FINRA Is Concerned About Firm Culture: What Does It Mean?

Law360, New York (February 29, 2016, 12:03 PM ET) -- The Financial Industry Regulatory Authority, in its 2016 exam priorities letter, identifies firm culture as its very first priority. FINRA quickly followed with an announcement on Feb. 18, 2016, of targeted examinations to review "how firms establish, communicate and implement cultural values." FINRA now expects broker-dealers not only to have implemented a firm culture, but to have metrics by which they monitor and enforce that culture. What does FINRA mean when it talks about firm culture? How does FINRA expect firms to measure it? Is it operas plus ballets attended per capita? Do you subtract for UFC and WrestleMania matches? Is it Meryl Streep movies watched divided by Vince Vaughn?

In fact, the subject of firm culture is quite serious and understanding this new regulatory expectation is important. Firms found to have poor cultures may face crippling sanctions. Individuals deemed to have contributed to those poor cultures can lose their careers. The securities industry should expect the U.S. Securities and Exchange Commission to soon announce its own firm culture initiatives.

Although FINRA has never before focused on firm culture in this way, its interest follows in the footsteps recently laid by other financial regulators, in particular the New York Federal Reserve Board. While waiting for more definite guidance from FINRA, members can and should begin to assess their firm culture now based on the principles discussed by other regulators.

FINRA's Exam Priorities Letter and Targeted Letter Relating to Firm Culture

On Jan. 5, 2016, FINRA released its annual exam priorities letter, which announced that culture, conflicts of interest, and ethics would be a top priority for the year. "Firm culture," FINRA said, is "the set of explicit and implicit norms, practices and expected behaviors that influence how employees make and carry out decisions in the course of conducting the firm's business." FINRA Chairman and CEO Richard Ketchum explained that FINRA is focusing on firm culture because "some firms continue to experience systemic breakdowns manifested through significant violations due to poor cultures of compliance." Ketchum stated that the goal is "not to dictate a specific culture," but to understand each firm's culture. He looks for firms to "set the right tone, lead by example, and impose consequences on anyone who violates the firm's cultural norms."

FINRA urged firms to take "visible action" to help mitigate conflicts of interest and promote the fair and ethical treatment of its customers, and identified the five indicators that it will use to assess a firm's culture: (1) whether control functions are valued; (2) whether policy or control breaches are tolerated; (3) whether risks and compliance events are proactively identified; (4) whether immediate managers are effective role models of firm culture; and (5) whether subcultures that may not conform to overall corporate culture are identified and addressed.

FINRA followed up with the targeted letter on Feb. 18, 2016, announcing that it will be reviewing how certain firms "establish, communicate and implement cultural values, and whether cultural values are guiding business conduct." FINRA will meet with "executive business, compliance, legal and risk management staff of firms" to discuss the communication, monitoring and enforcement of firm culture. Ahead of those meetings, targeted firms must send FINRA information about firm culture, including a description of policies and procedures, and how the firm responds to policy breaches and noncompliant subcultures.

According to FINRA, the inquiry was not initiated because FINRA "has concerns about [a] firm's culture or has determined that [a] firm violated any rules or regulations," but because FINRA seeks to better understand industry practices. FINRA states that it plans to use this information "to develop potential guidance for the industry." However, firms should be cautious and treat FINRA's inquiry seriously. The conclusions FINRA reaches will impact how firms are treated in the future. The review is a warning that

these fundamental concerns will be a core part of FINRA's examinations and investigations going forward, and perceived cultural deficiencies will likely justify increased sanctions for other violations.

Firms Can Draw Guidance From the Banking Regulators on Firm Culture

FINRA's new focus on firm culture is consistent with other financial industry regulators, such as the New York Federal Reserve Bank. The banking regulators have been concerned about firm culture for some time. Of course, most large broker-dealers are part of bank holding company structures. If FINRA and the SEC want to remain relevant as functional regulators for securities, they have to be able to speak to the banking regulators in their own language. Many areas of recent SEC and FINRA focus, such as liquidity risk management and stress testing, are borne from this same need to engage with the priorities of the banking regulators.

New York Fed Executive Vice President Alberto G. Musalem gave an important speech on Nov. 23, 2015,[1] about the New York Fed's focus on firm culture in the banking industry over the last several years. "Culture relates to the implicit norms that guide behavior in the absence of regulations or compliance rules — and sometimes despite those explicit restraints. Culture exists within every firm whether it is recognized or ignored, whether it is nurtured or neglected, and whether it is embraced or disavowed."

Musalem stated that the New York Fed's interest in reforming culture came from events since the financial crisis, such as the manipulation of Libor and foreign-exchange rates. He asserted that new laws, regulations and standards have failed to "curb banker misconduct." Rather, the issue is a "narrow cultural focus on short term gains and disregard of broader social consequences," including impacts on consumers, producers, savers and investors. Musalem noted that "[c]ultural problems are the industry's responsibility to solve. The official sector can monitor progress and deliver feedback and recommendations" but banks themselves must reform culture.

Musalem emphasized that culture is as important as liquidity and capital and requires continuous and persistent attention. "The reform of bank culture should aim to restore trust." And until firms do so successfully, the regulators must impose prescriptive rules rather than general standards. In terms later adopted by FINRA, Musalem counseled that firms should beware of dissonant subcultures — "silos" or "tribes." By sharing best practices across the industry, firms might identify common warning signs of problems within subcultures and behaviors that are incompatible with the firm's values. "Certain basic principles — fair treatment of customers and employees, for example — cannot be open to debate."

Regulators are Cracking Down on Individual Culpability as Part of the Focus on Culture

Regulators read their press clippings, and they are acutely aware of the criticism that they did not hold individuals sufficiently accountable after the 2008 financial crisis. An important part of the emphasis on firm culture is targeting individuals who do not comply with the culture.

The Yates Memorandum

On Sept. 9, 2015, Sally Quillian Yates, deputy attorney general of the United States, issued a memorandum, "Individual Accountability for Corporate Wrongdoing." The Yates memo has been widely discussed as a shift for prosecutors to focus on prosecuting individuals related to corporate misconduct. The Yates memo reflects newU.S. Department of Justice guidance — and a nationwide focus — on criminal and civil prosecution of individuals. The Yates memo requires corporations, in order to receive any cooperation credit at all, to provide all relevant facts about individual involvement in corporate misconduct. The Yates memo also prohibits settlements with corporations that protect individuals, and requires prosecutors, when settling with a corporation, to articulate how they will pursue the relevant individuals as well.

Regulators Have Already Began Cracking Down on Individual Chief Compliance Officers

In the last several years, regulators have brought a variety of enforcement actions against compliance officers. Many of these actions deal with the CCO's alleged failure to supervise, particularly for chronic violations of firm policy or standards. All of these should be understood as part of a larger attempt to create a culture of compliance.

Eugene Mason.[2] An investment adviser officer had misappropriated $670,000 from client accounts. The SEC charged the firm's CCO for causing the firm to violate Section 206(4) and Rule 206(4)-7 by failing to implement compliance policies that, if carried out, could have detected the misconduct.

Bartholomew Battista.[3] A prominent national investment adviser's high-performing energy sector portfolio manager founded and personally invested $50 million into his own oil and gas production company, which had a joint venture with the largest holding in the energy portfolio. The firm's CCO allegedly knew of the conflict, but did not force the firm to disclose it, and allegedly did not have sufficient policies or procedures around outside business activities. The SEC charged the CCO for violating Section 206(4) and Rule 206(4)-7 in connection with his failure to ensure that the firm had compliance policies to assess and monitor outside activities of employees and disclose conflicts of interest to fund boards and clients.

Thomas R. Delaney II.[4] An SEC administrative law judge sanctioned a broker-dealer CCO for negligently "causing" the firm's stock loan department to violate the closeout requirements of Reg SHO. The ALJ found that, even though the CCO did not act intentionally or recklessly, the continuous nature of the violations — at least 1,500 violations over two and a half years — makes this "an exponentially more serious matter than one matter in which a compliance office's failure to exercise reasonable care resulted in only one violation."

Thomas E. Haider.[5] The The Financial Crimes Enforcement Network imposed a $1 million civil penalty and industry bar on the chief anti-money laundering (AML) officer of a national money transmitter for failing to design an effective AML program and follow up on red flags, in large part because the AML officer did not believe he could close offices of the firm with unusually high rates of fraud complaints. FinCEN is currently seeking to enforce its penalty in the Southern District of New York.

Some of these cases have been controversial. The SEC investment adviser cases sparked dueling speeches by former SEC Commissioners Daniel Gallagher and Luis Aguilar concerning whether the SEC was inappropriately targeting CCOs for the failings of their business people. But as these cases illustrate, regulators regularly investigate and sometimes charge compliance officers for failing to supervise. This trend, in light of the focus on firm culture, calls for more attention by CCOs to document their firms' ethical culture, how they enforce the culture, and how they identify and manage potential conflicts of interest.

While most firms articulate some cultural values, FINRA has requested that firms provide a level of detail regarding those values that firms may not yet have developed. Responding to this request is a serious exercise that requires the active involvement of executive management, legal and compliance. It requires a firm to provide a detailed description of its core cultural values, not just a one-page mission statement. The firm must measure culture and tie it to individual compensation. A firm that has not received the targeted letter should take this opportunity to assess its culture based on FINRA's questions.

The focus on culture means it may no longer be enough simply to avoid actual violations of laws or rules. Woe to the firm that has emails about "ripping the face off" a counterparty, even if it has no legal duty to that counterparty. And the individuals who regularly fail to follow firm policies may be at risk, even if no legal violations result. For firms, culture may be a one-way, downward ratchet: firms simply are expected to have a good culture, but surely will be sanctioned for bad culture. But for supervisors and CCOs, good-faith, documented efforts to create a compliant culture may help avoid individual sanctions. These distinctions, with the Yates memo, may make it harder for counsel to represent both individuals and firms.

This focus on firm culture is likely to become a primary driver for regulatory and enforcement decisions for the foreseeable future.

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[1] https://www.newyorkfed.org/newsevents/speeches/2015/mus151123

[2] Eugene Mason, IA Rel. No. 4116 (June 15, 2015) (https://www.sec.gov/litigation/admin/2015/ia-4116.pdf)

[3] Bartholomew Battista, IA Rel. No. 4065 (April 20, 2015) (https://www.sec.gov/litigation/admin/2015/ia-4065.pdf)

[4] Thomas R. Delaney II, Init. Decis. Rel. No. 755 (Mar. 18, 2015) (https://www.sec.gov/alj/aljdec/2015/id755jsp.pdf)

[5] Thomas E. Haider, Number 2014-08 (FinCEN December 2014) (https://www.fincen.gov/news_room/ea/files/Haider_Assessment.pdf)

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