them into their emphasis on compliance.

Part II first sets forth the statutory and SRO framework in the Exchange Act that imposes a duty of supervision on mid-level supervisors in broker-dealers. It emphasizes that this kind of intermediate supervisory liability is unusual under agency law and the law of business organizations, where generally only the firm, as well as occasionally its senior executives and board members, has a duty of supervision. It also points out how FINRA rules make a broker-dealer adopt its own detailed procedures that set out the tasks, and ensure the oversight, of the mid-level supervisor. Part II then provides a bird's eye view of the history and policy origins for the imposition of this intermediate supervisory liability in broker-dealers. It explains how the Exchange Act at first did not focus on supervisory liability in general because the SEC could rely upon common law agency principles in a world where broker-dealers were small and in partnership form with few owners and employees all working in a main office and, at most, a few branches. It then discusses how, in the middle of the twentieth century, the SEC became concerned about securities law violations occurring in a new kind of broker-dealer that was emerging in the industry: the national firm, often in corporate form, that had many branches and large numbers of employees. In the SEC's view, these large broker-dealers were difficult to supervise—a critical shortcoming as new retail investors were entering the securities markets. The SEC

20. *See infra* notes 155–60 and accompanying text (discussing misconduct that automated surveillance cannot detect).

saw the middle manager equivalent in the broker-dealer, the salaried branch office head and similar department supervisors who filled broker-dealers' managerial needs, as the ideal person to resolve the firms' supervisory problems. Part II thus traces—again in broad strokes—how the SEC and the SROs, with the help of Congress, obtained jurisdiction over this intermediate supervisor, sought to professionalize this position through regulation, which imposed qualifications and standardized tasks upon the supervisor, and brought enforcement actions, which established acceptable standards of conduct for these kinds of supervisors. Part II shows how, as a result of the legislation and regulatory action, the mid-level supervisor became an established part of the regulatory structure of a broker-dealer.

Part III then explains how, almost at the same time as promoting the importance of the intermediate supervisor, regulators were concerned that these supervisors would need assistance to help them perform their supervisory tasks. Part III first discusses the validity of the regulators' concern, although it justifies their intuition in richer psychological, social psychological, and organizational terms. It explains the cognitive limitations facing supervisors, as well as the social psychological and organizational pressures that could lead them to condone misconduct by those being supervised.

Part III then identifies the two forms of assistance that regulators promoted to help the intermediate supervisor—compliance and technology. It briefly describes compliance and the ways in which compliance officers assist supervisors in the latter's supervisory tasks. It then offers an account of how, from psychological, social psychological, and organizational perspectives, compliance officers improve supervisor decision-making, even if regulators do not justify compliance in these terms. In sum, by keeping track of legal and professional obligations, embodying them in firm procedures, and by monitoring compliance with those procedures, compliance officers reduce supervisors' cognitive burdens, presenting them with targeted issues to decide and steps to take in their decisions. By being outside supervisors' groups and reporting lines, a compliance officer is resistant to the social pressures facing supervisors and can offer them an alternative group identity for the decision-making. Moreover, the compliance officer, as the proponent of broker-dealer values and goals, can bring these into the foreground so that they do not fade in supervisory decisions. Part III also discusses how, from the middle of the last century, the SEC and the SROs recognized that technology offered a potential resource for supervision, just as broker-dealers were using it for investing and order activities.

Part III also analyzes how the use of technology by compliance officers addresses psychological, social psychological, and organizational pressures on intermediate supervisors. In particular, technology so used can identify problematic transactions, which are then presented to a supervisor for review with steps to follow and organizational values to consider. Part III then highlights the limitations of compliance and technology.

Part III next analyzes why and how technology and compliance are pushing aside mid-level supervisors. Here it refers in more detail to organizational "flattening," a process that, generally with the help of technology, eliminates intermediate managers and supervisors and that occurs in large broker-dealers. Since technology has automated much of a broker's interaction with customers, it allows for automated guidance, monitoring, and supervision of the brokerage staff, thus dispensing with a layer of supervisors. In the hyper-competitive world of the securities industry, broker-dealers have embraced technology and its possibilities of cost reduction by allowing supervision to be done remotely from the main

office, often by a compliance staff with senior supervisors. Part III then explains that, although the SEC and the SROs have resisted remote supervision and still stand behind the local supervisor model, they are gradually allowing this kind of remote supervision to replace the mid-level supervisor. This Part contends that the acquiescence of the regulators to this trend is due both to their longstanding suspicion of the effectiveness of mid-level supervisors, who in their view are too affected by the profit-making activities of their firms, and to their increasing preference for the involvement of compliance officers in supervision. Part III reviews several ways in which compliance has been enhanced in broker-dealers through regulatory action and enforcement, in particular, by creating an alternative compliance structure that mirrors business operations, by mandating compliance involvement in substantive decisions, and by giving compliance officers close reporting ties to the regulators themselves. In sum, Part III contends that regulators in practice, albeit not in words, are allowing compliance officers, aided by technology, to make inroads upon the authority of the mid-level supervisor, who is disappearing in the brokerage industry.

Finally, Part IV contends that the mid-level supervisor should be maintained to promote effective compliance in broker-dealers. This Part offers psychological and organizational justifications for the existing supervisory structure. It argues that a supervisor who is close to and experienced in securities activities can most effectively act as a role model for brokerage and other securities staff in showing how policies underlying the securities laws can be put into effect in everyday sales activities. It also contends that organizational values are best conveyed, internalized, and perpetuated by examples "on the ground," rather than through inspirational and other messages sent remotely by senior executives from the central office. Here, Part IV's argument complements one that was offered in my earlier article on compliance. In my other work, I argued that the role of a compliance officer as an advisor and counselor must be emphasized and its position as an "external" monitor downplayed.[21] Part IV continues in the same vein by arguing that regulators must recognize that having compliance officers as technologically-enhanced monitors is not only crowding out their advisory role but is also pushing aside the supervisor as role model and conveyor of organizational culture. This presents the possibility that a broker-dealer will be left with surveillance administered remotely by compliance officers looking over the profit-making brokerage staff. Part IV argues that this is a recipe for widespread compliance failures, and that the ideal supervisory situation is to have the compliance officer counseling and advising, but not replacing, a mid-level supervisor so that business and compliance are closely intertwined.

Part IV offers several concrete steps that the SEC and FINRA can take to arrest, and even to reverse, the steady erosion of the authority and position of the mid-level supervisor. Whereas they have resisted industry pleas to allow more home office supervision that is accomplished remotely or through visiting supervisors, the industry pressure, animated by the costs of compliance and technological advances, is beginning to erode this regulatory position. This is evidenced by the most recent version of FINRA's supervisory rules.[22]

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21. Fanto, *supra* note 19, at 1171.

22. *See infra* text accompanying notes 49–59 (discussing the Rules' requirement that a broker-dealer establish a supervisory system).

This Part offers regulators a reasoned position on which to argue to the industry why the mid-level supervisor must be maintained in branches and other offices. It also contends that regulators must recognize that they are themselves at fault for the disappearance and downgrading of this supervisor because of their increasing emphasis on the importance and independence of the compliance officer. My earlier article acknowledged this regulatory emphasis but suggested that it be redirected so as to make the compliance officer less of monitor and more of an adviser.[23] The contention here is that the redirection should include within it a refocus on the importance of compliance's inseparable partner, the mid-level supervisor. Part V concludes.

II. THE SUPERVISORY DUTY OF THE MID-LEVEL SUPERVISOR AND ITS ORIGINS

A. The Statutory Framework and Its Uniqueness

To understand the key regulatory role of mid-level supervisors in broker-dealers, it is first necessary to understand the basic Exchange Act provision imposing a duty of supervision upon them. Section 15 of that Act, which gives the SEC's regulatory power over broker-dealers, empowers the SEC in section 15(b)(4) to take disciplinary actions against a broker-dealer, including revocation of its registration, for any of the enumerated past or present acts by the broker-dealer or its associated persons.[24] The misconduct triggering this discipline includes that enumerated in subparagraph (E), which is the failure by a broker-dealer, or by an associated person, "reasonably to supervise" a person who commits a securities law violation who is "subject to his supervision."[25] This provision thus imposes direct liability upon a broker-dealer for its own failure to supervise its brokers and other affiliated persons, as well as vicarious liability upon it for these persons' failure to perform their supervisory duties. While section 15(b)(4)(E) does not directly impose a duty of supervision upon the broker-dealer, the contours of that duty are implied by the remaining language of subparagraph (E), which provides for a defense to a charge of failure "reasonably to supervise." This defense is available in the following circumstances:

> (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[26]

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23. Fanto, *supra* note 19, at 1122.

24. 15 U.S.C. § 78*o*(b)(4)(E) (2012). "Associated person" is a broad term that includes supervisors and brokers in a broker-dealer. *See* 15 U.S.C. § 78c(a)(18) (stating that the term "person associated with a broker or dealer" or "associated person of a broker or dealer" can include a partner, officer, director, as well as other positions).

25. 15 U.S.C. § 78*o*(b)(4)(E). This provision, as well as the one discussed below relating to individual supervisors, is the preferred basis for SEC enforcement against firms and supervisors, respectively, for supervisory violations. *See generally* Task Force on Broker-Dealer Supervision and Compliance of the Comm. on Fed. Regulation of Sec., *Broker-Dealer Supervision of Registered Representatives and Branch Office Operations*, 44 BUS. LAW. 1361 (1989) (discussing the SEC's approach).

26. 15 U.S.C. § 78*o*(b)(4)(E)(i)–(ii).

In other words, the above defense suggests that to avoid supervisory liability a broker-dealer must fulfill its duty of supervision. This means having supervisory procedures and a system to apply them, and putting them into effect. All of this needs to be done in a reasonable manner so as to prevent securities violations.[27]

Where, then, does the liability for the intermediate supervisor come from, since section 15(b)(4)(E) by its terms imposes liability only on the broker-dealer itself? The answer is in section 15(b)(6), which empowers the SEC to take various disciplinary actions against associated persons for, among other things, their failure to supervise a person "subject to [their] supervision" who commits a legal violation.[28] The statutory defenses are also available to associated person-supervisors, who are responsible only for those under their supervision. Supervisors do not have to establish supervisory procedures and a supervisory system to take advantage of the defenses. Rather, they would be expected to fulfill their duty of supervision, and thus to defend themselves against supervisory liability, by showing that they followed the broker-dealer's supervisory procedures and system and reasonably fulfilled their obligations under them. The Exchange Act does not define supervisor or the meaning of having a person "subject" to one's "supervision." But, as will be discussed below, from the legislative history, Congress clearly had the mid-level supervisor, particularly branch managers, in mind by this term.[29]

It is important to understand that imposing a duty of supervision on a mid-level supervisor is unusual, even unique, under the laws relating to business organizations. As every student of business organizations knows, the foundational law for business relationships and business organizations is agency law. As is also well known, agency law establishes a legal relationship between the principal and the agent, with the latter being a

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27. Given the statutory language of reasonableness, the standard for liability here is negligence, i.e., whether the firm supervised reasonably in the circumstances in preventing a securities law violation. *See* Charles Schwab & Co., No. 3-6222, 1983 SEC LEXIS 2821, at *8–9 (Dec. 28, 1983) (emphasizing that the standard is reasonable conduct, not "willful" failure to supervise). Reasonable conduct turns on satisfying the factors enumerated in the statutory defenses. In other words, a broker-dealer commits a supervisory violation if it fails to have procedures, or has inadequate procedures, directing how a particular activity should be conducted in accordance with law and regulation and how it should be supervised to ensure this compliance. *See* Oppenheimer & Co., Exchange Act Release No. 15994, 1979 SEC LEXIS 1168, at *7–8 (July 5, 1979) (discussing a situation where a firm fails to have supervisory procedures that cover a consultant who has a title of Director of Special Acquisitions and has an office with the firm). In addition, a firm is at fault if it has no supervisory system, or an inadequate one, which has been interpreted to mean that it does not devote sufficient resources (generally, but not exclusively, enough supervisors) to ensure that the procedures are followed. *See* Mabon Nugent & Co., Exchange Act Release No. 19424, 1983 SEC LEXIS 2641, at *14 (Jan. 13, 1983) ("Apart from adopting effective procedures broker-dealers must provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised."). Finally, the firm must put the procedures and system into effect in a reasonable manner; they cannot treat them as a "check the box" routine or ignore them. *See, e.g.*, Charles Schwab & Co., No. 3-222, 1983 SEC LEXIS 2821, at *25–30 (observing how various supervisors did not examine underlying documents in accordance with the firm's supervisory procedures). The most striking example of an implementation problem is a failure to follow up on and to investigate a suspicious event or "red flag" of a potential violation. *See* Dean Witter Reynolds Inc., Exchange Act Release No. 40366, 67 SEC Docket 1847, at *1 (Aug. 26, 1998) (accusing multiple supervisors of ignoring warning signs of a rogue broker).

28. 15 U.S.C. § 78*o*(b)(6)(A)(i). This subparagraph cross-references violations enumerated under section 15(b)(4), including the supervisory liability of section 15(b)(4)(E).

29. *See infra* note 84 (setting forth the legislative history of section 15(b)(4)(E)).

party who consents to work under the direction of the principal.[30] A duty of supervision does arise under several agency law doctrines, but these all impose that duty upon the principal, not the agent. This makes sense since agency law is designed to ensure that the principal, who multiplies its productive power through its use of agents in its business,[31] bear the foreseeable costs of the agents. Since a principal controls, and benefits from, agents' work in the relationship, one would expect that the principal would have a supervisory duty over them. For example, a principal is directly liable for failing to supervise, train, and monitor its agents, and for negligently failing to investigate their backgrounds before hiring them.[32] In addition, there are several kinds of vicarious liability under agency law, i.e., where the principal is derivatively responsible for the agent's conduct, that impose the duty to supervise. The most well-known vicarious liability is respondeat superior, which is the liability of an employer for the torts done by employees (a category of agent) acting within the scope of their employment.[33] Indeed, section 15(b)(4)(E) reflects both kinds of liability for the broker-dealer, since, under this provision, it is responsible for its own failures to supervise, as well as being vicariously liable for the failures of its associated persons to supervise. Yet there is no provision comparable to section 15(b)(6) under agency law, for agents are not liable under that law for the conduct of other agents. In any agency relationship, there is one principal, with one or more agents. Although an agent may be subordinate to and supervised by another agent, they are all co-agents.[34] In other words, a supervising agent's duty to supervise would be part of its agreed-upon tasks with the principal, as opposed to arising under a separate agency law doctrine.

Similarly, there is nothing about the supervisory liability of mid-level supervisors in business organization law, whether in the statutes or in the common law. This is not surprising, since that law is built upon agency law foundations. Certainly, the firm, as principal, has a duty to supervise its employee–agents under the above agency law grounds. Moreover, as students of corporate law know, the foremost agents in a corporation, the board of directors, have a duty to supervise or monitor the firm, a duty that has received considerable attention in recent years in Delaware jurisprudence.[35] At the very most, senior

30. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. L. INST. 2006) (defining agency).

31. WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP 3 (3d ed. 2001).

32. *See* RESTATEMENT (THIRD) OF AGENCY, *supra* note 30, § 7.03 (stating the general liability of principal); *id.* § 7.05 & cmt. a. (explaining that this liability arises from the tort law concept that a person who is in a special relationship with another owes third parties a duty of reasonable care with respect to the foreseeable risks posed by that relationship); *see also* Fowler V. Harper & Posey M. Kime, *The Duty to Control the Conduct of Another*, 43 YALE L.J. 886, 894 (1934) (an early article on this direct tort liability for failure to control another person who is in a special relationship with oneself).

33. *See* RESTATEMENT (THIRD) OF AGENCY, *supra* note 30, §§ 2.04, 7.03, 7.07 (defining "acting within the scope of employment"). Since employees are under the control of the principal, any harms resulting from the employment should fall upon the principal, who again benefits from their labor and who can control them. *See id.* § 2.04 cmt. b; § 7.07 cmt. b. *See also* GREGORY, *supra* note 31, at 118–19 (noting that principal can more easily than third party insure against the costs of using an agent). Vicarious liability gives the employer the incentive to train employees and to monitor their conduct.

34. *See* RESTATEMENT (THIRD) OF AGENCY *supra* note 30, § 1.01 cmt. f, § 1.04(9) & cmt. i (defining superior and subordinate coagents).

35. *See, e.g.*, Stone v. Ritter, 911 A.2d 362 (Del. 2006) (acknowledging the correctness of the foundational decision on the duty to monitor of the Chancery Court in *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d

executives of the corporation, such as the chief executive officer who is usually the chair of the board of directors, must satisfy this duty.[36] Thus, the absence of a duty of supervision for mid-level supervisors under business organization law underscores the novelty of the express statutory duty for their counterparts in a broker-dealer under the Exchange Act.

It should also be mentioned that another important statutory foundation for the duty to supervise arises from control liability provisions under the Exchange Act, perhaps a closer counterpart to agency law's liability of a principal for the actions of an agent. Section 20(a) of the Exchange Act provides that a controlling person will be jointly and severally liable with the controlled person who commits a securities law violation "unless the controlling person acted in good faith and did not directly or indirectly induce the acts or acts constituting the violation or cause of action."[37] Although not defined in the Exchange Act,[38] control appears from the legislative history to have a broader meaning than the principal/agent relationship,[39] and has so been read by the courts. The term "controlling persons" clearly includes broker-dealers with respect to brokers and other associated persons since the firms employ and supervise them.[40] More significantly, it would include an intermediate supervisor in a broker-dealer with respect to the brokers under his or her control. As a defense, a controlling person can show that it "acted in good faith" in preventing, and not inducing, the violation. For a broker-dealer, this showing can be made if it established and enforced a system of supervision, reasonable under the circumstances, so as to prevent securities law violations.[41] A satisfactory supervisory system would in

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959, 970 (Del. Ch. 1996)).

36. *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) (holding that corporate officers owe duties identical to those of corporate directors). For a comprehensive discussion of liability of corporate officers for failure to supervise other corporate agents, as well as suggestions for limiting this liability, see Martin Petrin, *The Curious Case of Directors' and Officers' Liability for Supervision and Management: Exploring the Intersection of Corporate and Tort Law*, 59 AM. U. L. REV. 1661, 1666–75 (2010).

37. 15 U.S.C. § 78t (2012). Section 15 of the Securities Act of 1933 (Securities Act), § 78t(a), 15 U.S.C. § 77*o*(a), has a comparable provision, although the exception is differently worded. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 BUS. LAW. 1 (1997) (discussing provisions with a focus on firms other than broker-dealers).

38. *But see* 17 C.F.R. § 230.405 (2014) ("The term *control* . . . means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.").

39. *See* 2 NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW & REGULATION § 25.01[A][2], at 25-6 n.11 (4th ed. 2007. 2014 updated) [hereinafter POSER & FANTO] (citing H.R. REP. NO. 1383, 73rd Cong., 2d Sess. 26 (1934)).

40. *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) (holding that a broker-dealer is a controlling person under the Exchange Act).

41. *See* Zweig v. Hearst Corp., 521 F.2d 1129, 1134–35 (9th Cir. 1975), *cert. denied*, 423 U.S. 1025 (1975) (holding that, in order to satisfy the good faith requirement, a broker-dealer must show that it maintained and enforced a reasonable and proper system of supervision of controlled persons to prevent violations of the Exchange Act). *See generally* JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 1096–99 (12th ed. 2012); POSER & FANTO, *supra* note 39, § 25.01[A][3], at 25-12 n.38 (citing cases); Loftus C. Carson II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 310–11 (1997) (using supervisory and compliance systems as examples of a good faith defense). Reasonable here appears to mean not acting with extreme recklessness. *See* MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 342–44 (6th ed. 2014) (discussing that defendant's conduct must be intentional to further the fraud). Intermediate supervisors would make this defense by showing that they followed firm procedures.

effect be the kind that would give the broker-dealer or an intermediate supervisor a defense to an SEC charge of failure to supervise. Accordingly, the risk of control liability under section 20(a) reinforces section 15(b)(4)(E)'s impetus for a broker-dealer to have a supervisory system, and section 15(b)(6)'s direction that an intermediate supervisor follow it.

B. SRO Rules on the Intermediate Supervisor

As is well known, the Exchange Act was built upon a system of industry self-regulation, although in its initial form the only SROs were stock exchanges.[42] Self-regulation has always meant that the stock exchanges and other SROs are managed and governed by the market professionals that create, and operate within, them, essentially broker-dealers.[43] Under this governance, the broker-dealers collectively set the standards for their, and their brokers', conduct, ensuring that it meets mutually agreed-upon professional norms. In the Exchange Act, Congress adopted this self-regulatory model, thereby assuming that SROs would play a major role in enforcing the new federal securities laws.[44] Initially, the law covered only stock exchanges and did not address the activities of broker-dealers trading among themselves off of an exchange, which is known as the "over the counter" (OTC) market. In 1938, Congress amended the Exchange Act better to regulate the OTC market by allowing "an association of brokers or dealers" to register as a "national securities association" to regulate that market under the SEC's supervision.[45] FINRA, the successor to the NASD, is the only registered association.

The Exchange Act ensures, albeit indirectly, that securities exchanges and associations will require their broker-dealer members to supervise their brokers so that the latter comply with the federal securities laws and regulations. To take the example of securities associations, section 15A allows an association to be registered only if, among other things, the SEC determines under (b)(2)[46] that it can enforce compliance with the laws and regulations by its members, and under (b)(6) and (b)(7) that it has rules, among

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42. *See, e.g.*, *Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720*, 73d Cong. 514 (1934) (statement of John Dickinson, Asst. Sec'y. of Commerce) ("[B]ut self regulation in the first instance, with the Government holding its power in reserve to see that that self-regulation is exercised, is after all a necessary recourse in view of the mere physical limitations in time and in personnel, which operate on the direct exercise of the powers of government as the task of regulation becomes more and more extensive over a wider and wider field.").

43. *See* POSER & FANTO, *supra* note 39, § 4.01[A], at 4-4 to 4-5 (explaining that self-regulation was to be more efficient and more extensive than any oversight by a government agency).

44. *See* Pub. L. No. 291, Ch. 404, § 6(a)(1), 48 Stat. 881, 885–86 (1934) (codified at 15 U.S.C. § 78f(2012)) (requiring an exchange to have an agreement "to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder").

45. *See* Security Exchange Act Amendment of 1938, Pub. L. No. 719, 52 Stat. 1070 (June 25, 1938) (discussing an amendment known as the Maloney Act after its sponsor in the Senate); *see also* Regulation of Over-the-Counter Markets, REP. NO. 1455, 75th Cong. 3d Sess. (1938) (explaining the self-regulatory approach, described as "cooperative regulation," and its contrast with a system whereby the SEC itself would have expanded its staff to regulate the over-the-counter markets and their participants). The Maloney Act also gave the SEC direct authority, in a revised Exchange Act section 15(c), to address improper practices in the OTC market, particularly by OTC broker-dealers who did not join a securities association. *Id.* at 10.

46. 15 U.S.C. § 78*o*-3(b)(2) (2012).

other things, "to protect investors and the public interest" and to discipline its members for violations of the rules.[47] More specifically, section 19, which states the SEC's overall powers with respect to all SROs, requires in (g) that SROs enforce compliance with the Exchange Act, its rules, and their own rules by their members, and in (h)(1) that the SEC discipline an SRO for its failure to enforce this compliance by its members.[48]

To help fulfill the above statutory mandates, the SROs' rules require their members to have a supervisory system in place to ensure that they properly supervise their associated persons so that the latter comply with the law and regulations. In FINRA Rule 3110, FINRA demands that each of its members have "a system to supervise the activities of each associated person that is reasonably designed to achieve compliance" with securities laws and regulations and FINRA rules.[49] This rule establishes the need for and sets forth the duties of the mid-level supervisor. Among other things, a broker-dealer must have written procedures for the supervision (written supervisory procedures or WSPs) of each of its securities businesses and associated persons—in other words, a roadmap for supervisors as to how to do their job. The broker-dealer must have a supervisor for each regulated business, designate a supervisor for each branch where certain customer activities occur, assign each broker to a supervisor (and a supervisor to another supervisor), make sure that each supervisor is qualified by experience or training for the tasks, have an annual compliance review (generally done by compliance officers) for each broker and supervisor, and have a supervisor review the transactions and correspondence with the public by brokers relating to their securities business.[50] This supervisory rule also requires a broker-dealer to conduct inspections of its own offices, with a general prohibition on persons who are supervised by the office supervisor doing the inspections, and otherwise with an admonition to avoid conflicts of interest in the supervision of supervisors.

In addition, FINRA Rule 3120 requires that a broker-dealer have one or more principals who establish supervisory controls to test its supervisory system on a yearly basis in order to assess its compliance effectiveness and to identify the need for additional WSPs.[51] FINRA Rule 3130 requires a broker-dealer to appoint at least one CCO, and thus

47. 15 U.S.C. § 78*o*-3(b)(6)–(7). There are comparable provisions for securities exchanges. *See* 15 U.S.C. § 78f(b)(1) & (5) (outlining provisions for exchanges).

48. 15 U.S.C. § 78s(g)(1), (h)(1).

49. FINRA RULE 3110(a) (2015).

50. *See* FINRA RULE 3110(a)–(e). The term used in the Rule is "principal," which is a registration category for managers and supervisors in broker-dealers. The sheer detail of the tasks of an intermediate supervisor can be seen in the outlines for the qualification examinations for licenses that are necessary for these positions. *See* FINRA, GENERAL SECURITIES PRINCIPAL QUALIFICATION EXAMINATION SALES SUPERVISOR MODULE (TEST SERIES 23) (2015), https://www.finra.org/sites/default/files/Series_23_Content_Outline.pdf.; FINRA, GENERAL SECURITIES PRINCIPAL QUALIFICATION EXAMINATION (TEST SERIES 24) (2015), https://www.finra.org/sites/default/files/Series_24_Content_Outline.pdf; FINRA, GENERAL SECURITIES SALES SUPERVISOR QUALIFICATION EXAMINATION (TEST SERIES 9 AND 10) (2015), https://www.finra.org/file/series-9-and-10-content-outline.

51. FINRA RULE 3120(a) (2015). Under the Rule, the responsible principal or principals (generally compliance officers) establish the controls, conduct the testing, create additional WSPs to respond to weaknesses revealed by the testing, and annually report to a broker-dealer's senior management about the above. FINRA RULE 3120(a)(2). This Rule essentially requires a broker-dealer to establish an internal control over the supervisory system. *See generally* Denise S. Saxon & Beth D. Kiesewetter, *Supervising the Supervisors: Internal Controls in the Brokerage Industry*, 3 J. INV. COMPLIANCE 5 (2003) (discussing regulatory focus on internal

formally establishes the compliance function that aids supervisors.[52] Under this Rule, a firm's chief executive officer (CEO) must certify annually that there are "in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with" SRO rules and federal securities laws and regulations and that the CEO has had "one or more meetings" with the CCO in the preceding 12 months to discuss the processes.[53] Rule 3130 underlines an issue to be discussed further below: the need for a broker-dealer to have a group of employees who can keep track of all of the legal and regulatory duties of the firm and its brokers, and who can thus help supervisors satisfy their supervisory duties, through guidance, monitoring. and follow-up.[54] As the NASD emphasized when the Rule was adopted, it does not relieve supervisors of their supervisory obligations.[55]

FINRA amended and replaced its former supervisory rules, NASD Rules 3010 and 3012, with FINRA Rules 3110 and 3120.[56] The new rules maintain the general content and overall orientation of the former NASD rules, while importing some content from the NYSE rules.[57] The FINRA rules also continue the traditional emphasis upon the mid-level supervisor. For example, FINRA Rule 3110 requires that a supervisor of the branch where important customer activities occur have a physical, onsite presence.[58] Yet, as will be discussed below, they also reflect today's realities of technology-enhanced supervision.[59]

C. A Look at the History of the Regulation of Intermediate Supervisors

When Congress passed the Exchange Act, there was no evident need for it to require broker-dealers to supervise their brokers and other staff; respondeat superior, as well as other agency doctrines discussed above, provided that duty. In its early years, the SEC relied upon these doctrines to pursue broker-dealers when securities law violations

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controls leading to the predecessor of this rule).

52. FINRA RULE 3130(a) (2015). With some exceptions, the broker-dealer's CCO must have the same qualification or licensing (i.e., General Securities Principal, Series 24) as a general supervisor. NASD RULE 1022(a).

53. FINRA RULE 3130(b). The Rule also provides a "model" certification for the CEO. FINRA RULE 3130(c).

54. *See* NASD, Annual Compliance Certification and Designation of Chief Compliance Officer, 2004 WL 2587763, at *1 (Nov. 1, 2004) ("NASD Rule 3013 is intended to bolster attention to members' compliance programs by requiring substantial and purposeful interaction between business and compliance officers throughout the firm."). *Infra* Section III.A.1.

55. *See* NASD, *supra* note 54, at *2 ("The NASD Board of Governors recognizes that supervisors with business line responsibility are accountable for the discharge of a member's compliance policies and written supervisory procedures.").

56. *See* FINRA, REGULATORY NOTICE 14-10, CONSOLIDATED SUPERVISION RULES (Mar. 2014) (discussing the new rules). These rules were years in the making. The new rules are also part of the ongoing consolidation of the NASD and NYSE rules into FINRA rules.

57. For example, new FINRA Rule 3120 incorporates from NYSE rules special reporting requirements for large broker-dealers on their compliance efforts in particular domains. *See* FINRA RULE 3120(b).

58. These offices are known as Offices of Supervisory Jurisdiction (OSJ). *See* FINRA RULE 3110(f)(1) (definition of OSJ). A physical presence makes it hard for a supervisor to be in charge of multiple offices, or to supervise remotely. *See* FINRA RULE 3110(b)(6), 3110.03 supp., 3110.13 supp. (describing the circumstances requiring the physical presence of an OSJ).

59. *Infra* Section III.A.2.

occurred in them. There are reasons other than the need to cover an area unaddressed by the law to explain the development of a statutory duty of supervision for broker-dealers, as well as for the supervisors themselves in these firms.

There was no initial reference to supervision or to a broker-dealer's duty of supervision in the Exchange Act, and certainly no provision dealing with this duty of broker-dealer supervisors. The original section 15 of the Exchange Act—that part of the Act dealing with broker-dealers—did not even provide for the federal registration of broker-dealers. The section only prohibited a broker-dealer from making a market in securities in the OTC market in contravention of the rules of the SEC, which was itself empowered to regulate broker-dealers and this market.[60] The 1936 amendments to the Act added the broker-dealer registration requirement.[61] The amendments also included a new section 15(b), which empowered the SEC to deny or to revoke the registration of a broker-dealer for, among other things, misconduct committed by itself or by parties "related" to it.[62] Therefore, by its terms section 15(b) made the broker-dealer directly liable (i.e., suffer revocation of its registration) for its own securities law violations, and vicariously liable for the violations by any related party.[63] The statute did not reach brokers who may have caused the revocation, for they, unlike the firm, were not registered with the SEC nor subject to its jurisdiction.[64] Thus, a duty of supervision indirectly arose under the statute because a broker-dealer would want to protect itself against incurring this drastic vicarious liability for the misconduct, including the prior misconduct, of its related persons.[65]

Moreover, at the time of passage of the Exchange Act, the rules of the predecessors

60. 15 U.S.C. § 78a (1934). *See* David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U. L. REV. 899, 902 (1987) (noting that the initial system of broker-dealer regulation allowed under section 15 was just a supplement to the regulation of broker-dealers through exchanges).

61. The requirement was in a new section 15(a), which replaced section 15 of the original Act. The Act of May 27, 1936, Pub. L. No. 621, 74th Cong. 2d Sess. 74 Stat. 1375 (1936). This Act ratified a registration process that the SEC had instituted for broker-dealers operating in the OTC market. H.R. REP. NO. 2601, 74th Cong. 2d Sess. 4 (May 8, 1936); S. REP. NO. 1739, 74th Cong. 2d Sess. 3 (Mar. 31, 1936). For all practicable purposes, most broker-dealers had some involvement in the OTC market, which triggered their registration pursuant to this new provision.

62. This was under a subsection (D), which punished a broker-dealer for its or its related person's willful violations of the Securities Act and Exchange Act and their respective rules. Pub. L. No. 621, 74 Stat. at 1378. This was the predecessor to current section 15(b)(4). 15 U.S.C. § 78*o*(b)(4) (2012).

63. This related party became the "associated person," a term added by the Securities Act Amendments of 1964. *See* Pub. L. No. 467, 78 Stat. 565 (1964) (adding section 3(a)(18) to the Exchange Act). This is roughly the same definition currently in effect. 15 U.S.C. § 78c(a)(18) (2012).

64. The SEC eventually found indirect ways of reaching "bad" brokers, despite its lack of jurisdiction over them. *See, e.g.*, Berko v. SEC, 316 F.2d 137 (2d Cir. 1963) (explaining the SEC's procedure of joining an offending broker in a proceeding to revoke a broker-dealer's registration and having findings made about the broker's conduct, which would prevent other broker-dealers from hiring that person); *In re* Sutro Bros. & Co., File No. 8-776, 41 S.E.C. 470 (1963) (declaring a broker's and his supervisor's conduct the "causes" of the suspension of their broker-dealer from NASD membership).

65. There is no evidence, however, that in the 1936 amendments Congress had in mind the imposition of any such duty on broker-dealers, for the legislative history suggests that it was specifically empowering the SEC better to regulate broker-dealers involved in the OTC market and that market itself. H.R. REP. NO. 2601, *supra* note 61, at 4; *Hearing Before House Committee on Interstate and Foreign Commerce on S. 4023: Unlisted Securities*, 74th Cong. 10 (May 6, 1936) (statement of SEC Chairman James Landis) (discussing the large number of broker-dealers in that market).

to the SROs required their member firms to supervise their brokerage staff (but made little mention of a supervisor's supervisory duty), which may also explain why Congress saw no need to address the firm's duty in the Exchange Act or in the early amendments to it. The NYSE imposed a duty of supervision on a firm with respect to any branch offices that it established.[66] With respect to the OTC market, the Code of the Investment Bankers Conference, promulgated in 1934, imposed a duty of supervision of its sales force on a firm, which required it to review sales methods, correspondence, and transactions and to look into the background of, and hire, qualified brokers.[67] This Code was the predecessor to the NASD Rules of Fair Practice, which came into force when the NASD registered as the first (and so far only) national securities association in 1939.[68] And, in the original Exchange Act and its early amendments, Congress ensured, albeit indirectly, that the securities exchanges and associations would maintain these supervisory rules and require their member firms to ensure that their brokers and other securities staff complied with the federal securities laws and regulations.[69]

While the above discussion explains the lack of a statutory supervisory duty for the broker-dealer, it does not account for the absence of any such duty for supervisors within the broker-dealer. The answer is that the supervisors already *had* this duty, whether under agency doctrines or implicitly under the Exchange Act provisions discussed above, since they *were* the broker-dealer. That is, at the time of passage of the Act and for several decades thereafter, broker-dealers were primarily in partnership form, which meant that, as every student of business organizations knows, the partners were the owners and operators of the firm.[70] During this period, broker-dealers were small to mid-sized firms that concentrated in certain activities and operated in a main office with, at most, a few nearby branches. The partners, who were few in number, were entirely capable of directing the work and supervising the brokers and other employees, who were also not numerous.

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66. *See* Art. XXXV, Section 6, NEW YORK STOCK EXCHANGE CONSTITUTION, *reprinted in* SAMUEL P. GOLDMAN, STOCK EXCHANGE LAWS 172 (1914).

67. This Code was produced in 1934 by a committee of the Investment Bankers Association, an industry group that the federal National Recovery Administration had empowered to regulate securities firms. The Code lost the force of law and became voluntary once the Supreme Court struck down the National Industrial Recovery Act. For a discussion of the history of the Code and its relationship to the NASD, see generally WALLACE H. FULTON, NASD, THE OVER-THE-COUNTER MARKET AND NASD (1947). *See also* Thomas K. McCraw, *With Consent of the Governed: SEC's Formative Years*, 1 J. POL'Y ANALYSIS & MGMT. 346, 357 (1982) (discussing how the SEC supported this Code by advocating legislation to recognize securities associations). The Code did provide for supervision by an intermediate supervisor by stating that "any sale made by any such salesman to any investor, other than another investment banker, shall be approved by a partner, duly accredited executive, or branch office manager of such investment banker." INVESTMENT BANKERS CODE COMMITTEE, CODE OF FAIR COMPETITION FOR INVESTMENT BANKERS, Art. VII, Sec. 1, 23 (Apr. 19, 1934).

68. Nat'l Ass'n of Sec. Dealers, Inc., Exchange Act Release No. 342211, 1939 WL 36389 (Aug. 7, 1939).

69. This conclusion is reflected in the legislative history of the Maloney Act. *Supra* note 45. *See, e.g.*, *Regulation of Over-the-Counter Markets, Hearings before the S. Comm. on Banking & Currency*, 75th Cong. 17 (1938) (wherein SEC Chair Matthews stated that "[t]here are likewise in existence in the country a number of other associations of brokers and dealers which have for some time exercised a degree of supervision over the conduct of their members") (referring to such organizations as the New York Security Dealers Association, the Investment Bankers Conference, and the Investment Bankers Association). The predecessors to the provisions discussed under Section II.B, which required SROs to police their members, had this effect.

70. When broker-dealers were incorporated, they were for all practical purposes functioning as partnerships since the corporations were closely held and the officers and directors were generally their shareholders.

Existing law thus imposed a supervisory duty on broker-dealer supervisors.

However, as early as the 1940s, the SEC began to encounter misconduct in large broker-dealers, some in corporate form, where a firm's owners and senior executives contended that neither they nor the firm should be responsible for a "bad" broker or brokers who were operating in a distant branch so far removed from them in the chain of command. In these situations, there often figured a supervisory employee who was neither a partner nor an equity owner of the firm and who had not prevented or stopped the securities law violation. In its administrative decisions, the SEC suggested that, regardless of the firm's size, the firm and its owners had a supervisory duty because of the Exchange Act's goal of investor protection. In an early case involving an incorporated broker-dealer, the SEC stated that section 15 imposed a supervisory responsibility upon the firm's officers and directors, who could not use their own lack of oversight of each broker in a large organization to justify the firm's freedom from liability.[71] Another early case highlighting supervision problems in a large incorporated firm involved E.H. Rollins & Sons, Inc., which had five principal offices, including its main office in New York, and 24 suboffices.[72] In the St. Louis suboffice, a broker, who was also its manager, engaged in fraudulent conduct involving excessive mark-ups and churning.[73] The SEC faulted the firm, as well as individual mid-level executives—particularly those in the Chicago principal office that was responsible for oversight of the St. Louis suboffice—for not having stopped the misconduct, despite having received warnings of it.[74] As the SEC

71. *See In re* Bond & Goodwin, Inc., Exchange Act Release No. 343543, 1944 WL 26022 (March 17, 1944) ("Where a broker-dealer firm has a substantial number of employees, where considerable authority is delegated and where subordinates have power to exercise wide discretion, the protection of investors can obviously not be achieved if the firm is permitted to shield itself from the consequences of a subordinate's undetected violations by pleading the very conditions which made the violations possible. It cannot, therefore, be allowed to point to the officers' ignorance of the actual violations to insulate itself from the consequences of such actions."). Here, a broker had been engaged by a customer to purchase bonds at specific prices with a set commission, but, unbeknownst to the customer, the broker often had his firm purchase the bonds at a lower price and resell them to the customer at an undisclosed mark-up.

72. *In re* E.H. Rollins & Sons, Inc., Exchange Act Release No. 342272, 1945 WL 73020 (Feb. 22, 1945).

73. A mark-up is the profit that a broker-dealer charges for selling a security in its inventory to a customer, whereas churning is engaging in unnecessary purchases and sales of securities in a customer account in order to generate commissions for the broker.

74. It also dismissed the broker-dealer's contention that officers of a large broker-dealer had little responsibility for conduct in branches and suboffices. *See In re* E.H. Rollins & Sons, Inc., Exchange Act Release No. 342272, 1945 WL 73020 (Feb. 22, 1945) ("It is, of course, inherent in the very nature of a large organization that the bulk of transactions are handled by subordinates, that principal officers do not as a matter of course concern themselves with details, and that many officers and employees are ignorant of what other members of the organization may do. These facts make it especially imperative that the internal control of such an organization be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication of possible irregularity reaches their attention. Where a large organization neglects such safeguards, responsibility for the consequences of remedial action on officers and employees who are innocent of wrongdoing rests directly upon it. It can hardly argue that such consequences are grounds for our refraining from taking action. Nor do the wide independence and discretion granted to the branch offices relieve Rollins as a whole of responsibility for violations."). *See generally* Kidder Peabody & Co., Exchange Act Release No. 3673, 1945 SEC LEXIS 285 (April 2, 1945) (involving the manipulation of a bond price on an exchange by a broker-dealer's traders shortly before they engaged in a large secondary distribution of the bonds; the SEC determined that the broker-dealer's supervision of the trading department was deficient, and that it was no excuse that many of its partners were sick or on vacation or drawn into the war efforts (the misconduct occurred during 1942) and that

explained in another case on a firm's duty of supervision, broker-dealers had to implement supervisory systems with intermediate supervisors, such as branch managers, to be responsible for the growing numbers of brokers, who were themselves often new to the securities industry.[75] This supervisory system requirement was due to broker-dealers becoming larger with more branches as a result of increasing customer participation in the securities markets. By its enforcement actions and administrative decisions, the SEC thus sent a message to the large broker-dealers that intermediate supervisors were critical in preventing serious securities law violations and supervisory liability for the firm.[76]

As these cases demonstrate, the SEC became aware of the critical importance of the intermediate supervisor in the large, multi-branch, often national broker-dealers that were replacing the small partnership firms in the post-World War II years. Yet it had no direct way of disciplining these supervisors (nor any other brokerage employee), nor of imposing the standards of conduct that they should follow in their supervisory activities.[77] In its

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supervision had thus fallen to non-partner supervisors).

75. *See, e.g.*, *In re* Reynolds & Co., Exchange Act Release No. 346273, 1960 WL 56264, at *10 (May 25, 1960) ("The circumstances of this case illustrate vividly the necessity for this rule and call for further consideration of its implications particularly under present conditions of active markets, increased interest in securities by inexperienced customers, and the rapid growth and broadened operations of certain large securities firms of which registrant is one. The existence of numerous and scattered branch offices complicates the problem of supervision and makes essential the installation of an adequate system of control. The growth of securities firms also tends to increase the number of inexperienced personnel who require especially careful supervision, particularly where many firms are growing at the same time and thereby creating a shortage of experienced people. Supervisory personnel cannot rely solely upon complaints from customers to bring misconduct of employees to their attention, particularly where customers may be inexperienced and may fail to realize that they have been mistreated, or where rising markets tend to obscure the effect of such mistreatment. All of these conditions increase the importance of maintaining and enforcing adequate standards of supervision. The duty of supervision cannot be avoided by pointing to the difficulties involved where facilities are expanding or by placing the blame upon inexperienced personnel or by citing the pressures inherent in competition for new business. These factors only increase the necessity for vigorous effort."). Reynolds was typical of a large broker-dealer at the time: a partnership, with 36 partners and 1232 employees operating in a main New York office and 38 branch offices. The problems in this case revealed a lack of supervision by the branch managers and other intermediate supervisors. In the SEC's view, if there was an underlying violation by a related person (typically an employee) and if it appeared that the broker-dealer had failed to supervise the violator, including through intermediate supervisors, that firm was considered to have participated in the underlying misconduct and was therefore vicariously liable (and faced the risk of losing its registration and thus its access to securities markets). *Id. See generally* Task Force on Broker-Dealer Supervision and Compliance, *supra* note 25, at 1363–64 (discussing the SEC's initial legal theories for imposing supervisory liability upon broker-dealers); *see also* SEC v. Torr, 22 F. Supp. 602, 607 (S.D.N.Y. 1938) (discussing early use of respondeat superior in a case involving a broker-dealer's employment of independent contractors).

76. *See* R.H. Johnson & Co., Exchange Act Release No. 345255, 1955 WL 43200, at *15 (Nov. 16, 1955) (revoking registration of a broker-dealer (a partnership with a main office in New York, branches in Boston and Philadelphia and 12 sales offices and over 100 brokers) for failing to supervise brokers who had, among other things, churned customer accounts), *aff'd*, 231 F.2d 523 (D.C. Cir. 1956), *cert. denied*, 352 U.S. 844 (1956); Merrill, Lynch, Pierce, Fenner & Beane, Exchange Act Release No. 344451, 1950 WL 40293, at *5 (June 7, 1950) (finding that Merrill was not the supervisor of an independent broker with whom it had a correspondent relationship and carried both customer accounts and segregated accounts and who defrauded customers).

77. As noted above, *supra* note 64, the SEC found ways around this limitation in its actions against broker-dealers. Moreover, under the then-existing rule in section 15A(b)(4), a broker-dealer could not remain in the NASD if, among other reasons, one of its related persons had been "found" to be or to have been the cause of another broker-dealer's loss of registration or expulsion from the NASD, which provision kept a broker-dealer

landmark special study of the securities markets undertaken at the beginning of the 1960s, the SEC reviewed the state of, and practices in, the securities industry, including supervision.[78] It particularly emphasized the critical role of the intermediate supervisor, such as a branch manager, in the large broker-dealers.[79] Among other things, the SEC recommended that it be given "more flexible" powers to deal with supervisory and other violations and specifically that it receive the power itself to discipline directly individuals working in broker-dealers, including the intermediate supervisor.[80] Congress responded to the SEC's recommendation in the Securities Act Amendments of 1964.[81]

Among other things, these amendments added a provision that was the predecessor to the present section 15(b)(4)(E), which imposes liability upon a broker-dealer for its, or an associated person's, failure to supervise[82] and provides defenses outlining how a firm might satisfy the duty of supervision.[83] Not surprisingly, the legislative history on this addition suggests that it was just codifying a longstanding SEC position based upon the common law of agency.[84] This history reveals that the real focus of the additions to the Exchange Act addressing supervision was Congress's grant to the SEC of the power to

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from hiring a "bad apple." Indeed, identifying a particular person as a cause of the NASD action against a broker-dealer became easier after 1945, because the NASD in that year changed its rules to require employees and related persons of NASD member firms also to register with the NASD and to abide by its rules. *See* Nat'l Ass'n of Sec. Dealers, Inc., Exchange Act Release No. 3734, 1945 SEC LEXIS 325 (Sept. 3, 1945) (noting the rule change). The justification for this rule change was in part to allow the NASD directly to reach the person who was the violator. *See id.* (also listing supervision as one of the tasks triggering the registration of the associated person: "Briefly, the amendments require that no member shall permit any person to manage, *supervise*, solicit or handle securities business, trade in or sell securities or solicit investment advisory or investment management business unless that person is registered with NASD.") (emphasis added).

78. *See, e.g.*, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, 88th Congress, H.R. DOC. NO. 95, PT. 1, 290 (1963) (describing internal, centralized controls) [hereinafter SEC SPECIAL STUDY, PT. 1] ("First, each salesman is covered by the supervisory activities and policies of his own employer, who, if only because of his legal duty to adequately supervise his sales force, has an interest in ensuring that the salesman does not stray beyond the bounds of propriety."). In this passage, the SEC goes on to cite the *Reynolds* case discussed above.

79. *See* SEC SPECIAL STUDY, PT. 1, *supra* note 78, at 291–94, 325 (referring to branch managers, regional managers, and national managers).

80. *Id.* at 330.

81. Pub. L. 88-467, 78 Stat. 565, 571–72 (1964).

82. 78 Stat. at 571 (15 U.S.C. § 78*o*(b)(5)(E) (1964)) (codified at 15 U.S.C. § 78*o*(b)(4)(E)).

83. 78 Stat. at 572 (15 U.S.C. § 78*o* (b)(5)(E)(i)–(ii)) (codified at 15 U.S.C. § 78*o*(b)(4)(E)(i)–(ii)). That the SEC should specify specific supervisory procedures for broker-dealers met industry resistance and was not implemented in the legislation. *Hearings Before the Subcomm. of the H. Comm. on Interstate & Foreign Commerce, Pt. 2*, 88 Cong. 694 (1964) [hereinafter *House Hearings, Pt. 2*] (statement of the Investment Bankers Association of America).

84. *See Hearings Before the Subcomm. of the H. Comm. on Interstate & Foreign Commerce, Pt. 1*, 88 Cong. (1964) [hereinafter *House Hearings, Pt. 1*] (statement of SEC Chair Cary) ("The proposed amendment will make this important supervisory responsibility explicit on the face of the statute *and set express guidelines for its fulfillment.*") (emphasis added). In its report on the legislation, the Senate refers to "a slight broadening of the category of crimes, injunctions, acts, and omissions that afford a basis for [SEC] disciplinary proceedings" and does not discuss specifically the failure to supervise. *See* REP. OF THE SEN. COMM. ON BANKING AND CURRENCY TO ACCOMPANY S. 1642, REP. NO. 379, 88th Cong. 1st Sess. 41 (July 24, 1963) [hereinafter SEN. COMM. REP. NO. 379]. The House Report is no more enlightening on this subject. *See* H.R. REP. NO. 1418, 88th Cong. 2d Sess. 21 (May 19, 1964) (discussing the 1964 Amendments).

discipline directly the new intermediate supervisors for their failure to supervise.[85] In fact, echoing the SEC, Congress underlined how critical this supervisor was when the securities industry and markets were becoming more complex, when firms were becoming larger, and when new retail investors were entering securities markets.[86] The amendments thus added the predecessor to section 15(b)(6), which, among other things and as noted above, imposes liability on associated persons for their failure to supervise another person under their supervision.[87] Although the 1964 Amendments did not define "supervision" or "supervisor," or what it means to have a person "subject" to one's "supervision" (nor did any future amendment to the Exchange Act), from the legislative history it appears that Congress had branch managers and the other intermediate supervisors in mind with this statutory change.[88]

Other additions to the Exchange Act made by the 1964 Amendments showed Congress's intent to improve the performance of the supervisors who now fell under the SEC's jurisdiction. A new section 15A(b)(5) required a national securities association (i.e., the NASD) to set standards, qualifications, and classifications for membership and for a person's association with membership, including application procedures, examinations, and training.[89] This provision was designed to raise the competence of individuals working in the securities industry.[90] Importantly, it required key employees, including supervisory

85. *See* SEN. COMM. REP. NO. 379, *supra* note 84, at 76 ("The primary purpose of inserting failure to supervise as an independent ground of disciplinary action would be to enable the Commission to reach more directly supervisory personnel who fail to discharge their responsibilities."); *see also House Hearings, Pt. 1*, *supra* note 84, at 158 ("Section 6(b) of the bill gives proper supervision more emphasis on the face of the statute, for that section of the bill would expressly provide that a supervisor failing properly to supervise a person who is under his supervision and who commits a disqualifying act may be barred from registration as a broker-dealer or from being a person associated with a broker-dealer, if the Commission finds it in the public interest to do so.") (submission of the SEC). *See* Richard M. Phillips & Morgan Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706, 807–08 (discussing this amendment).

86. In debates on the legislation, Senator Williams of New Jersey observed that "[t]his bill would require a broker-dealer to supervise its employees much more closely than it has in the past. A large firm would be required to check the activities of its branch offices, or suffer censure by the association." 110 CONG. REC. 18,386 (Aug. 6, 1964).

87. *See* 78 Stat. at 572 (adding 15 U.S.C. § 78*o*(b)(7)) (codified at 15 U.S.C. § 78*o*(b)(6)). This provision empowered the SEC to pursue directly individual broker-dealer employees for their violations and failures (including the failure to supervise). *See* SEN. COMM. REP. NO. 379, *supra* note 84, at 41 ("The Commission would be empowered, in disciplinary proceedings, to proceed directly against an individual associated with a broker or dealer in lieu of proceeding against the entire firm, and the authority of a national securities association to do the same would be clarified."). *See generally* Phillips & Shipman, *supra* note 85, at 813–14 (describing the background to the provisions). As the above quotation suggests, the NASD's power to pursue individuals was clarified, and the SEC also received the power to suspend or bar individuals from associating with NASD members.

88. *See House Hearings, Pt. 1*, *supra* note 84, at 129 (statement of SEC Chair Cary referring to broker-dealer principals).

89. *See* 78 Stat. at 575–76 (15 U.S.C. § 78*o*-3(b)(5)) (current version codified at 15 U.S.C. § 78*o*-3(g)(3)).

90. *See* SEN. COMM. REP. NO. 379, *supra* note 84, at 81 ("While the National Association of Securities Dealers, acting under section 15A(b)(3) and other provisions of the act, has adopted certain rules requiring examinations by new salesmen, and specifying other standards, these controls have not been comprehensive. Section 15A(b)(5) is designed to carry out one of the most important recommendations of the Special Study."); *see also* 78 Stat. at 572–73 (adding a new 15 U.S.C. § 78*o*(b)(8), which required the SEC to do the same for broker-dealers that were not members of an SRO, and their associated persons). All broker-dealers today must be

employees, to have experience, training, and testing to qualify for their position.[91] Traditionally, there had been no qualifications for supervisors, particularly as to their knowledge of laws, regulations, and SRO rules, other than the one criterion that broker-dealers had generally used for their hiring or promotion—that the supervisor be an accomplished salesman and producer.[92] While the NASD and other SROs had begun to impose enhanced requirements for supervisory employees in the years before the 1964 Amendments,[93] at the SEC's direction, Congress intended to require the SROs to make them more rigorous.[94]

SRO members.

91. *See* 78 Stat. at 576 (adding 15 U.S.C. § 78*o*-3(b)(5)(D), providing that SRO rules must "(D) provide that persons in any such class other than prospective members and partners, officers and supervisory employees (which latter term may be defined by such rules and as so defined shall include branch managers of members) of members, may be qualified solely on the basis of compliance with specified standards of training and such other qualifications as the association finds appropriate.") (current version codified at 15 U.S.C. § 78*o*-3(g)(3)). *See House Hearings, Pt. 1*, *supra* note 84, at 226 ("Thus, it is contemplated that members, officers, partners, and other supervisory employees might be required to meet standards of experience as well as training.") (Technical Statement of the SEC).

92. SEC SPECIAL STUDY, PT. 1, *supra* note 78, at 133–38 (describing the history and background of supervisors); *id.* at 157–58 ("At the heart of the problem of supervisors' qualifications lies the industry's reluctance to recognize that persons in this capacity serve functions distinct and different from the roles played by those whom they supervise . . . . Separate qualification standards and separate licensing of supervisors on an industrywide basis is of first importance in raising industry standards generally."). As the SEC noted in its recommendation No. 8:

> Quite apart from knowledge as tested through examination procedures, appropriate experience in the securities business should be a requirement for individuals in certain crucial roles. The individuals for whom there should be an experience requirement include at least one principal in each registered firm and, if other than such principal, the individual designated as being in charge of regulatory and self-regulatory matters, the supervisor of selling activities, the supervisor or manager of each branch office, and the supervisor of research activities.

Id. at 161 (bold omitted).

93. *See House Hearings, Pt. 1*, *supra* note 84, at 147 ("The association has also recently adopted a written examination for member firm principals and officers who are new to the securities business. The examination is 4 hours' long and covers the Commission's recordkeeping, net capital, and hypothecation rules as well as its statement of policy on investment company matters. The association's rules on supervision of salesmen and its uniform practice code are also covered.") (from SEC submission by Chairman Cary entitled "Current Industry Developments"). For a description of the background to the NASD's, NYSE's, and other SROs' qualifications for supervisors, which had been developed or enhanced only in the 1960s, see SEC SPECIAL STUDY, PT. 1, *supra* note 78, at 139–41.

94. Like the 1964 Amendments, the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (June 4, 1975), also tried to enhance the performance of intermediate supervisors by amending section 15 to require the SEC specifically to promulgate tests for managerial employees, which included, as one of the subjects of the tests, supervision. This amendment provided that the SEC should:

> (B) require persons in any such class to pass tests prescribed in accordance with such rules and regulations, which tests shall, with respect to any class of partners, officers, or supervisory employees (which latter term may be defined by the Commission's rules and regulations and as so defined shall include branch managers of brokers or dealers) engaged in the management of the broker or dealer, include questions relating to bookkeeping, accounting, internal control over cash and securities, supervision of employees, maintenance of records, and other appropriate matters.

89 Stat. at 124 (new Section 15(b)(7)(B)). Formerly the statute had provided only that the SEC should "require

As a result of the above statutory changes, the SRO requirements for supervisory systems became extremely detailed, particularly with respect to setting forth the role and duties of the intermediate supervisor. Prior to 1989 section 27 of article III of the NASD's Rules of Fair Practice was the only supervisory rule for that SRO, and it covered the entire supervisory spectrum in five subsections.[95] A major revision of this section, which took effect in 1989, considerably expanded the supervisory requirements of an NASD member firm and resulted in a rule similar to the detailed one that is in force today.[96] In particular, the revision required a member firm to ensure that it had adequate numbers of intermediate supervisors and that they all had specified tasks.[97] Significantly, NASD Rule 3012, which came into effect in 2004 and greatly expanded the provision in section 27 that required the firm to review and supplement its supervisory system, was inspired by a notable failure of supervision of a mid-level supervisor who, working in numerous broker-dealers, had misappropriated over $100 million in customer money for over 15 years.[98] Thus, it included control policies that, among other things, mandated independent supervision of the customer account activity of supervisors and imposed special supervision for high producing managers.[99] In other words, in 2004 the NASD focused on the same issue—the

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persons in any such class [of brokers] to pass examinations prescribed in accordance with such rules and regulations." 78 Stat. at 573 (former section 15(b)(8)(C)). The 1975 Amendments were primarily designed to establish a national market system for the trading of securities, in response to the fragmentation of securities markets, and the necessary infrastructure for clearing and settling modern securities trading, in response to breakdowns in that infrastructure, particularly the paperwork crisis of 1967. Congress understood that one of the reasons for the failure of broker-dealers in the crisis was the low competency of broker-dealer supervisors and thus that the standards of qualification and testing of them by SROs had not succeeded. As the House said in its report, the provision was needed since "[i]t also became clear that these examinations did not cover certain topics which were vital to sound management of a brokerage firm." SECURITIES REFORM ACT OF 1975, H.R. REPORT NO. 94-123, 94th Cong., 1st Sess. 76 (Apr. 7, 1975). *See generally* SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. Doc. No. 92-231, 92d Cong., 2d Sess. 5–7, 18 (Dec. 1971) (discussing lack of trained supervisors and continued emphasis in broker-dealers upon sales and expansion of branch offices without adequate supervision).

95. *See* RALPH C. FERRARA ET AL., STOCKBROKER SUPERVISION: MANAGING STOCKBROKERS AND SURVIVING SANCTIONS 74–75 (1989) (reprinting supervisory rule prior to amendment discussed below). Under the rule a member had to have written supervisory procedures, to designate supervisory persons in the main office and OSJs, to review transactions and correspondence and preserve records of the same, to review and inspect offices, and to investigate, and to ensure the qualification of, personnel.

96. *See* NASD, NOTICE TO MEMBERS NO. 88-84, at 2–3 (1988) ("In recent years, the NASD has become increasingly concerned that many persons associated with NASD members are engaging in the offer and sale of securities to the public without adequate ongoing supervision . . . . The amendments substantially expand the specificity of article III, section 27 of the NASD Rules of Fair Practice with respect to a member's supervisory obligations."). In 1989, the section was considerably expanded. *See generally* Task Force on Broker-Dealer Supervision and Compliance, *supra* note 25, at 1389–94 (providing a summary of these rules).

97. For a discussion of these changes, see FERRARA ET AL., *supra* note 95, at 68–70, 83–88 (describing how a broker-dealer had to designate a supervisor for each associated person, have a plan of supervision setting out the identity, location, and responsibilities of the supervisors, have one or more principals who would review the supervisory system and propose necessary changes to it, and designate certain offices as OSJs if certain activities occurred there (thereby removing a broker-dealer's discretion as to this), with an OSJ having to have a registered principal in charge of its supervision).

98. *See* Ass'n. of Sec. Dealers, Inc., 83 SEC Docket 192, 192 (2004) (recounting the case of Gruttadauria, the rogue supervisor/broker).

99. *See generally* NASD NOTICE TO MEMBERS NO. 04-71 (2004) (discussing these provisions).

quality of intermediate supervisors—that Congress had tried to address in both 1964 and 1975.

The SEC continued to be concerned about the quality of supervision in firms and the qualifications and performance of the intermediate supervisors, especially as the securities markets, and retail investor participation in them, grew through the end of the last century.[100] It addressed this concern with rule enforcement, targeting branch managers and other intermediate supervisors who had failed adequately to supervise their brokers and staff.[101] In addition, the NASD expanded its own enforcement of the duty to supervise, particularly after it enhanced its supervisory rule in 1989, focusing on the typical supervisory failures involving intermediate supervisors who failed to monitor the sales practices of brokers in branch offices.[102]

The SEC, SROs, and eventually Congress all recognized that there was a new kind of national brokerage firm with numerous branch offices. These firms, which became prevalent in the industry in the middle of the twentieth century, posed novel problems for ensuring compliance with the securities laws, at a time when securities markets were growing as many retail investors were entering them for the first time. The regulators saw the intermediate supervisor as an important solution to these problems. As typified by a branch manager who was an employee, not an owner, of the firm, they fulfilled an important managerial role in these expanding businesses. Initially under the law, the SEC and the SROs could not directly regulate these supervisors, as they could the traditional owners/operators of the small brokerage firms that had formerly dominated the market, and could not use them for their regulatory purposes. Accordingly, legislation and SRO rulemaking during this period were designed to enable the SEC and the SROs to impose a duty of supervision on these supervisors and to raise their qualifications, competence, and professionalism. The "professional" branch or division manager thus became the regulatory capstone in helping broker-dealers fulfill the primary goal of the federal securities laws: investor protection. By the end of the twentieth century, both broker-

100. The issue of supervision of large broker-dealers was highlighted in a broker-dealer compliance guide done in 1974 by an industry group at the direction of the SEC. SEC, GUIDE TO BROKER-DEALER COMPLIANCE, REPORT OF THE BROKER-DEALER MODEL COMPLIANCE PROGRAM ADVISORY COMMITTEE TO THE SECURITIES AND EXCHANGE COMMISSION 6–7 (1974).

101. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Broker-Dealer Supervision: A Troublesome Area*, 25 SETON HALL L. REV. 527 (1994) (reviewing broker-dealer supervision cases prior to the time of its writing); *see also* POSER & FANTO, *supra* note 39, §§ 9.02, 9-30–9-52.3 (reviewing broker-dealer supervision cases). SEC jurisprudence also addressed the issue of who was a supervisor. The SEC traditionally interpreted supervisor to mean someone in the broker-dealer's chain of command who had the power to hire, fire, and to control the actions of a subordinate. Arthur James Huff, Exchange Act Release No. 29017, 1991 SEC LEXIS 551, at *18 (Mar. 28, 1991). At other times, it offered a broader definition of supervisor to include one who has the ability "to affect the conduct" of the supervised person. John H. Gutfreund, Exchange Act Release No. 34-31554, 1992 SEC LEXIS 2939, at *49 (Dec. 3, 1992). For a comprehensive discussion of rulings on this subject, see POSER & FANTO, *supra* note 39, §§ 9.03, 9-52.3–9-76. Recently, the SEC appeared to back away from this expansive definition by suggesting that being a supervisor involves the power to hire, fire and punish, to reassign, and to affect very strongly the working conditions of an individual. *See Frequently Asked Questions on Compliance and Legal Personnel*, U.S. SEC. & EXCHANGE COMM'N (Sept. 30, 2013), www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm. In any event, an intermediate supervisor, such as the branch manager, is the paradigm of a supervisor.

102. *See* FERRARA ET AL., *supra* note 95, at 76–82 (collecting cases on broker-dealer supervision).

dealers and regulators viewed the intermediate supervisor as indispensable.

III. LIMITATIONS OF THE INTERMEDIATE SUPERVISOR AND REGULATORY RESPONSES

A. Regulatory Responses to the Limitations of the Intermediate Supervisor

While the SEC and the SROs were espousing the importance of intermediate supervisors in ensuring compliance by broker-dealers in the changing investment landscape, they were concerned about these supervisors' limitations. These limitations involved the backgrounds of branch managers and division chiefs and the effect of the industry pressures upon them. Regulators saw that broker-dealers typically selected successful brokers as branch managers because they reasoned that a branch manager should be someone who had succeeded in the brokerage business.[103] Of concern for regulators, not only would these producing managers be busy with their own clients, but they would also be strongly affected by the brokerage industry's compensation structure, where managers typically share in brokers' commissions.[104] As discussed earlier, regulators wanted the managers to ensure that their brokers complied with law, regulations, and professional standards, which task would be at times at odds with profit-making. Accordingly, the SEC and the SROs tried to transform the position, and to raise the qualifications of the intermediate supervisors to make them professionals managers.[105] Despite their efforts, they believed that the intermediate supervisors would not be up to the challenge of ensuring compliance by those they supervised, even with the threat of liability, unless the supervisors received assistance within the firm. The SEC and the SROs thus devised responses to these limitations with help from compliance and technology.

Before turning to these responses, it is worthwhile briefly to examine the regulators' intuitions about the intermediate supervisor's limitations. The regulators were astute in identifying the kinds of assistance that a supervisor might well need. However, their stated concern about supervisor limitations does not entirely capture their intuitions. Psychological and organizational literature presents a more complete account of the limitations, which account will also lead to a better understanding of the responses.

This account first requires a thought experiment about why an intermediate supervisor would fail to detect a supervised employee's securities law violation, or to address it, once it was revealed. A rational supervisor might weigh the costs and benefits in deciding whether or not to perform a supervisory task. For example, imagine that a branch manager reviews a monthly exception report that highlights active trading in an account of a retiree

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103. *See, e.g.*, NEW YORK STOCK EXCHANGE, PATTERNS OF SUPERVISION: A GUIDE TO THE SUPERVISION AND MANAGEMENT OF REGISTERED REPRESENTATIVES AND CUSTOMER ACCOUNTS 34 (1982) ("In fact, it is a misconception in many sales-oriented industries that a large producer automatically will be a successful manager.").

104. *See id.* (discussing compensation of managers). Branch managers generally receive a portion of the commissions of their sales force brokers.

105. *See supra* Section II.C (detailing the history of broker-dealer supervision). By 1974 a committee of industry representatives, on behalf of the SEC, could set down in detail the typical responsibilities of the mid-level supervisor. *See* GUIDE TO BROKER-DEALER COMPLIANCE, *supra* note 100, at 49–71 (discussing these responsibilities), and at 72–86 (discussing recommendations for training and oversight of the intermediate supervisor).

with a conservative investment strategy.[106] The manager would identify the benefits, including the commissions from the trading in the account that come to the firm and the supervisor himself, as well as the promise of future discounted benefits. By contrast, the identified costs would include the effort that the supervisor expends checking on this trading (e.g., discussing it with the broker and the client), the possibility of alienating the broker in charge of the account by questioning him or her about it, the loss of a client, and the potential liability and FINRA discipline if the trading is improper. When expressing their concern about a supervisor's limitations, regulators were suggesting that a supervisor would engage in this calculus, but would find the benefit of profits to be greater than the potential costs.

Supervisors undoubtedly make the kind of calculations described above within the limits of the information available to them.[107] Yet this perspective does not fully capture the limitations of intermediate supervisors. Other approaches give a more complete view of these limitations. As psychologists point out, because rational thinking takes energy, a supervisor's ability decreases when the supervisor is cognitively overloaded.[108] When rational decision-making functions poorly or breaks down—a common occurrence—an "automatic" decision framework supplants it. This account of decision-making reflects the reality of an intermediate supervisor in a broker-dealer. Pursuing profits for the firm and themselves and conducting legal supervision all create a cognitive demand.[109] A supervisor's rational decision-making will falter on a daily basis, particularly in busy moments, and be stronger at some times rather than others.[110] When supervisors lack cognitive ability to do their jobs *and* to ensure proper compliance with the laws, regulations and professional standards, they will likely sacrifice compliance, because automatic decision-making favors the "want" self, i.e., immediate profit for the supervisor.[111] This account provides a more realistic justification for regulators' concerns about the limitations of the intermediate supervisor, than does the discounted cost/benefit perspective.

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106. An exception report shows activity outside the parameters or expectations of a given account. It lists all "problem" accounts under a manager's supervision. *See, e.g.*, David Tilkin, *The Landscape of Broker-Dealer Compliance and Exception Reporting Systems*, 17 PIABA B.J. 65 (2010) (discussing the exception report in the context of automated surveillance systems).

107. A "calculative mindset" can also lead individuals to focus on their self-interest at the expense of a consideration of the effects of their conduct on others and on its ethics. *See* Long Wang & J. Keith Murnighan, *On Greed*, 5 ACAD. MGMT. ANNALS 279, 295, 301 (2011) (identifying greed's effect on cognitive decisions); *see also* Long Wang et al., *The Ethical and Social Consequences of a Calculative Mindset*, 125 ORG'L BEHAV. & HUM. DECISION PROCESSES 39, 43 (2014) (reciting results of experiments showing that triggering a calculative mindset produces more self-interested conduct at the expense of social and ethical values).

108. *See generally* DAN ARIELY, THE (HONEST) TRUTH ABOUT DISHONESTY 101 (2012) (discussing cognitive depletion).

109. *See id.* at 113 (discussing how making constant complex decisions weakens one's willpower).

110. *See id.* at 115 (recommending that harder decisions or tasks be made or done in the morning before cognitive depletion occurs).

111. Psychologists explain that, if the rational, reflective self (often referred to as "system 2") is not triggered, the automatic or instinctual self (referred to as "system 1"), which is oriented to self-interest, takes over. *See generally* DANIEL KAHNEMAN, THINKING, FAST AND SLOW 20–29 (2011) (discussing the two selves in general); JONATHAN HAIDT, THE RIGHTEOUS MIND: WHY GOOD PEOPLE ARE DIVIDED BY POLITICS AND RELIGION 54–55 (2012) (discussing the metaphor of the automatic, emotional "elephant," which is oriented towards the self, and the rational, but secondary, "rider").

Social psychologists also identify how a supervisor's decision-making could allow noncompliance to exist and continue. Under one social psychological approach, individuals adopt multiple identities, according to the social groups and subgroups to which they belong.[112] These identities powerfully influence their decision-making. Acting within a particular group identity formed in a branch, a supervisor could view the primary goal as the welfare of brokers, rather than of customers. Thus, the supervisor might be inclined to ignore compliance deficiencies. For example, he or she may accept a broker's questionable explanation regarding improbable transactions.[113] Of course, a given social identity does not always override individual decision-making, but it always influences it. Consequently, an account of the limitations of the intermediate supervisor must take into consideration the social context.

Organizational theory further identifies the limitations of the intermediate supervisor. Organizational theorists explain that an organization's culture institutionalizes certain ways of perceiving, thinking and acting.[114] Organizational norms strongly influence how an intermediate supervisor performs the tasks. Indeed, when regulators speak about a broker-dealer's "culture of compliance," they are often referring to this phenomenon.[115] By contrast, a firm understood to be highly profit-driven and aggressive in dealing with the law and regulations will have a different culture of compliance and supervision from compliant firms. In aggressive firms, supervisors may be tacitly encouraged to allow certain transactions to proceed, and not to impede high producers.[116] Organizational culture does not supplant supervisors' rational decision-making, but it does shape and transform their social identities, which directly affects their decisions.[117] Therefore, regulators' concerns about intermediate supervisors' limitations are valid because supervisors will have difficulty resisting the cultures of broker-dealers employing them, as well as those of certain sectors of the brokerage industry.

This account of the limitations of the intermediate supervisor fleshes out the SEC's and SROs' intuitions about them.[118] In addressing these limitations, the SEC and FINRA

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112. *See generally* S. ALEXANDER HASLAM, PSYCHOLOGY IN ORGANIZATIONS: THE SOCIAL IDENTITY APPROACH 30 (2d ed. 2004) ("As a group member the self is defined stereotypically in terms of attributes (such as values and goals) that are shared with others who are perceived to be representative of the same social category.").

113. Under FINRA's suitability rule, a broker can make recommendations to, or conduct trades for, a customer only if that action is "suitable" for the particular customer, based upon a list of customer attributes that constitute the customer's "investment profile." FINRA RULE 2111(a) (2012).

114. *See generally* Jennifer K. Kish-Gephart et al., *Bad Apples, Bad Cases, and Bad Barrels: Meta-Analytic Evidence about Sources of Unethical Decisions at Work*, 95 J. APPLIED PSYCHOL. 1, 6–7, 21 (2010) (discussing organizational causes of misconduct); MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT (2011) (discussing how organizations influence our decision-making and ethical conduct).

115. *See generally* WHITE PAPER, *supra* note 11, at 7 (regarding culture of compliance referenced by SEC officials).

116. This seems to have been the culture of the broker-dealer where Theodore worked in the first story of this Article.

117. *See* Gehman et al., *supra* note 18, at 108 (arguing that organizational values are constantly subject to change and refinement).

118. There are no doubt other factors that influence a supervisor's decision-making. *See, e.g.*, JOHN M. COATES, THE HOUR BETWEEN DOG AND WOLF: RISK TAKING, GUT FEELINGS, AND THE BIOLOGY OF BOOM AND

provided intermediate supervisors with two forms of assistance to perform their supervisory tasks, compliance and technology. As will be explained below, the assistance addressed the psychological, social psychological, and organizational pressures affecting the supervisors.

1. Compliance as a Response

While recognizing the importance of the intermediate supervisor, the SEC, SROs, and firms themselves acknowledged that these supervisors needed assistance to perform adequately their supervisory tasks.[119] Their justification for encouraging—and mandating—this assistance was the same as that for their effort to professionalize the supervisor position. Therefore, it did not reflect any express acknowledgement of the psychological and organizational pressures facing supervisors. However, these forms of assistance, like supervisors' limitations, make sense in psychological, social psychological, and organizational terms.

Regulators claimed that a broker-dealer's compliance function should provide the major kind of assistance to intermediate supervisors. While this is not the place to discuss broker-dealer compliance,[120] a few words about this subject are necessary.[121] Broker-dealer compliance consists of a division or group of compliance officers under the direction of a CCO that keeps track of all legal and professional obligations of a broker-dealer and its brokers and that institutes a compliance system, which tells brokers how to conduct their securities activities in compliance with these obligations. Compliance officers establish compliance policies and procedures for a particular activity, with policies setting forth its overall legal, regulatory or professional goals and with the procedures outlining the specific conduct that will achieve them.[122] They also produce written supervisory policies and procedures (WSPs), which guide supervisors with respect to their responsibilities. These compliance and supervisory policies and procedures must be comprehensive, covering all aspects of the securities business in which a broker-dealer engages.[123] In addition to drafting policies and procedures, compliance officers educate brokers and supervisors about the policies and procedures, both initially (when the policy or procedure is new or when a broker joins the firm) and on a continual basis, when the firm develops new activities and products.[124] Compliance officers also monitor brokers and supervisors to ensure that they are following the policies and procedures.[125] This monitoring, in turn,

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BUST (2012) (discussing biological basis for risk-taking in securities trading and its effects upon the industry); Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209 (2011) (discussing industry pressures affecting the conduct of securities professionals).

119. *See, e.g.*, SEC SPECIAL STUDY, PT. 1, *supra* note 78, at 293–94 (finding that the large broker-dealers were already developing internal compliance systems to help with supervision).

120. I have addressed this subject in another article. Fanto, *supra* note 19.

121. The discussion reflects compliance in a medium or large broker-dealer.

122. *See* John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 COLUM. BUS. L. REV. 165, 189–91 (describing compliance procedures).

123. *See supra* note 50 (stating the requirements for supervision).

124. *See* WHITE PAPER, *supra* note 11, at 4 (describing the ways in which compliance managers "keep business personnel and other employees apprised of policies and procedures").

125. *Id.* at 4–5. This is often referred to as compliance's "control" function. *See* THE EVOLVING ROLE OF

entails their following-up and investigating evidence of violations of policies and procedures, which might indicate a securities law or other legal or professional violation.[126] Most importantly, compliance officers have an important advisory role, where they counsel supervisors and brokers on legal, professional and ethical matters.[127]

Over the years, the SEC and SROs have mandated that broker-dealers have an adequate compliance group to assist supervisors. The SEC achieved this primarily through enforcement actions against broker-dealers for their supervisory failures.[128] In resolving these actions, the SEC explained its expectations for an adequate compliance department in a broker dealer: that compliance officers should be in a reporting line separate from brokers and under the authority of a CCO,[129] that there should be an adequate number of compliance officers for the business of the broker-dealer,[130] that the compliance organization should reflect the size and operations of the broker-dealer,[131] and that compliance officers should have real authority in the firm, which means that supervisors have to pay attention to them.[132] FINRA has similarly spelled out the contours of an adequate compliance department in its rules and enforcement actions.[133]

Compliance officers clearly help mid-level supervisors deal with their psychological, social psychological and organizational limitations. Supervisors rely upon compliance officers to prepare the compliance and supervisory policies and procedures, instead of themselves having to digest and then to explain the constant and changing laws, regulations and professional standards affecting the firm and the brokers. This assistance relieves supervisors of a heavy cognitive demand. Supervisors must understand the law, are still responsible for supervision, and must engage in numerous supervisory tasks,[134] but compliance officers make these tasks cognitively manageable. For example, a compliance

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COMPLIANCE, *supra* note 11, at 4 ("Compliance also exercises its control function through various monitoring and testing activities.").

126. *See* WHITE PAPER, *supra* note 11, at 6 (explaining the investigation and reporting processes); THE EVOLVING ROLE OF COMPLIANCE, *supra* note 11, at 26 (same).

127. *See* WHITE PAPER, *supra* note 11, at 3 (describing compliance managers' advisory roles).

128. For a discussion of these actions and their results, see Walsh, *supra* note 122, at 193–96 (outlining the duties of a compliance department); FERRARA ET AL., *supra* note 95, at 16–27. The compliance position was already well established by 1974, for an industry group referred to the "Compliance Official," a person responsible for compliance in a given area of business activity in a broker-dealer. GUIDE TO BROKER-DEALER COMPLIANCE, *supra* note 100, at 3, 11. FERRARA ET AL., *supra* note 95, at 13.

129. *See* Prudential Sec. Inc., 51 S.E.C. 726, 27 (1993) (explaining the organizational structure regarding compliance officers).

130. *See* First Affiliated Sec., Inc., Exchange Act Release No. 23335, 35 SEC Docket 1580, 1586 (June 18, 1986) (finding the corporation had "inadequate staffing of its compliance department").

131. Shearson Lehman Brothers, Inc., Exchange Act Release No. 23640, 36 SEC Docket 1075, 1083 (Sept. 24, 1960). Indeed, in large broker-dealers with many branches, the SEC also sought to increase the authority of compliance departments working in the home office with senior supervisors.

132. *See* Prudential Sec. Inc., Exchange Release Act No. 34-22755, 1986 SEC LEXIS 2210, at *69 (Jan. 2, 1986) (explaining that compliance procedures must be taken seriously).

133. *See* FERRARA ET AL., *supra* note 95, at 75–82 (citing cases); POSER & FANTO, *supra* note 39, at § 9.02; *see also supra* text at notes 51–55 (describing the required process of establishing compliance rules and procedures).

134. *See, e.g.*, FINRA RULE 3110.08 (noting, with respect to the supervision of communications, ". . . the supervisor/principal remains ultimately responsible for the performance of all necessary supervisory reviews, irrespective of whether he or she delegates functions related to the review").

officer may review transactions, identify problematic ones, and even set out the steps that a supervisor should follow in investigating and resolving them. As a result, a supervisor can perform the targeted supervisory task of deciding whether and how to discipline a broker for a particular violation.[135] In addition, the existence of supervisory procedures emphasizes to supervisors that their decisions are subjects for rational decision-making in line with standard procedures and rules, rather than matters to be dealt with hastily and emotionally.[136]

Similarly, compliance officers help reduce the social psychological and organizational pressures on a supervisor. Since compliance officers are within the different reporting line of compliance[137] and likely have their own group identity, they can challenge a supervisor's automatic application of a social identity that would cause the supervisor to overlook violations. Indeed, a well-known symptom of a pathological group identity is the unwillingness of the group and its leader to look at the reality of its members' misconduct from an outside, and thus corrective, perspective.[138] In addition, compliance officers could help extricate supervisors from problematic social identities, by reminding them of other social identities upon which supervisors should be basing their decision-making, such as that of being part of a group collectively responsible for legal compliance. In a related vein from an organizational perspective, a compliance officer also reminds the supervisor of the organization's culture of compliance and the values that go with it, such as investor confidence and welfare. The compliance officer thus ensures that the values will not fade away in a supervisor's decision-making, and that they will displace self- and group-interest that will be conducive to securities law violations.[139]

Yet compliance officers cannot respond to all of the intermediate supervisor's limitations. While, as explained above, the compliance officer can relieve the supervisor of much of the cognitive load associated with supervision, the supervisor must make the final decisions. Compliance officers are effective, moreover, only if supervisors follow the WSPs and seek their counsel. There is always a risk that a supervisor may regard a compliance officer as an outsider from a non-business function to be disregarded or gamed in some way, and may tacitly reject the compliance officer's perspective. Furthermore, compliance officers are entirely dependent upon the broker-dealer for their organizational position and the organizational values that they can convey. That is, if compliance is not taken seriously in a particular broker-dealer, as was partly the case in the first story, a compliance officer will have a difficult time convincing a supervisor to make decisions in

135. For example, a compliance officer might identify trading in a customer's account that is out of line with the customer's investment profile. *Supra* note 113. He or she would alert the supervisor, who would have steps laid out in the WSPs to undertake to check on the matter, such as speaking with the broker, sending a letter to the customer with a response demanded, looking at the broker's transactions with other customers, etc.

136. *See supra* note 107.

137. *See* THE EVOLVING ROLE OF COMPLIANCE, *supra* note 11, at 17–18 (discussing the various compliance structures used).

138. *See, e.g.*, IRVING L. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 174–75 (1982) (discussing group blindness to facts not recognized by a group, or "groupthink").

139. *See* BAZERMAN & TENBRUNSEL, *supra* note 114, at 69–70 (discussing "ethical" fading, where ethical dimensions of a decision "fade" at the time of decision-making); Ann E. Tenbrunsel & Kristen Smith-Crowe, *Ethical Decision Making: Where We've Been and Where We're Going*, 2 ACAD. MGMT. ANNALS 545, 561 (2008) (discussing literature on the subject of ethical fading).

accordance with a culture of compliance that does not in fact exist.

2. Technology as a Response

When in the 1960s the SEC was urging Congress to give it direct regulatory power over the intermediate supervisor, it also highlighted a major development in broker-dealers that would provide a significant form of assistance to this supervisor, one that went hand in hand with compliance: communications technology and data processing.[140] The SEC noted that national broker-dealers were using technology to connect their many offices for order processing and to assist in the supervision of transactions and personnel in these offices.[141] The technology here ranged from electronic transmission of orders to the early forms of electronic data processing that collected and organized data about customers and their investment activity. Firms also used data processing for surveillance because the technology made possible a more efficient review of customer accounts and transactions for problems. Moreover, compliance officers began to be major users of this surveillance technology.[142]

As communications and data processing technology developed since the 1960s, it became an indispensable tool for intermediate supervisors, especially for those in large broker-dealers.[143] Indeed, a few contemporary examples illustrate the extent of this assistance. A supervisor must review communications between brokers and customers, as well as certain internal ones among the brokerage staff.[144] This is a potentially massive supervisory task, especially today with the many new forms of electronic communications.[145] Here, technology comes to the supervisor's rescue. Software exists that can scan communications and flag those demanding further review, generally because they use problematic words or expressions suggestive of a potential violation.[146] In

140. *See* SEC SPECIAL STUDY, PT. 1, *supra* note 78, at 294–95 (describing use by large broker-dealers of electronic data processing in their supervision).

141. *See id.* (stating that "[o]f the study sample of large firms, 23 out of 25 have such equipment").

142. So established became technology in surveillance and other compliance tasks that by 1974 a committee of industry officials could include a chapter on the uses of electronic data processing technology for compliance purposes, including surveillance. *See* GUIDE TO BROKER-DEALER COMPLIANCE, *supra* note 100, at 267–72 (describing the uses of electronic data processing for tasks by the "Compliance Official").

143. *See id.* at 267 (noting how data processing was useful for the supervision of the activities of brokers), *id.* at 269 (noting how data processing analyzed accounts for supervisor's behalf).

144. *See* FINRA RULE 3110(b)(4) (2015) (referring to correspondence with customers and among the brokerage staff). In FINRA terminology, communications generally refers to advertisements and sales literature. FINRA RULE 2210(a).

145. As we all know, communications technology has expanded from the telephone, letter, and facsimile to email, instant messages, and online chats. Broker-dealers must record all business-related communications, no matter the communications platform, and supervisors must monitor it. FINRA RULE 2210(b)(4). FINRA has reminded them of these obligations, and counseled them on how to satisfy them, in this age of changing communication technologies. *See, e.g.*, FINRA, SUPERVISION OF ELECTRONIC COMMUNICATIONS, REG. NOTICE 07-59 (Dec. 2007) (discussing supervision of different kinds of electronic communications); FINRA SOCIAL MEDIA WEB SITES, REG. NOTICE 10-06 (Jan. 2010) (guidance on broker-dealer and broker involvement with sites such as blogs); FINRA, SOCIAL MEDIA WEBSITES AND THE USE OF PERSONAL DEVICES FOR BUSINESS COMMUNICATIONS, REG. NOTICE 11-39 (Aug. 2013) (providing further guidance).

146. The kinds of software that do this are numerous. *See, e.g.*, Press Release, Compliance Made Easy: Introducing the Bloomberg Compliance Center CMPC (Dec. 17, 2013) (providing real time review of electronic

practice, a compliance officer or a supervisory assistant identifies suspicious communications with the help of this technology and then sends them along to the supervisor for targeted consideration and action. A supervisor must also review all securities transactions.[147] A broker-dealer is likely to have a computer-based software platform that both executes and monitors all transactions by the brokerage staff,[148] or a software program that, based on established parameters related to transactions and customers, flags certain ones for additional review.[149] This technology creates an electronic exception report.[150] Once again, a compliance officer or a supervisory assistant notifies the supervisor of the problems, and may even first follow-up with the broker and the customer if further information and clarification about a transaction are needed. Then the officer presents findings to the supervisor for a decision or action on the matter. Supervisors often come into the process only when they need to make a decision.

Technology thus helps a supervisor deal with the psychological and organizational issues discussed earlier.[151] Data processing technology clearly limits a supervisor's cognitive exertions since it gathers and reviews information, identifying problematic communications, transactions, or other matters.[152] When a compliance officer further screens the filtered information and lays out possible steps for a supervisor, the supervisor need expend energy only on a decision. Moreover, technology can even help prevent problematic transactions, and thus remove the possibility that a supervisor might allow them because of self interest or the pressures of a group identity. For example, trading and surveillance software might not allow a broker to execute a transaction for an account where the product involved was not in line with the customer's investment objectives or was not otherwise appropriate for the customer.[153] If supervisors were able to override this technological "block," the very check itself would remind them of their legal, regulatory, and professional duties, especially because override procedures, which would be

communications). In fact, FINRA rules assume that broker-dealers will use this kind of monitoring software because it allows review of communications to be "risk based," i.e., not every communication is actually looked at, but only those identified by the software as problematic, so long as the software is reasonably designed to identify problematic communications. FINRA RULE 3110.06–07.

147. FINRA RULE 3110(b)(2) (2015).

148. *See Broker-Dealer Sales Practice Oversight: Secrets of their Success*, ALBRIDGE BEACON STRATEGIES (2012), http://www.albridge.com/live/media/WP_ALB_BD.pdf (emphasizing the growing importance of the use of automated systems of compliance, which is effective when all products are sold through the broker-dealer's, not another provider's, platform); Mitchel Kraskin & Todd Spillane, *Technology, Compliance and the Future of Fund Governance*, 23 INSTITUTIONAL INV.: FUND DIRECTIONS 12 (Sept. 2014) (discussing, albeit in the investment adviser context, the demands that the compliance department have technological capacities equal in sophistication to those used in the business and partner with their technology departments).

149. DST Brokerage Services, for example, provides compliance and surveillance software for transactions. *See* Shannan Layette et al., *Best Practices for Selecting Governance Risk and Compliance Software*, 7 PRAC. COMPLIANCE & RISK MGMT. FOR SEC. INDUS. 4, 19 (2014) (discussing how to select this software).

150. *See* Tilkin, *supra* note 106 (observing how almost all broker-dealers today use automated surveillance software for supervisory and compliance tasks).

151. *Supra notes* 112–17 and accompanying text.

152. *See* GUIDE TO BROKER-DEALER COMPLIANCE, *supra* note 100, at 269 (discussing the benefits of transaction analysis).

153. The system might flag the transaction as out of line with the customer's "customer specific suitability." FINRA RULE 2111.05 (2014). Alternatively, the product might be allowed only for institutional, not retail, investors.

supervisory procedures, would lay out the steps and basis for the override, and thus prevent them from simply acting automatically for the benefit of a broker in the group.[154] In addition, organization values can be programmed into the technology, although generally as reminders with respect to decision-making.[155]

Despite its ever-expanding uses, technology, like compliance, has its own limitations. After all, it is only as good as its creators and implementers. Software programs may miss issues and not be comprehensive; there may be software glitches or hardware breakdowns (as seen in the second story of this Article).[156] Furthermore, technology can also give supervisors and compliance officers the illusion of comprehensive control, which may lead them to be less vigilant as to how the technology can fail, be gamed, or miss issues. For example, broker-dealers and supervisors must monitor the outside business and securities activities of brokers.[157] However, these activities might not always be detected by a firm's surveillance software because they occur away from the firm, especially if the broker does not report them.[158] Similarly, sales materials, such as advertisements, aimed at retail investors must generally be pre-approved by a supervisor.[159] But there are other forms of advertising, such as seminars and other public appearances made by a broker, that must be monitored in person.[160] Thus, while technology is an invaluable aid to supervisors, particularly when it is also used by compliance officers assisting them, it has its own limitations.

B. The Threats to Intermediate Supervisors Posed by Compliance and Technology

From being important kinds of assistance to the intermediate supervisor, compliance and technology are now "squeezing out," and in some cases replacing, that supervisor. As in the case of the rise of the mid-level supervisor in the twentieth century, business and

154. Under FINRA Rule 2111, a supervisor would have to make his or her own determination that the transaction is suitable for the customer, which would have to be documented.

155. For example, the WSPs for a particular supervisory decision would remind the supervisor of the broker-dealer's values involved in a decision (e.g., a suitable investment is defined as one being in the customer's interest).

156. *See* Kenneth A. Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669, 708 (2010) (discussing values that may be embedded in the technology, but that may be at odds with regulatory policies). For a good example of how a coding error in an automated compliance monitoring system can lead to problems, see Western Asset Management Company, Advisers Act Release No. 3763 (Jan. 27, 2014) (describing how security's designation is changed, which makes the automated system allow the security to be placed into ERISA accounts, even though it was non-ERISA eligible).

157. Brokers must report to the broker-dealer their outside business activities and must receive pre-approval to engage in securities activities done away from the firm. *See* FINRA RULE 3270 (2015) (governing outside business activities); NASD RULE 3040 (2015) (governing private securities transactions) (as of Sept. 21, 2015, FINRA RULE 3280 will replace this NASD Rule). In both cases, the outside activities might adversely affect the broker-dealer and its customers, such as where a broker sells an interest in a dubious private fund to the broker-dealer's customers, who mistakenly believe that it is supervising the broker and standing behind the product.

158. Other kinds of technological surveillance, such as regular Internet searches of the broker's name, could identify some of these outside activities. Compliance officers in fact conduct these searches, which may also be programmed into certain kinds of surveillance software.

159. FINRA RULE 2210(b)(1) (2015).

160. *See* FINRA RULE 2210(f) (2014) (governing public appearances, which are inherently difficult to supervise).

regulatory reasons explain the current disappearance of this position. The business reasons have much to do with organizational changes made possible by technology. Large firms have experienced organizational "flattening," which means that the firms with multi-level managers that predominated in the post-war years shed many of their intermediate layers of management.[161] This loss occurred because information and other technologies eliminated part of the workforce, and thus their supervisors.[162] Moreover, since much of the training of, reporting on, and surveillance of employees could be automated, there was less need for lower-level supervisors.[163] In addition, because technology facilitated the dissemination of information directly to employees to coordinate their work, lower-level supervisors lost their traditional coordination and information management role.[164]

This phenomenon of organizational flattening has affected large broker-dealers. Here, too, technology is a significant cause.[165] Since technology has automated much of a broker's interaction with customers and, as discussed above, allows for automated guidance, monitoring, and supervision of brokers, a broker-dealer can put less emphasis upon, and even dispense with, intermediate supervisors. In the hyper-competitive world of the securities industry, firms have embraced this cost reduction, particularly national firms with large branch networks or those using independent contractor brokers.[166] Under this latter model, as independent contractors, individuals are brokers of the broker-dealer and

161. *See* Julie Wulf, *The Flattened Firm—Not As Advertised*, 55 CAL. MGMT. REV. 5, 6 (2012) (citing the literature on this elimination of middle management and explaining reasons for it). As Wulf explains, one purpose of flattening was to put more decision power lower in the organization to those close to customers. However, she notes that it has had the result of moving more decisions upwards to senior management "teams."

162. *Id.* at 7. Moreover, since much work in businesses is no longer routinized, skilled employees work in teams with less defined boundaries between a supervisor and the supervised. *See* John Hensley & Debra D. Burke, *The Changing Nature of Supervision: Implications for Labor-Management Relations in the Twenty-First Century*, 33 SETON HALL LEGIS. J. 397, 422–27 (2009) (discussing transformation in supervision in business today). New generations of employees, moreover, may prefer interaction through technological means, rather than face to face, which lessens the importance of the traditional supervisor.

163. *See* Rachel Feintzeig, *Radical Idea at the Office: Middle Managers*, WALL STREET J. (Aug. 18, 2015), http://www.wsj.com/articles/radical-idea-at-the-office-middle-managers-1439941798 (discussing standard model of firm without middle managers since their managerial and surveillance tasks could be automated, but also how firms are finding the business need for this manager).

164. *See* Wulf, *supra* note 161, at 3–4 (discussing information technology reasons for flattening of firms' hierarchies).

165. Technology first resulted in consolidation in the brokerage industry, as only large broker-dealers can make the necessary investment in trading and communication technologies. *See, e.g.*, Andre Cappon, *The Brokerage World is Changing, Who Will Survive?*, FORBES (Apr. 16, 2014, 11:46 AM), http://www.forbes.com /sites/advisor/2014/04/16/the-brokerage-world-is-changing-who-will-survive/ (explaining how electronic trading transformed the brokerage industry and how five giant "wire houses" dominate the retail brokerage business). For 2006 statistics about how large broker-dealers dominate the brokerage industry, see ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 50–52 (2008).

166. Examples of independent contractor broker-dealers are like LPL Financial and Lincoln Financial. LPL FIN., http://lplfinancial.lpl.com (last visited Oct. 19, 2015); LINCOLN FIN., http://lfg.com (last visited Oct. 19, 2015). These often have the largest number of registered representatives for broker-dealers not in financial conglomerates. *See Broker-dealer Database*, INVESTMENT NEWS, http://www.investmentnews.com/section/ broker-dealer-data (last visited Oct. 19, 2015). There may well be a symbiotic connection between broker-dealers in conglomerates, like Morgan Stanley and Merrill Lynch, and the independent contractor model, since brokers trained in the former often leave for the independence and possibility of higher compensation in the latter. *See* Cappon, *supra* note 165 (describing how the process brokers use to conduct their trades have changed).

own and operate their own offices as branches or non-branch offices of a broker-dealer. This offers them a trading and investing platform, securities products, and the necessary supervisory oversight on regulatory matters.[167] In all large broker-dealers, whether or not using this model, senior supervisors with compliance staff in the home office generally conduct much of the management and oversight of the branches and other offices, which downgrades the role of intermediate supervisors, such as branch managers.[168]

The SEC and FINRA have resisted the supervisory consequences of organizational flattening and the rise of remote supervision by maintaining the requirement of intermediate supervisors in their regulation and pronouncements. This position, as well as the countervailing pressure from the brokerage industry, was vividly demonstrated by FINRA's adoption of its new supervision rules.[169] As noted above, the new rules recognize that broker-dealers use technology for compliance and supervisory purposes by allowing the review of communications and transactions to be automated and risk-based.[170] However, FINRA made it clear that, despite any automation of supervisory tasks, the branch manager and other intermediate supervisors remain responsible for supervision.[171] More significantly, FINRA reaffirmed the longstanding rule that an OSJ have a supervisory principal who has a regular physical presence in the office.[172] On this point, FINRA had to resist pressure from large broker-dealers, particularly those using independent contractors, that wanted the supervisory rule to allow for more remote supervision.[173]

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167. For a discussion of this model and the regulatory challenges posed by it, see Charles V. Senatore, *Supervision Challenges Facing Broker-Dealers Employing the Independent Contractor Small Branch Office Model: A Call to Action*, 52 BUS. LAW. 1359, 1370–72 (1997). *See also* Alexander C. Dill, *Broker-Dealer Regulation Under The Securities Exchange Act of 1934: The Case of Independent Contracting*, 1994 COLUM. BUS. L. REV. 189, 195–207, 234–52 (identifying the working of this model, business reasons for the model and the regulatory challenges posed by it, as well as regulatory responses as of that date). For an SEC settlement over the failure to supervise by a broker-dealer using this model, see Royal Alliance Associates, Inc., Exchange Act Release No. 38174, 63 S.E.C. Docket 1606 (Jan. 15, 1997). For SEC staff guidance for independent contractor broker-dealers, see SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (Mar. 19, 2004) (acknowledging remote supervision by compliance staff but emphasizing the importance of physical supervision at a time when there was a growth in branch offices). *See also* Ronak V. Patel & Courtney Bowling, *Broker-Dealer Supervision: Evolving Business Practices and Regulatory Enforcement*, 59 ADVOC. (2012) (noting regulatory suggestions that the independent contractor model demands a higher level of firm supervision).

168. *See supra* Section III.A.2 (describing technological advances that assisted supervisors).

169. *See supra* text accompanying notes 56–58 (discussing the amended rules' emphasis on the mid-level supervisor).

170. *See supra* text accompanying notes 145 & 149 (describing the technology used).

171. *See* FINRA, REGULATORY NOTICE 14-10, *supra* note 56 (stating that"[t]he supervisor remains responsible for the discharge of supervisory responsibilities in compliance with the rule and also is responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed"); FINRA RULE 3110.08 (referring to the responsibility of a supervisor for any delegation of tasks, such as to a supervisory assistant or to compliance officers).

172. *See* FINRA RULE 3110.03; *see also* FINRA, REGULATORY NOTICE 14-10, *supra* note 56 at 2. For the predecessor rule, which mandated the presence of a supervising principal in these offices, see NASD Rule 3010(a)(4).

173. Letter from Patricia Albrecht, FINRA Associate General Counsel, to Elizabeth Murphy, SEC Secretary, File No. SR-FINRA-2013-025 – Response to Comments 11–12 (Oct. 2, 2013) (discussing comments advocating, among other things, that a home office supervisor be able to act as an OSJ principal). In a significant concession to the industry, however, the new rule allows a broker-dealer to have one principal to supervise two or more OSJs,

Yet the SEC and FINRA appear to be gradually acceding to this pressure.[174] This change may be partly due to their longstanding suspicion of the effectiveness of mid-level supervisors and their related worry about the effect of the heightened profit goal of broker-dealers.[175] Despite imposing direct liability upon these supervisors for their failure to supervise, surrounding them with a web of detailed WSPs, trying to make them professionals, and giving them the assistance of compliance and technology, regulators appear to have an underlying skepticism of the supervisors' ability or willingness to enforce legal and professional compliance.

Yet the SEC and FINRA are unlikely to change their long-held and well-established position in favor of the intermediate supervisor in response to industry pressure or because of their suspicion about the intermediate supervisor's effectiveness. Rather, they have a regulatory reason for the change that is partly their own creation—the compliance officer. The SEC and FINRA can be confident that compliance with the law will not diminish if they accede to an industry de-emphasis upon—and even the gradual disappearance of—the intermediate supervisor, because compliance officers are firmly established in broker-dealers. They could even believe that compliance would actually improve in these firms if compliance officers take over many of the tasks of intermediate supervisors under the direction of senior supervisors.[176] If the compliance group or division in a broker-dealer has been instituted in accordance with the regulators' specifications, it mirrors the supervisory structure in the firm.[177] At the highest level of executive decision-making, CCOs make known their views on compliance matters relating to the firm's business—an involvement that should be mirrored by compliance officers at each level of the organization. Moreover, compliance officers use technology, often remotely, in creating and administering WSPs and compliance procedures, monitoring compliance with them, and investigating and following-up on "red flags."[178] Most importantly for the regulatory

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if it concludes that this supervision can satisfy the criteria set out in the rule. FINRA Rule 3110.03.

174. Arguably, FINRA's accommodation on the issue of one principal supervising two or more OSJs is an example of this bowing to the pressure. *Supra* note 173. Both the SEC and FINRA may be becoming more sensitive to the cost pressures of broker-dealers and to the fact that these firms and brokers have a regulatory alternative—to become investment advisers; both contribute to their shrinking numbers. *See* Jonathan Macey & Caroline Novograd, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963, 965 (2012) (discussing these issues in the context of FINRA's legal inability to enforce its fines against violators).

175. *See* FINRA, REPORT ON CONFLICTS OF INTEREST 31-32 (Oct. 2013) (discussing how some compensation structures for supervisory personnel could create a conflict of interest and discourage them from conducting adequate supervision). For an "in the trenches" view of the pressures on and tasks of typical branch managers and the pressures on them to focus on office profits, rather than compliance, see generally Frank A. Sullivan, *Expert's Corner: The Roles and Responsibilities of the Branch Office Manager*, 12 PIABA B.J. 36 (2005) (discussing the roles and responsibilities of the Branch Manager).

176. *See, e.g.*, Aulana L. Peters, SEC Commissioner, Investor Protection: The First Line of Defense, Address to Brooklyn Law School's A Securities Regulation Symposium (March 15, 1985) (noting as an early statement of the importance of remote oversight by compliance staff). There is a more recent statement on the closeness between regulators and compliance officers, see Kara M. Stein, SEC Commissioner, Remarks at the 9th Annual Conference of Compliance Week, Washington, D.C. (May 19, 2014) ("And know that we 'have your back' when others try to prevent you from doing your job.").

177. *See supra* text accompanying notes 129–33 (describing the requirements of compliance departments).

178. *See supra* note 142 (describing the technology in compliance departments).

perspective, compliance officers are not compensated for business productivity and have close professional ties to the regulators.[179]

Regulators are inclined to accept compliance officers as part of the replacement for the intermediate supervisor since the regulators are themselves increasingly using technology and "big data" that would allow them to conduct real-time monitoring of broker-dealers, which is the "Holy Grail" of their surveillance. Broker-dealers already do their regulatory filings and much of their mandated reporting on FINRA's Central Registration Depository (CRD).[180] In addition, FINRA is proposing to adopt the Comprehensive Automated Risk Data System (CARDS), which would require broker-dealers to provide customer account data to FINRA so that it can identify problems, trends, and risks for customers and firms.[181] In addition, for a number of years the SEC, FINRA and other SROs have been working with broker-dealers to implement the Consolidated Audit Trail (CAT), which would allow regulators to track the history of every order and provide a repository of order data.[182] The ultimate regulatory goal of all of this activity is to enable regulators to monitor, as close to real-time as possible, all market activity so that they can identify securities law and other violations, as well as nascent risks to firms, investors, and markets, and then take necessary action to address them. Technologically-enhanced compliance officers in broker-dealers could feed into, and be part of, the regulators' surveillance.[183] This kind of external and internal monitoring of broker-dealers lessens the need for the intermediate supervisor and thus reinforces the brokerage

179. *See generally* INSTITUTE FOR INTERNATIONAL FINANCE & OLIVER WYMAN, COMPENSATION REFORM IN WHOLESALE BANKING 2011: ASSESSING THREE YEARS OF PROGRESS 11–12 (Oct. 20, 2011), https://www.iif.com/publication/regulatory-report/compensation-reform-wholesale-banking-2011-assessing-three-years (describing survey results of compensation practices in large financial firms for compliance and other control functions); *see also* WHITE PAPER, *supra* note 11, at 6 (describing the roles and collaborative activities of compliance departments); THE EVOLVING ROLE OF COMPLIANCE, *supra* note 11, at 26 (describing assistance offered by compliance officers to FINRA and SEC in their examinations of broker-dealers).

180. *See* FINRA, *Central Registration Depository (Web RD)*, http://www.finra.org/industry/compliance/registration/crd/ (last visited Oct. 20, 2015) (providing access to "licensing and registration system for the U.S. securities industry and its regulators").

181. *See* FINRA, COMPREHENSIVE AUTOMATED RISK DATA SYSTEM, REGULATORY NOTICE 14-37 (Sept. 2014) (presenting revised proposal of the CARDS); *see also* Rick Ketchum, FINRA Chairman/CEO, "Restoring Investor Trust in the Markets," FINRA Annual Conference, Washington, D.C. (May 19, 2014), https://www.finra.org/newsroom/speeches/051914-remarks-2014-finra-annual-conference (explaining how FINRA must be "data informed," "technology empowered," so as to respond more quickly to trends and to discipline bad actors, and how the CARDS fits into this strategy); Jason Zweig, *Get Ready for Regulators to Peer Into Your Portfolio: Bad Brokers, Meet RoboRegulator*, WALL STREET J. (May 2, 2014, 6:00 PM), http://blogs.wsj.com/moneybeat/2014/05/02/get-ready-for-regulators-to-peer-into-your-portfolio/ (discussing proposal). FINRA has recently put the project on hold out of concern for data security issues. *See* Richard G. Ketchum, FINRA Chairman and CEO, Speech before the House Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services, Washington, D.C. (May 1, 2015).

182. *See* FINRA, *Consolidated Audit Trail* (CAT) (Aug. 27, 2015), http://www.finra.org/industry/issues/cat; Fanto, *supra* note 19; *See* Letter of BATS Exchange, Inc., to Brent J. Fields, SEC Secretary (Sept. 30, 2014), http://www.sec.gov/divisions/marketreg/cat-nms-plan-letter.pdf (letter accompanying plan submission).

183. Regulators in fact demand that broker-dealers have the technological capacity of surveillance to feed into the SEC's and FINRA's data-driven initiatives, which could not work without these firms providing data in a standardized format. *See* REGULATORY NOTICE 14-37, *supra* note 181, at 12 (setting forth data standards for broker-dealers' CARDS submissions).

industry's reasons for eliminating their middle managers.[184]

IV. THE NEED FOR THE INTERMEDIATE SUPERVISOR

A. The Psychological and Organizational Benefits of the Intermediate Supervisor

This Section contends that the mid-level supervisor should be maintained to promote effective compliance in broker-dealers. It offers psychological and organizational justifications for this supervisory structure, arguing in particular that a supervisor who is close to and experienced in securities activities can most effectively act as a role model for brokerage and other securities staff in showing how policies underlying the securities laws can be put into effect in their everyday sales activities. It also argues that organizational values are best conveyed, internalized and perpetuated by examples "on the ground," rather than through inspirational and other messages from senior executives in the home office. Here the Section complements the argument made in my article on compliance. There I explained that a broker-dealer achieves more effective compliance when it emphasizes the role of a compliance officer as an advisor and counselor and downplays its position as an "external" monitor.[185] This Section continues in a related vein by arguing that the compliance officer as a technologically-enhanced monitor not only adversely affects that officer's advisory role but also threatens the supervisor's value as role model and conveyor of organizational culture. The Section argues that broker-dealer surveillance administered remotely by compliance officers, under the direction of senior supervisors, who are completely divorced from the profit-making brokerage staff is a recipe for the loss of a compliance culture and for resulting compliance failures. It also contends that the ideal supervisory situation is to have the compliance officer counseling and advising, but not replacing, a mid-level supervisor so that business and compliance are closely intertwined.

The weaknesses of the intermediate supervisor in psychological, social psychological, and organizational terms have been highlighted, as has how compliance and technology respond to them and make for effective supervision.[186] However, nothing has been said about the strengths of that supervisory position, other than its historical origin as a business and regulatory response to the size growth of broker-dealers. Yet there are strong social psychological and organizational justifications for the intermediate supervisor. From the social identity perspective introduced earlier,[187] the leader of a group, like a branch manager, is critical in defining the contours of the group's identity, which other group members adopt.[188] The creation of a group identity is admittedly a complex process, varies depending upon the setting, and is not always the straightforward imposition of the leader's beliefs and values upon the group.[189] This complexity is clear when one considers a typical

184. Yet FINRA asserts that CARDS will not supplant "legal, compliance and supervisory programs" of broker-dealers. *Id.*

185. *See* Fanto, *supra* note 19, at 1122 (noting that a compliance officer is more effective as an advisor and educator than as a transcriber of rules).

186. *Supra* Section III.A.

187. *See supra* note 110.

188. *See* ARIELY, *supra* note 108, at 40–59 (describing traits of leaders).

189. *See* Gehman et al., *supra* note 18, at 108 (arguing that, constantly subject to change and refinement, values emerge locally and "through discussions, negotiations, and ongoing network reconfigurations that values

brokerage branch, where high producing brokers may work with a less productive or even a nonproducing supervisor and may set the identity and "tone" for the group, unless reined in.[190] But the social psychological literature suggests that, even in these circumstances, a supervisor can serve as a role model on legal compliance and particularly on the conveyance of values.[191] These values reflect the "soft" side of compliance, which refers to, in the case of a broker-dealer, policies underlying the securities laws and to the professional standards and ethics of brokers.[192] While, as noted earlier, the compliance officer is the repository of these policies and values and reminds the intermediate supervisor and others about them,[193] it is important to have a supervisor who is in the securities business espouse and exemplify them. As a result and despite other prominent figures in a branch, brokers will have a role model demonstrating how the policies and values can be put into effect in their everyday sales activities.[194]

Related support for the importance of an intermediate supervisor comes from organizational literature. Organizational studies recognize that an organization, like a broker-dealer, has its own systems and codes of conduct, beliefs, and values—its culture—even if these are taken or influenced from outside the organization (e.g., industry values).[195] Certainly, the senior leaders of organizations influence the creation and maintenance of the codes, beliefs, and values, which is why a "tone at the top" can be influential in an organization, for better or for worse.[196] However, organizational culture is best conveyed, internalized in participants, and institutionalized by examples "on the ground" throughout the organization, rather than only through inspirational and other messages from senior executives in the central office.[197] The intermediate supervisor is a key part of this cultural dissemination in a broker-dealer. Indeed, as will be discussed further below, eliminating the intermediate supervisor means getting rid of a primary actor

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practices are performed").

190. Broker-dealers encourage this celebration of the high producers. *See, e.g.*, Corrie Driebusch, *Wall Street Revives Reward Junkets for Top Brokers*, WALL STREET J. (July 30, 2014, 3:19 PM), http://www.wsj.com/articles/wall-street-revives-reward-junkets-for-top-brokers-1406747989 (noting lavish attention brokerage firms spend on top producers, even following the financial crisis). The problem in the first story of this Article was due to a high producing broker.

191. *See* David M. Mayer et al., *Who Displays Ethical Leadership, and Why Does It Matter? An Examination of Antecedents and Consequences of Ethical Leadership*, 55 ACAD. MGMT. J. 151, 153–54 (2012) (arguing that leaders who have internalized moral values and who give public expression to them help produce organizations that have less unethical conduct because organization members model their conduct on the leader, who generally typifies the "ideal" of the group).

192. *See* Gary R. Weaver & Linda Klebe Treviño, *Compliance and Values Oriented Ethics Programs: Influences on Employees' Attitudes and Behavior*, 9 BUS. ETHICS Q. 315, 320–21 (1999) (contrasting two kinds of compliance programs, the legal or compliance approach, and the values-oriented one).

193. *See* Walsh, *supra* note 122.

194. For a discussion of what an intermediate supervisor can do in everyday practice to set an example and to foster a values-oriented approach in a broker-dealer, see Alan Besnoff, *Failure to Supervise: An Inside Perspective*, 20 PIABA B.J. 233 (2013).

195. *See generally* W. RICHARD SCOTT, INSTITUTIONS AND ORGANIZATIONS (1995) (exploring the relationship between institutional theory and organizations).

196. *See* YOAV VARDI & ELY WEITZ, MISBEHAVIOR IN ORGANIZATIONS: THEORY, RESEARCH, AND MANAGEMENT 215–18 (2004) (discussing embedded corruption).

197. Blake E. Ashford &Vikas Anand, *The Normalization of Corruption in Organizations*, 25 RES. ORG. BEHAV. 1, 8–15 (2003).

in the creation and maintenance of organizational culture and in effect leaves brokers adrift, with potentially negative consequences to customer protection.

One could conclude that the above social psychological and organizational benefits could be effected by compliance officers assisting more senior supervisors, a solution, as noted above, that is attractive to large broker-dealers and regulators. However, this would be the wrong path to follow both for compliance officers and for overall legal compliance in a broker-dealer. I have argued elsewhere for promoting internal, as opposed to external, compliance, with the former being demonstrated by a person's espousal of the values and policies of securities regulation and the latter reflecting compliance with the letter of law and regulation.[198] Internal compliance guides decision-making in the many circumstances where WSPs and compliance policies and procedures do not give a clear answer and it reinforces legal compliance. For example, from an internal compliance perspective, the compliance officer provides supervisors with a policy-oriented framework for, and reminds them of the firm values implicated in, a decision.[199] While compliance officers are necessary to broker-dealer's external compliance, regulatory pressures are diminishing their role as advisor, counselor, and educator, which is how officers create internal compliance among brokers.

Compliance officers will lessen their role of advisor and promoter of internal compliance by taking on more of the tasks of the intermediate supervisor, although operating remotely and conducting fewer occasional inspections.[200] Compliance officers already face the challenges of overcoming the business view that they are external and inessential to business activity. Compliance officers may, because of this view, integrate themselves within a branch office or business group so that they can provide advice on business decisions. If brokers see them engaged in surveillance, investigation, and recommendations of punishment, even if a senior supervisor must approve these, they will keep compliance officers at arm's length. In addition, and somewhat ironically, as their role blends with that of supervisors, compliance officers will have to accept a greater risk of supervisory liability, which they have been contesting for at least 20 years.[201]

Having compliance officers replace intermediate supervisors will erode a firm's culture of compliance and lead to less compliance with laws, regulations, and ethics. Brokers may lose a supervisor who does or has done their job, who can offer them, through advice and example, the model of a financial professional following the law and regulation, who is motivated by securities law policies, firm values and ethics, and who is with them "in the trenches." Instead, brokers will have compliance officers who often monitor the

198. *See* Fanto, *supra* note 19, at 1163 (discussion the importance of keeping standards in the minds of decision makers).

199. *Supra* note 139 and accompanying text.

200. The model is a staff of compliance officers operating primarily in the home office, and reporting directly, or indirectly through a CCO, to senior supervisors.

201. A sensitive issue in broker-dealer compliance is when a compliance officer is a supervisor for purposes of supervisory liability. This was the issue in the first story of this Article. *Supra* note 2. The accepted position is that supervisory liability should lie with the individual who has the power to hire, fire and take significant action regarding conditions of employment. *Supra* note 101. In other words, it should exclude the compliance officer who is advising on the decision and suggesting courses of action and who therefore should not be subject to supervisory liability. Giving the compliance officer more power in these managerial decisions might make them supervisors and expose them to supervisory liability.

brokers from remote locations, communicate with them remotely, occasionally visit them for inspections, and report their results, findings, and suggestions for discipline to senior supervisors.[202] Is it surprising that this environment will further separate business from laws, regulations, and ethics and will cause brokers to think of these subjects as imposed from outside and to be ignored when they are not being watched? Moreover, removing the intermediate supervisor will create a space for informal "leaders" outside the supervisory structure of the firm—the big producers like Louis of the first story—bringing with them unknown values and perspectives.[203] This environment would be a breeding ground for illegal and unethical practices, which could spread through a branch before the remote supervisors became aware of it.[204]

B. Regulatory (Re)Promotion of the Intermediate Supervisor

The SEC and FINRA must take concrete steps to halt, and even reverse, the steady erosion of the authority and position of the mid-level supervisor. While they have resisted industry pressure to allow entirely remote supervision, this pressure will continue because of the costs of compliance and advances in surveillance technology.[205] Thus, regulators need a reasoned position to explain to the industry why broker-dealers must maintain the mid-level supervisor in branches and other offices. Regulators must also recognize that they are partly at fault for the de-emphasis of this supervisor through their increasing highlighting of compliance officers. They must admit that compliance officers will succeed only when they work with their indispensable partner, the mid-level supervisor.

Large broker-dealers, particularly those using independent contractors, will continue to pressure regulators to allow more remote supervision. These firms argue that they can

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202. *See* Gerard S. Citera, *Broker-Dealer Supervision: A New Paradigm*, 21 INSIGHTS 1, 5–6 (July 2007) (discussing the creation of teams of senior executives to function as a supervisory control group).

203. If brokerage, such as other financial services, is an occupation where someone can make a lot of money with few social obligations, it is likely to attract (as it may do now) the most self-interested people in society, who are predisposed to form corrupt groups and organizations. *See, e.g.*, PAUL BABIAK & ROBERT HARE, SNAKES IN SUITS: WHEN PSYCHOPATHS GO TO WORK (2006) (discussing the problems of those with personality disorders in the workplace). Yet ordinary investors and retirees with an investment portfolio generally rely upon, and are at the mercy of, brokers and other financial professionals in deciding how to invest, particularly for retirement. *See* Lydia Saad, *U.S. Investors Opt for Human Over Online Financial Advice*, GALLUP (Aug. 15, 2014), http://www.gallup.com/poll/174851/investors-opt-human-online-financial-advice.aspx (discussing how retirees are more likely to use financial advisers than their younger counterparts).

204. *See, e.g.*, *Why the U.S. Corporate World Became 'A Bull Market for Corruption'*, KNOWLEDGE WHARTON (June 30, 2014), http://knowledge.wharton.upenn.edu/article/u-s-corporate-world-became-bull-market-corruption-bad-conduct/ (discussing the prevalence of corruption and unethical practices in the financial industry as seen by Gretchen Morgenson, financial reporter for The New York Times). This outcome could also lead to increasing direct government regulation of the industry, for the inevitable scandals would lead to public calls for more oversight of broker-dealers by FINRA and the SEC who, as discussed above, are trying to increase their own technological monitoring of these firms. *Supra* notes 180–84 and accompanying text.

205. *Supra* notes 163–64 and accompanying text. This pressure may increase as the number of broker-dealer firms continues to decline and the number of branches to rise, both of which reflect industry consolidation. *See* SIFMA, FACT BOOK 2013 27 (listing declining number of broker-dealers since 2000); SIFMA, BROKER-DEALER HEATMAP, https://docs.google.com/spreadsheets/d/1JTsGbMOGGL_sUM_ysCo87sKRCcvMf27xrjN7rnFnVyk/edit#gid=525260640 (last visited Oct. 20, 2015) (listing steady growth in branch offices from 1990 to 2013).

rely more on remote office supervision in order to extend their supervisory resources. For example, senior supervisors, with the help of compliance officers, can monitor and be responsible remotely for multiple branches and offices.[206] As the technological tools available for surveillance improve, this argument becomes harder to resist, particularly since, as noted above, the SEC and FINRA are increasing their own remote monitoring of broker-dealers.[207] Firms can make powerful arguments that they are just following the model used by regulators and that their resources for supervision and compliance are limited, especially when more regulatory obligations are imposed upon them.[208]

The SEC and FINRA need persuasive arguments to justify the position that the intermediate supervisor who has a *physical* presence in the branch or office must be maintained. A pragmatic argument, which has been alluded to and which regulators use now, is that remote surveillance is no substitute for supervisors in the office, where they can observe and investigate the conduct of brokers and ask them questions about their activities.[209] For example, many problems with brokers come from the activities in which they engage outside the office, such as outside business and securities activities. These activities are less likely to be identified by remote supervision or occasional inspection, but a supervisor who is on the premises would be better positioned to learn about them.[210] Regulators would thus state that intermediate supervisors are necessary, given the broker-dealers' duty of supervision and the regulators' own statutory obligation to ensure compliance with the securities laws.

Yet this Article contends that the most significant arguments that the SEC and FINRA can advance to the brokerage industry are that the intermediate supervisor is an important role model who helps define the social identity of his or her branch or group, who promotes a firm's culture of compliance, and who is a major figure in effective compliance. The regulators, therefore, need to broaden their traditional bases of support beyond economic and financial analysis and look to social psychology and organizational studies.[211] Many of these studies are empirically based and come from scholars who teach in business schools, making it easier, from a symbolic perspective, for the SEC and FINRA to justify using them.[212] Regulators would have to argue that their statutory responsibility to ensure compliance requires them to promote the most effective supervisory structures in broker-dealers and to offer a scholarly basis for their advocacy of a compliance culture. They would also argue that the learning from these disciplines supports the contention that the intermediate supervisor, coupled with compliance officers, plays a critical role in creating

206. *Supra* note 166 and accompanying text.

207. *Supra* notes 182–83 and accompanying text.

208. The obligations have grown as a result of Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

209. *Supra* notes 169–72.

210. *Supra* notes 154–60 and accompanying text.

211. For example, the SEC has a Division of Economic and Risk Analysis, which integrates financial economics and data analysis into its mission. *See* ECONOMIC AND RISK ANALYSIS, U.S. SEC. & EXCHANGE COMM'N, http://www.sec.gov/dera (last visited Oct. 20, 2015). Why might it not have the same for the social sciences? On using psychological studies in government regulation, see generally Cass R. Sunstein, The Council of Psychological Advisers, ANN. REV. PSYCH. (2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2496438.

212. *Supra* notes 189 & 192.

this compliance culture in the branches and offices of broker-dealers.

Regulators must also recognize that they contributed to the downgrading of the intermediate supervisor because of their longstanding suspicion about its effectiveness coupled with their increasing championing of the compliance officer. This is not to say that, having succeeded so well in pushing firms to develop the compliance function, they should now deemphasize it. Instead, they should publicly advocate that the intermediate supervisor is an indispensable partner with compliance officers, not someone to be replaced by them. This advocacy would not demand any change to the law or regulation, for the duties of intermediate supervisors and their liability are well established under the Exchange Act, FINRA rules, and the respective jurisprudence.[213] However, they should reaffirm the importance of this position by giving it the kind of public recognition that they have conveyed on compliance officers.[214] That is, they need publicly to discuss the reasons for this role, to highlight its historical origins and significance, and to develop programs for these supervisors so that the latter understand how their conduct ensures that brokers under their supervision follow their legal, professional, and ethical obligations. Indeed, the SEC and FINRA could take the modest step of expanding their outreach programs for compliance officers to include sessions for supervisors in order to bring them into the compliance conversation. This promotion will encourage the broker-dealers to highlight within the firm the intermediate supervisor's compliance role. Unless regulators undertake this mission of restoring the intermediate supervisor to its former regulatory significance, they will find it increasingly difficult to resist the industry's pressure for remote supervision and this supervisor's resulting disappearance.

V. CONCLUSION

This Article began with two stories that underlined the importance of the major ways of ensuring compliance with laws, regulations, and professional standards in broker-dealers today: compliance officers and technology. In one story, the SEC pursued a chief compliance officer for not having reined in a rogue broker, while in the other, a firm's technological surveillance and control system was not properly programmed to stop questionable transactions. While the stories were emblematic of these developments, they also made little or no mention of the intermediate supervisors involved, the branch, or office chief in either case. This Article emphasized that this omission was surprising in light of the history of supervision in broker-dealers, for regulators had enlisted these kinds of supervisors to play a key role in ensuring compliance in the firms.

Providing the background to this role, Part II first set out the Exchange Act's provisions for supervisory liability and highlighted how unusual they are in business organization law insofar as they impose liability upon, and thus indirectly establish a duty of supervision for, intermediate supervisors, not just the firm itself. It then showed how

213. *Supra* Sections II.A–B.

214. For example, in conjunction with FINRA, the SEC sponsors from time to time a program of "outreach" to CCOs in financial firms under their regulation to promote compliance. U.S. SEC. & EXCH. COMM'N, FY 2011 PERFORMANCE & ACCOUNTABILITY REP. 17. *See also* U.S. SEC. & EXCH. COMM'N, STRATEGIC PLAN: FISCAL YEARS 2014-2018 PERFORMANCE & ACCOUNTABILITY REP. 17 (2014 draft for comment) (discussing SEC's outreach efforts on compliance).

FINRA rules underline this statutory role by making intermediate supervisors the linchpin of broker-dealer supervision and by specifying in considerable detail their tasks. Part II next provided an overview of the origins of the Exchange Act provisions and the FINRA rules. It explained how the intermediate supervisor constituted a business and regulatory response to an industry development in the middle of the last century, the expansion of broker-dealers from small partnerships to national organizations that, often incorporated, had a network of branches and numerous employees. This expansion reflected the growth in the securities markets and the influx of new investors during the post-World War II years. Regulators realized that the branch manager, who was generally not a partner or owner of the firm and who was the "middle manager" in large broker-dealers, would have a critical role of ensuring compliance with the law in these expanding firms. This Part told the story of how, with the help of Congress, the SEC and the SROs made the intermediate supervisor a key part of compliance in broker-dealers in the self-regulatory system and sought to professionalize the position.

Part III then explained how, while promoting the compliance importance of intermediate supervisors, regulators were acutely concerned about the supervisors' limitations, chiefly that, drawn from brokerage ranks, supervisors were in the regulators' view overly influenced by the profit-making in broker-dealers that would undermine their fulfilling the supervisory duty. It then offered psychological, social psychological, and organizational support for regulators' concerns. From the psychological perspective, it identified the cognitive overload facing supervisors, who have to conduct supervision while overseeing a profitable office, division, or firm and who may be themselves producing brokers. Social psychology suggests that group identity and loyalty can make these supervisors overlook legal and ethical violations by brokers in their group. Organizational culture and values also influence supervisors. These pressures all make effective supervision by the intermediate supervisor a challenge and support the regulators' concerns about this supervisor's limitations.

Part III next discussed how regulators promoted two related forms of assistance to the intermediate supervisor, compliance and technology, to address the supervisor's limitations. It explained how compliance officers help supervisors by translating the laws, regulations, and professional standards into compliance and supervisory policies and procedures for brokers and supervisors to follow. Compliance officers do this by monitoring compliance with them and by identifying problems for supervisors to resolve. Again, from a psychological, social psychological, and organizational perspective, it recounted how, through the above activities, compliance officers assist supervisors in dealing with their cognitive limitations, help counter social psychological pressures, and remind supervisors of organizational values. This Part also discussed how regulators saw technology as another major form of assistance to supervisors, often as a tool used by compliance officers in their surveillance. This Part again discussed technology in primarily psychological terms as relieving supervisors of the need to do all the monitoring themselves and as also highlighting regulatory aspects of a supervisory decision. This Part identified the limitations of both compliance and technology that prevent them from being complete solutions to ensuring compliance in broker-dealers.

Part III then explained how compliance, coupled with technology, was threatening to replace, rather than just assist, the intermediate supervisor. It discussed how, as in the case

of the rise of this supervisor, there were business and regulatory reasons for the intermediate supervisor's demise. The business reason was the "flattening" of the large broker-dealer: the simplifying and elimination of layers of its managerial hierarchy, in response to cost and technology pressures, in the same way as this had occurred in other industries. The regulatory reasons arose from the fact that, animated by their continuing suspicion about the effectiveness of the intermediate supervisor, regulators found a replacement in the compliance officer, who is attractive to them since that officer has no direct profit-making role and is seen by them as their representative in the firm. Part III discussed how regulators have resisted industry pressure to eliminate the intermediate supervisor, to be replaced by remote supervision done by compliance officers under the direction of senior supervisors, but explained that the pressure would continue to build as a result of growing regulatory costs.

Part IV contended that the intermediate supervisor should be maintained despite the pressures for the elimination of the position. It offered psychological and organizational justifications for this supervisory structure, arguing in particular that a supervisor who is close to and experienced in securities activities can most effectively act as a role model for brokerage and other securities staff by showing how a broker can put into effect in everyday sales activities the policies underlying the securities laws. It also argued that role models "on the ground," rather than inspirational and other messages sent from senior executives in the home office, most effectively convey organizational values. This Part explained that replacing the intermediate supervisor with a compliance officer who is a technologically-enhanced monitor will not only adversely affect that officer's important advisory role but will also eliminate the supervisor's contribution to a broker-dealer's compliance culture. A broker-dealer would be left with offices monitored remotely, and occasionally inspected, by compliance officers looking over and completely divorced from the profit-making brokerage staff. This would be a recipe for compliance failures; the ideal supervisory situation is to have the compliance officer counseling and advising, but not replacing, a mid-level supervisor so that business and compliance are closely intertwined.

Finally, Part IV asserted that the SEC and FINRA should take concrete steps to arrest, and even to reverse, the steady erosion of the authority and position of the mid-level supervisor. It observed that the brokerage industry, animated by the costs of compliance and technological advances, will continue to press for remote supervision. Regulators thus need a reasoned position on which to explain why the mid-level supervisor must be maintained in branch and other offices. The Article suggested that they draw support from psychological, social psychological, and organizational studies, which establish the importance of this kind of supervisor for an organization's compliance culture. It also observed that, since the regulators are partly at fault for the demise of the intermediate supervisor through their increasing emphasis upon the compliance officer, they must discuss the reasons for this supervisor's role, highlight its historical origins and significance and develop programs for these supervisors so that the latter understand how their conduct ensures that brokers under their supervision satisfy their legal, professional, and ethical obligations. Regulators should also bring these supervisors into the public conversation with compliance officers about how to achieve effective compliance in firms, which may even lead broker-dealers to rediscover the firm importance of this position.

More than 80 years ago, Congress decided that the brokerage industry requires

regulation in the public interest. This regulation has always been accomplished partly through compliance within firms, and, as the industry changed and expanded, a key component of compliance became the intermediate supervisor. Yet, as the industry is once again transforming itself, and downsizing and flattening, this supervisor's existence is threatened. Content with the now established importance of compliance officers, whose position owes much to their efforts, and themselves enamored of surveillance technology, the SEC and FINRA are gradually giving way to industry pressure to allow supervision to be done remotely, as technologically-assisted compliance officers monitor the workforce for senior supervisors. In such a scenario, there would be less of a need for intermediate supervisors. This Article argues that the elimination of this supervisor would be a grave mistake for compliance.

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