Surveillant and Counselor: A Reorientation in Compliance for Financial Firms

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by

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Abstract

This Article argues that the compliance officer should play a major role in the ongoing reform of financial firms because compliance is now well established and accepted and compliance officers are close to decision-making at all levels of a firm. The contention is that the role of compliance must be rethought and reoriented if it is to contribute fully to the reform. Compliance officers now ensure that the firms and their employees comply with the numerous laws and regulations governing them and their activities, primarily by producing detailed compliance procedures and policies and then revising, and monitoring compliance with, them. The policies and procedures direct the conduct of employees by surrounding them with a web of detailed instructions, procedures, supervisory review, reporting, oversight and investigation, where necessary. This approach, which is based on a well-established “external” model of direction, discipline and surveillance, is necessary to prevent self-interested and opportunistic conduct by financial firm employees. However, there is a risk that employees follow only the letter of compliance and even at times ignore it because they understand that the rules are different from, and necessarily secondary to, the actual securities business. Moreover, the external approach “crowds out” another model that is necessary to achieve the most effective compliance. Ideal financial firm compliance would promote “internal,” in addition to external, compliance. The goal of the internal approach is to have firm employees internalize the policies of the laws and regulations and the professional and ethical standards so that they come into the foreground when the employees are making business decisions. In psychological terms, the internal model of compliance would ensure that the policies and standards do not “fade” in employee decision-making. Thus, rather than being only a transcriber of rules and monitor of their enforcement, a compliance officer would be an educator about policies, standards and the appropriate firm and industry culture and an advisor and counselor concerning how they should inform daily employee decisions.

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I. Introduction

In the regulatory reform in response to the financial crisis of 2007-2008, a key participant is the compliance officer, whose basic task is to ensure that a financial firm and its employees comply with applicable laws and regulations. The compliance officer typically occupies a middle, and sometimes difficult, position between business and regulation. On the one hand, the officer does not engage in the firm’s business, but belongs to one of its oversight functions, like accounting, internal control and legal. As a result, those involved in the business, such as investment bankers, brokers and investment advisors, may look upon a compliance officer as not being productive and even as an impediment to business. On the other hand, the compliance officer is not a regulator or an official of a self-regulatory organization (“SRO”), ¹ although he or she may often have spent part of his or her career with the Securities Exchange Commission (“SEC”) or the Financial Industry Regulatory Authority (“FINRA”).² He or she thus does not have the complete independence from the securities business that comes with the government or self-regulatory role. However, regulators often expect that compliance officers are in fact their “eyes and ears” in the financial firm.

This Article argues that the compliance officer should play a major role in the ongoing reform of the regulation of financial firms because compliance is now well established and accepted (even if occasionally resented) in financial firms and compliance officers are close to decision-making at all levels of a firm. The contention of this Article is that the role of

¹ Self-regulatory organizations are essentially organizations of financial professionals or markets authorized under federal securities laws to regulate their own participants, with this regulation subject to the oversight of the Securities and Exchange Commission (the “SEC”). See 15 U.S.C. § 78c(a)(26).
² FINRA, which is a union of the former self-regulatory arms of the National Association of Securities Dealers (“NASD”) and the New York Stock Exchange (“NYSE”), is a registered securities association under Section 15A of the Securities Exchange Act of 1934 (the “Exchange Act”), 15 U.S.C. § 78o-3. On the movement of people between financial regulators and the financial industry, see PROJECT ON GOVERNMENT OVERSIGHT, DANGEROUS LIAISONS: REVOLVING DOOR AT SEC CREATES RISK OF REGULATORY CAPTURE 2 (Feb. 11, 2013) (“The movement of people to and from the financial industry is a key feature of the SEC, and it has the potential to influence the agency’s culture and values). But see David Zaring, “Against Being Against the Revolving Door” (Mar. 29, 2013 draft), available at <http:www.ssrn.com> (questioning the criticism of this phenomenon).
compliance must be rethought and reoriented if it is to contribute fully to the reform. Compliance officers now ensure that the firms and their employees comply with the numerous laws and regulations governing them and their activities, primarily by producing detailed compliance procedures and policies and then by revising, and monitoring compliance with, them.\(^3\) The policies and procedures direct the conduct of employees by surrounding them with a web of detailed instructions, procedures, supervisory review, reporting, oversight and investigation, where necessary. This approach, which is based on a well-established “external” model of direction, discipline and surveillance, is necessary to prevent self-interested and opportunistic conduct by financial firm employees. Certainly, when individuals are told what to do and know that they are being watched, their misconduct is checked and thus reduced.\(^4\) Indeed, in a theoretical sense, the most effective disciplinary system would be to have a compliance officer everywhere, scrutinizing and reviewing every client interaction and client transaction. However, this approach is impossible in the real world, given resource constraints in firms.

There are other, even more significant, problems with the external approach to compliance. The imposition of detailed rules of conduct with compliance officers enforcing them reinforces the distinction between the business of the firm, on the one hand, and law and regulation, on the other. Under this model of compliance, the securities business becomes the world of profit-making through talent, discretion and effort, whereas compliance restricts this creativity and profitability through its rules, procedures and monitoring. It is true that the rules have become ingrained into the securities business and the Chief Compliance Officer (“CCO”), which is required by regulation, has become a significant position that is part of management.\(^5\) However, there is a risk that employees follow only the letter of compliance and even at times ignore it, albeit at their peril, for, even in the routines of their business, they understand that the rules are different from, and necessarily secondary to, the actual securities business. Moreover, compliance officers monitor that employees fulfill the obligations imposed by securities laws and regulations, as well as SRO rules, and they investigate and report violations of them, which can lead to criminal or civil enforcement by the Justice Department (“DOJ”), the SEC and FINRA.\(^6\) In these situations, compliance becomes part of enforcement and prosecution, which further distances compliance officers from other firm employees, who see them as threatening their livelihood and even their liberty.

A significant problem with the external approach is that it “crowds out” another model that is necessary to achieve the most effective compliance. The contention here is that the ideal financial firm compliance orientation would promote internal, in addition to external, compliance. The goal of the internal approach is to have firm employees internalize the policies of the laws and regulations and the professional and ethical standards so that they come into the foreground when the employees are making business decisions. In psychological terms, the internal model of compliance would ensure that the policies and standards do not “fade” in employee decision-making, which fading could occur even when firm employees are outwardly

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3 See infra subpart II.B.
5 See infra text accompanying notes 45 to 66 (discussing FINRA Rule 3013).
6 See infra subpart III.A.
following compliance procedures because other concerns influence their decision-making.\(^7\) Thus, this internal approach means that compliance would come from within the employee and be part of his or her mindset and personal identity. Rather than being a transcriber of rules and monitor of their enforcement, a compliance officer would be an educator about policies, standards and the appropriate firm and industry culture and an advisor and counselor concerning how they can be applied in daily employee decisions in the firm.

This reorientation of financial firm compliance to develop internal compliance is critical for the continued growth and development of finance. Finance allows capital to move to its best use and to address, through new financial products, risks facing all of us.\(^8\) The financial system appears to work best when entrepreneurs and financial institutions can compete with their various products and services, with the inevitable successes and failures. In the last thirty years, however, financial firms have perverted this system by creating great wealth for their employees and owners, and even a financial oligarchy in this country, and by externalizing and socializing the risks of their failure.\(^9\) They have also created and sold certain products with little social value in order to enrich themselves, or their favored partners, at the expense of the less initiated.\(^10\)

This situation in finance culminated in the 2007-2008 financial crisis, which started at the margins of finance with subprime lending done by unregulated financial firms, an activity that was then taken up by major financial institutions attracted by its profitability. They in turn spread subprime-loan based securities throughout the financial system.\(^11\) In the worst financial crisis in modern memory, many of the large financial firms failed or had to be rescued by the government; indeed the financial system nearly collapsed.\(^12\) The collapse disrupted the essential back-and-forth flow of resources from investors to capital raisers, with the result that the federal government had to provide funds to financial institutions and market participants.\(^13\) The ensuing downturn in the economy created social and political unrest, when the unemployed and the underemployed were discontented with, and correctly looked to blame financial firms for, their

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\(^10\) See generally Sheila Bair, *Bull By The Horns: Fighting to Save Main Street from Wall Street and Wall Street From Itself* 52-57 (2012) (discussing the mortgage-based products sold before the crisis).


\(^12\) For a chronology of the financial crisis, see The Panic of 2008: Causes, Consequences and Implications for Reform 22-35 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr., eds.). For a vivid, journalistic review of it, see generally Andrew Ross Sorkin, *Too Big To Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System from Crisis—and Themselves* (2009).

difficult situation.\textsuperscript{14} In reaction, Congress produced the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), and regulators have issued voluminous regulations based on it.\textsuperscript{15} Not surprisingly, the creation of new financial regulators,\textsuperscript{16} or new offices within existing ones,\textsuperscript{17} accompanied this growth in law and regulation. SROs, particularly FINRA, enhanced their own regulatory and enforcement capabilities as well.\textsuperscript{18} This resulted in an enormous amount of regulation being placed on financial firms. But if legislators, regulators and SROs keep adding regulatory and thus compliance burdens upon them, the firms will lose their flexibility or, at worse, will collapse under the very weight of these rules, and the financial sector will thus lose its diversity and competitiveness that allow it to supply its benefits.

Highly visible, well functioning compliance, which helps firm employees make decisions animated by legal policies and professional and ethical standards, could save finance from this fate. It could convince legislators, regulators and, most important of all, the public that financial firms are dedicated to a public mission and not simply in the business for their employees’ self-interest. Financial firms would thus need fewer rules of conduct.\textsuperscript{19} Moreover, a compliance approach that changes the perspective of firm employees so that they consider policies behind the rules, which include the long-term stability of the financial system and customer confidence in the markets, would help employees understand the potential dangers of certain financial products and services. It could have the added virtue of preventing the loss of investor and


\textsuperscript{15} See Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010). This Act and its regulations will be discussed from time to time in the Article. Among other things, this law brought within regulation activities, like swaps, and market participants, like hedge fund advisors, that had previously been unregulated, and it changed, such as through the controversial “Volcker Rule,” how financial firms conducted their business. Title VII of Dodd-Frank regulated swap markets and swap market participants; Section 403 of Title IV of Dodd-Frank eliminated, by amending 15 U.S.C. § 80b-3(b), an exemption from regulation as an investment adviser that hedge fund advisers traditionally relied upon; and the “Volcker Rule”, Section 619 of Title VI (codified at 12 U.S.C. § 1851) prohibits bank holding companies, banks and their affiliates and subsidiaries from engaging in proprietary trading, or sponsoring or investing in hedge or private equity funds, subject to certain controversial exceptions.

\textsuperscript{16} Dodd-Frank, for example, created the Financial Stability Oversight Council (“FSOC”), which is designed, among other things, to monitor the overall soundness of the financial system. See Sections 111, 112 of Title I of Dodd-Frank, codified at 12 U.S.C. §§ 5321-22. More controversially, the Consumer Financial Protection Bureau was created within the Board of Governors of the Federal Reserve System (the “Federal Reserve”) to regulate financial products and services from a consumer protection perspective. See Sections 1011 and 1021 of Title X of Dodd-Frank, codified at 12 U.S.C. §§ 5491, 5511.

\textsuperscript{17} For example, the SEC created a new Division of Economic and Risk Analysis in 2009 “to integrate financial economics and rigorous data analytics into the core missions of the SEC.” See <http://www.sec.gov/divisions/riskfin.shtml> (visited Aug. 16, 2013).

\textsuperscript{18} For a discussion of several FINRA actions following the crisis, see FINRA, 2008 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT: REFORMING REGULATION TO BETTER PROTECT INVESTORS 5 2009 (letter of FINRA CEO, Richard G. Ketchum).

\textsuperscript{19} Other reforms, such as a change in business school education, would be useful, but they are outside the scope of the Article. See, e.g., Robert Giacalone & Mark Promislo, Broken When Entering: The Stigmatization of Goodness and Business Ethics Education, 12 ACAD. MGT. LEARNING & EDUC. 86 (2013) (explaining how many business students have been taught to belittle and to espouse materialistic values, before they enter business schools).
public confidence in the financial markets and, perhaps, the recurrence of the kind of risks that threaten the entire financial system.20

The Article proceeds as follows. Part II provides a brief history of compliance in broker-dealers21 and its growth in importance over recent years as laws and regulations affecting these firms have increased. This Part then discusses the role and functions of the typical compliance department, generally as the producer, the administrator and enforcer of firm rules reflecting this ever-growing number of laws, regulations and professional standards. Part III first offers an account of the origins of the current “external” compliance orientation, which is based upon employee control and monitoring. This orientation is designed to dictate in detail the conduct of a broker and to surround him or her with a web of oversight, so as to make the broker both productive and disciplined. The Part relies here on historical scholarship on the origin and purpose of this disciplinary approach. The Part acknowledges that this approach contributes to compliance, for it constrains employees to act in accordance with the law and checks their misconduct through its monitoring.

The Part then uses social psychological and organizational research to point to several problems with external compliance. One problem is that, as noted above, its heavily rule- and procedure-based orientation may lead it to become a routine, which may cause firm employees to act in accordance with the form, not the spirit, of the rules and standards. Moreover, although compliance with the law has become ingrained in the conduct of the securities business, the external approach inevitably makes brokers think of compliance as secondary in importance to that business, particularly since a firm must leave considerable discretion to its employees in their dealings with clients. Thus, in the worst cases, this kind of compliance can be ignored or gamed, which, in a perverse way, contributes to illegal and unethical practices in these organizations. More significantly, it crowds out other approaches to compliance, particularly the internal one, for individuals meeting external compliance requirements may feel not need to understand, and to be motivated by, the legal policies and ethical standards underlying the requirements. The Part then observes that, although regulators and SROs advocate a compliance orientation that encourages conduct in accordance with legal policies and professional standards, the “culture of compliance,” they constantly reinforce the model of all encompassing external control over firm employees.

Part III next observes that there were many cases of failure of compliance in the financial crisis, for illegal and unethical practices occurred in firms with robust external compliance. This

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20 This is systemic risk, which is simply a risk to the entire financial system. See LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS 156 (4th ed. 2011). The kinds of problems that lead to systemic risk may arise slowly and from the ground up. The financial crisis was a long time coming and the problems in the financial system that led to it were apparent to many before it emerged. Thus, systemic and other massive disasters are not always due to unexpected, unforeseeable events, popularly known as “black swans,” defined by Nassim Taleb as events that are outside the realm of expectation, with a large impact, that generate an after-the-fact explanation. See NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE xvii-xviii (2007).

21 In the interest of keeping the discussion manageable, the Article focuses on compliance only in firms regulated as broker-dealers under the Exchange Act, 15 U.S.C. § 78o, and by FINRA, which is the SRO for them. A broker-dealer typically conducts both the functions of a “broker,” which acts as an agent for others in securities transactions, 15 U.S.C. § 78c(a)(5), and a “dealer,” which generally is in the business of making markets in securities, 15 U.S.C. § 78c(a)(5). However, this analysis could apply equally to compliance in other financial intermediaries, such as registered investment advisers.
suggests that the external compliance model has serious limitations. Yet reforms following the crisis have reinforced the external approach and even expanded the mission of compliance, by adding to the laws and rules it must translate into firm procedures, by enhancing regulatory examinations and by extending the external control model to other financial institutions. This Part emphasizes how this increase in compliance burdens on financial firms may smother them to the point where they lose the flexibility and capacity for innovation that is the hallmark of a beneficial finance.

Part IV offers a reorientation in the compliance approach: compliance must be transformed so as to downplay, but maintain, the external perspective and to reemphasize an internal approach that promotes the goals, policies, and standards of the federal securities laws and the broker-dealer profession in employee decision-making. The goal of compliance and compliance officers would be to change the decision framework of brokers so that they would consider the goals, policies and standards in their business activities. In a word, the compliance officer would become an advisor and counselor to the firm, reminding brokers and other firm employees of their public responsibilities. This approach finds support in current social psychological and organizational research on ethical and pro-social decision-making.22 The Part reviews ways in which compliance officers can promote this internal compliance and also contends that this changed emphasis requires the assistance of FINRA and the SEC. It recognizes that FINRA and SEC would resist this change, which differs from their established approach and which risks making them appear to be soft towards the securities industry. The Part then discusses, as a way to overcome their resistance to the reorientation, how the success of the internal approach could be assessed and measured in a multi-year pilot program. It recommends that FINRA propose the reorientation in new supplementary material to an existing supervisory rule, which will provide the reorientation with express regulatory authority, as well as allow potential problems with the approach to be elicited. The Part concludes by discussing ways that FINRA and the SEC could promote internal compliance and by making several suggestions about how FINRA and the SEC could lessen the enforcement role of compliance, which is an impediment to the internal approach. Part V concludes.

II. The History and Present Configuration of Compliance

A. The History of Compliance in Broker-Dealers

The current state of compliance in broker-dealers is to a great extent a product of the federal securities laws in that it grew directly out of a broker-dealer’s supervisory obligations over its personnel.23 Compliance means that a broker-dealer and its employees must conduct their business in accordance with their legal, regulatory and professional obligations, which generally, but not exclusively, arise under federal securities laws and regulations and FINRA rules. Section 15(b)(4)(D) of the Exchange Act empowers the SEC to discipline a broker-dealer for, among other things, the willful violation of, or the inability to comply with, the federal

22 See infra subpart IV.A.
23 The focus here is on the industry-specific origins of compliance within broker-dealers. These compliance systems have been influenced and shaped as well by factors leading to compliance in business (particularly publicly traded) firms. These systems are the subject of a rich scholarly literature. See generally Miriam Baer, Governing Corporate Compliance, 50 B.C. L. REV. 949, 958-75 & accompanying notes (2009) (discussing origins of corporate compliance and referencing much of the significant contributions to this literature).
securities laws or their regulations by the broker-dealer itself or by any person associated with such broker-dealer. This means that, if an employee of a broker-dealer willfully violates the securities laws or regulations, the broker-dealer is subject to SEC discipline under the statutory provision, which could include suspension of its registration for up to twelve months or the “death sentence” of revocation of its registration. In addition to this statute, as enforcer of the federal securities laws the SEC also historically used the common law doctrine of respondeat superior to make a firm responsible for the acts of its employees engaged in the securities business. Accordingly, the statute, together with the common law obligation, gives broker-dealers an incentive to supervise their employees to ensure that they comply with applicable laws and regulations. Supervisors and employees need to know what compliance with the laws and regulations entails so that compliance and the accompanying supervision can be properly done. The compliance function or department of a broker-dealer accomplishes this task.

Section 15(b)(4)(D) proved to be inadequate for the SEC’s enforcement of legal compliance by broker-dealers and their employees. By its terms, the provision allows the SEC to discipline only the firm, not the violating employee. Moreover, it does not provide for discipline of firm supervisors who failed to prevent the violations. The Securities Acts Amendments of 1964 remedied these problems, and they thus enhanced supervision and gave a major impetus to compliance, by adding Sections 15(b)(4)(E) and 15(b)(6). Under Section 15(b)(4)(E), a broker-dealer is subject to sanctions if, among other things, it or an associated person willfully aided or abetted a federal securities law or rule violation or “failed reasonably to supervise, with a view to preventing” such violation, another person who committed the violation. This amendment makes the broker-dealer explicitly liable for its own, and its associated persons’, supervisory violations. Furthermore, Section 15(b)(6) provides for SEC discipline of the associated person who, among other things, willfully aids and abets a violation of the federal securities laws or who commits a supervisory violation. Under this latter section the SEC can discipline branch managers and other supervisors in a broker-dealer for their failure to supervise employees under their authority. These statutory additions reinforced the need for a firm function (i.e., compliance) that would assist individual supervisors, who now had personal supervisory liability, in fulfilling their supervisory obligations. Moreover, since these provisions gave further enforcement powers to the SEC, compliance had strong enforcement origins, which has influenced its orientation, as discussed later below.

24 See 15 U.S.C. § 78o(b)(4)(D). “Associated person” is defined in Section 3(a)(18) of the Exchange Act to include the following:

any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer...

15 U.S.C. § 78c(a)(18). This definition sweeps in all those who engage in the securities business in a broker-dealer, as well as controlling persons, but excludes clerical and ministerial employees.

25 See generally Task Force on Broker-Dealer Supervision and Compliance of the Committee on Federal Regulation of Securities, Broker-Dealer Supervision of Registered Representatives and Branch Office Operations, 44 BUS. LAW. 1361, 1363-64 (1989) (discussing the SEC’s initial legal theories for imposing supervisory liability upon broker-dealers).


Section 15(b)(4)(E) provides both the firm and, through Section 15(b)(6), firm supervisors with defenses to a charge of supervisory liability. It states that no person “shall be deemed to have failed reasonably to supervise any other person” if, first, there were “established procedures and a system for applying” them, “which would reasonably be expected to prevent and to detect, insofar as practicable,” any securities law violations by the supervised person.29 It further stipulates that the supervisor has “reasonably” to discharge the duties under the procedures and system “without reasonable cause to believe” that these procedures and system were not being complied with.30 This means that, to offer this statutory defense, a firm has to have well drafted supervisory procedures for ensuring that the firm and all its employees comply with securities laws and regulations as well as a system, which implies the resources and responsible people, to implement these procedures. Moreover, the firm and its supervisors have to demonstrate that they fulfilled their responsibilities under these procedures and system and, therefore, that the procedures and system were not simply “window dressing.”

This statutory defense to an SEC charge of failure to supervise is clearly a roadmap for the growth of compliance, since there would have to be a firm department or group—compliance—that would be responsible for drafting the supervisory procedures and assisting in the implementation of the supervisory system. Moreover, compliance officers would be critical in ensuring that the last prong of the statutory defense was satisfied. They would ensure that the procedures and the system were being followed. This would be accomplished through their monitoring for legal compliance and following up on any problem or potential problem (know in the trade as a “red flag”)31 that surfaced in a firm, which could suggest a legal violation and thus potentially a supervisory one. In sum, a firm had to have a compliance department, or at least a compliance officer, devoted to creating a well-functioning supervisory system to take advantage of the statutory defense, which was critical now that the firm and its top employees faced explicit supervisory liability.

The SEC in fact used its interpretation of a firm’s supervisory obligations under Section 15(b)(4)(E), as well as of the statutory defense, to push for the development of compliance, often through its opinions issued in administrative proceedings.32 In these cases, it found that securities law violations occurring in a broker-dealer indicated that the firm and its supervisors had failed in their supervisory duties by not having an adequate compliance function.33 As a

31 A “red flag” is an unusual event or practice that could be a sign of a securities violation and, therefore, that must be monitored or investigated. See, e.g., FINRA, Unauthorized Proprietary Trading, Reg. Notice No. 08-18 3-4 (Apr. 2008) (identifying “red flags” for improper conduct by proprietary traders in firms); In re John H. Gutfreund, et al., Exchange Act Release No. 31,554, 52 S.E.C. Docket 2849, 1992 WL 362753 (Dec. 3, 1992) at *12 (“red flags” are “‘suggestions’ or irregularity”). So ingrained is this notion in brokerage culture that parties engaging in inappropriate conduct and attempting to avoid detection state that they do not want their conduct to raise any “red flags”! See In re Guggenheim Sec., LLC, FINRA Letter of Acceptance, Waiver and Consent No. 20100226640003 6 (Oct. 11, 2012) (traders hiding improper transactions write the following email: “‘this is not about the money, but really about not raising any more red flags on a settlement that already caused so much trouble for everyone.’”). See generally Barak Orbach, “Red Flags” (July 5, 2013), available at <http:/www.ssrn.com> (discussing the “red flag” phenomenon and the legal responses to it).
32 The SEC can bring actions against regulated firms, such as broker-dealers, in its own administrative proceedings before administrative law judges, whose decisions the SEC itself can review. See 15 U.S.C. § 78u-2. On the rules governing the proceedings, see 17 C.F.R. §§ 201.200-490 (2013).
result of the proceedings, the SEC required a prosecuted firm to expand its compliance department, and this outcome became in turn a model for other firms. In this vein, a major SEC goal was to have broker-dealers with a compliance department with adequate staff whose size was proportional to the size of the firm and the growth and complexity of the firm’s activities. In this way, the compliance function would be able to oversee each part of the firm’s business. Moreover, the SEC demanded that compliance officers have autonomy within the firm: they would have their own reporting structure and lines of authority apart from those of the firm’s business. They also needed the power to report their concerns about problems in transactions and new business development to senior firm decision-makers and to have the supervisors explicitly address them.

The SEC might especially make this point if the firm had expanded its product offerings or entered into new business lines without similarly expanding compliance. See, e.g., Prudential Sec., Inc., Exchange Act Release No. 33,082, 55 S.E.C. Docket 624 (Oct. 21, 1993), 1993 WL 430273, at *10 (in this case, the broker-dealer entered into the sale of limited partnership interests, which activity was not adequately supervised). For a recent example, see In re TD Ameritrade, Inc., Exchange Act Release No. 63,829 (Feb. 3, 2011), available at <http://www.sec.gov> (discussing supervisory and compliance failures in the firm’s marketing of a new fund that was misrepresented in the sales process as a money market fund).

For example, in the Prudential administrative proceedings, the SEC insisted that this broker-dealer have regional compliance directors, who would report to the chief compliance officer, in specific regions where Prudential had branches. See Exchange Act Release No. 33,082, supra note 33, at *27.

See Prudential-Bache Sec. Inc., Exchange Act Release No. 22,755, supra note 38 (faulting firm for failing to follow directions of compliance as to dismissal of rogue brokers). These SEC administrative decisions also raise an important issue about the relationship between supervision and compliance that has not been definitively resolved. Supervision refers to the power of one person over another in a firm’s chain of command, which includes, as discussed above, the obligation to ensure that the supervised employee complies with securities laws and regulations. It is often typified by the power of the supervisor to control the actions of, and ultimately to dismiss, an employee. See Arthur James Huff, Exchange Act Release No. 29,017, 1991 WL 296561, at *9 (Mar. 28, 1991). In a seminal SEC decision on this subject, In re John H. Gutfreund, et al., Exchange Act Release No. 31,554, 52 S.E.C. Docket 2849, 1992 WL 362753 (Dec. 3, 1992), the SEC made the following observation in the context of discussing the supervisory responsibilities of legal and compliance officers, which offers a broader view than the control standard:

Employees of brokerage firms who have legal or compliance responsibilities do not become “supervisors” for purposes of Sections 15(b)(4)(E) and 15(b)(6) solely because they occupy those positions. Rather, determining if a particular person is a “supervisor” depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.

Id. at *15. Compliance in a broker-dealer is not, without more, part of the supervisory structure and a compliance officer is not a supervisor, again without more facts, such as that a compliance officer has additional, business line responsibilities. Rather, as explained above, compliance makes effective supervision possible. Compliance officers are not themselves supervisors because they do not hire and fire employees, tell them what to do or make disciplinary decisions when a violation is found—they are for the supervisors. However, the SEC has held that, once a compliance or legal officer has a sufficient position of influence within a firm, he or she may have the responsibility, with other supervisors, for taking appropriate action in response to misconduct. This action could include, in extreme circumstances such as when the main supervisors do not adequately respond to the misconduct, escalating the matter to the board of directors, resigning or reporting the problem to regulatory authorities. See id. at *16.

This issue has recently come to the forefront mainly because of a case involving a disciplinary action involving a general counsel who was also the CCO of a broker-dealer. See In re Theodore W. Urban, SEC Initial Decision Release No. 402 (Sept. 8, 2010). In that case, Urban attempted to take action against a rogue broker, who engaged in numerous legal violations, including unauthorized trading in client accounts and doing trades for a stock
Similarly, SRO supervisory requirements significantly spurred the growth of compliance in firms. The Exchange Act requires SROs to enforce among their members compliance with federal securities laws and regulations, as well as their own rules, and to have rules designed to “prevent fraudulent and manipulative acts and practices, [and] to promote just and equitable principles of trade.” To achieve these purposes, the NYSE and the NASD (FINRA’s predecessor), as well as other SROs, required their members to have a supervisory system in place to ensure that their associated persons were properly supervised so as to comply with the law and rules. Over the years, the SRO requirements for supervisory systems became extremely detailed. FINRA now requires each of its members to have “a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance” with securities laws and regulations and FINRA rules.

Among other things, the system requires a broker-dealer to have written procedures for the supervision (written supervisory procedures or “WSPs”) of each of its securities businesses and associated persons, to designate supervisors for each regulated business, to have annual compliance reviews for each registered representative and principal, to have internal inspections of all offices, to have a principal review the transactions and

\[\text{Urban urged that the broker be dismissed, but he was overruled by the head of retail sales who agreed to supervise him personally. The broker ultimately left the firm in the wake of numerous customer problems that resulted in a significant financial loss to the broker-dealer. Urban was charged with a supervisory violation. The SEC took the position on supervision that was broader than the two traditional theories of “control” and “affect,” since it would find supervisory liability when a person, such as a compliance officer, has “authority” in the firm, i.e., is listened to. See id., at 46. The administrative law judge ruled that he was in fact a supervisor, but that he had fulfilled his supervisory responsibilities. At the urging of the Enforcement Division, the SEC declined to affirm summarily the judge’s ruling, stating, among other things, that it needed to consider whether it was enough for Urban to report problems to the supervisor of the broker or whether he should have escalated the matter to the firm’s chief executive officer and its board of directors. See In re Theodore W. Urban, SEC Admin. Proc. File No. 3-13655 (Dec. 7, 2010). Eventually, the SEC dismissed the proceedings because, with three members recusing themselves, the other two split on the decision. See In re Theodore W. Urban, SEC Admin. Proc. File No. 3-13655 (Jan. 26, 2012). The case raised concern among practitioners that compliance officers were being inappropriately pulled into the supervisory structure of a firm. See, e.g., David C. Prince, NSCP Files Amicus Brief with SEC in Theodore W. Urban Case, NSCP CURRENTS 1 (Nov./Dec. 2010) (discussing position of the National Society of Compliance Professionals on this case).

\text{The then NASD required in Article III Section 27 of its Rules of Fair Practice written supervisory procedures to ensure the supervision of each associated person. In 1989, the Section was expanded to include assignment of each associated person to the supervision of a principal, an annual compliance review and special characterization of certain offices (Offices of Supervisory Jurisdiction or “OSJs”) where major client activities are conducted. See generally Task Force on Broker-Dealer Supervision and Compliance, supra note 25, 44 BUS. LAW., at 1389-94 (for a summary of these rules).

\text{“Principals” are associated persons “who are actively engaged in the management of the member’s investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions are designated as principals.” See NASD Rule 1021(b). As a result of the consolidation of the NASD and the regulatory arm of the NYSE, a new FINRA rulebook, combining the rules of each of these SROs, is being prepared and implemented. Therefore, current FINRA rules include some NASD rules, some NYSE rules (which apply only to broker-dealers formerly regulated by the NYSE) and the new FINRA rules.

\text{See NASD Rule 3010(a). FINRA has issued a rule proposal to create a new FINRA Rule 3110 to replace NASD Rule 3010. See Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, Exchange Act Release No. 69902, 78 Fed. Reg. 40,792 (July 8, 2013).} \]
correspondence with the public of registered representatives relating to their securities business and to investigate the character and qualifications of any associated person. In other words, while the duty of supervision under the Exchange Act is general, as one would expect in the foundational statute, the FINRA supervisory requirements are both general and detailed. Indeed, since FINRA rules govern each securities business activity and generally dictate how it is to be conducted in accordance with the law, nearly every FINRA rule has supervisory and, therefore, compliance implications. Since the number of FINRA rules grows, or the rules are modified, each year as firms develop new businesses and products and as new legal obligations are imposed upon them, the rules reinforce the need for a broker-dealer to have a division or group of employees—in other words, compliance—who can keep track of all of the legal and regulatory duties of the firm and associated persons and who can help the firm’s employees satisfy their obligations, and the supervisors their supervisory duties, through guidance, monitoring and follow-up. Moreover, as in the case of the SEC, a broker-dealer needs to have compliance to help establish supervisory procedures in order to avoid a FINRA charge of failure to supervise, if a violation occurs in the firm. Yet, as discussed above, the FINRA supervisory procedures are part of an independent, positive duty of a broker-dealer; in their origin, they did not come into existence as a defense to a potential enforcement action.

SRO supervisory rules promulgated in reaction to scandals in the brokerage industry gave yet an additional impetus to the growth of compliance. As a result of a notable failure of supervision by numerous broker-dealers, where, undetected, a broker misappropriated over $100 million in customer money for over 15 years, in 2004 the SROs issued two compliance-related rules. To use the FINRA example, NASD Rule 3012 requires that a firm 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. Under the Rule, the responsible principal or principals 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. This kind of supervisory control system

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40 See NASD Rule 3010(a)-(e).
41 A good example is FINRA’s recently promulgated suitability rule, FINRA Rule 2111. See FINRA, Know your Customer and Suitability, REG. NOTICE No. 11-02 (Jan. 2011) (announcing SEC approval of the new rule and discussing it and its difference with the earlier NASD version). Suitability is essentially a duty imposed on a broker when he or she recommends an investment product or (under the new rule) an investment strategy to a customer. Under the rule, a broker must understand what he or she is recommending (known as “reasonable-basis suitability”) and make a determination that the product or strategy is suitable for a particular client (“customer-specific suitability”). See FINRA Rule 2111.05. Compliance of course must lay out the steps for a broker as to how he or she satisfies the suitability requirement and how a supervisor reviews a broker’s transactions to see that he or she in fact satisfied these requirements for a given recommendation.
43 See NASD Rule 3012(a)(1). FINRA is proposing to replace NASD Rule 3012 by FINRA Rule 3120. See supra note 39.
44 See NASD Rule 3012(a)(1). At a minimum, the controls must cover (i) customer account activity conducted by branch office managers and other supervisors, (ii) customer account activity, such as the transmittal of funds or securities, address changes, changes of investment objectives, and (iii) heightened supervision of certain “producing managers” who generate a significant portion of the revenue of a particular business unit. See NASD Rule 3012(a)(2).
and related testing procedure clearly increased the demand for compliance specialists who understood supervisory and compliance systems, weaknesses in them and industry developments with respect to their improvement. Even more specifically for promoting compliance, NASD Rule 3013 (now FINRA Rule 3130) requires a firm to appoint at least one chief compliance officer (“CCO”). 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. This rule is both a regulatory acknowledgment of the importance of compliance and an effort to increase its visibility and authority in broker-dealers.

The Exchange Act requirements and SRO rules thus helped ensure that compliance became a specialized occupation within financial firms. Compliance duties initially were often done by firm supervisors, aided by in-house lawyers and outside counsel. However, not surprisingly, compliance became an increasingly specialized occupation, particularly in larger firms, as the SEC and the SROs pushed them to have a compliance function that reflected their size and activities. The increase in and complexity of financial activities done by larger firms and the accompanying growth in laws and regulations relating to them meant that firm supervisors could no longer stay current with all of the legal, regulatory and SRO responsibilities of their firm and associated persons. They thus had to create and then to rely upon a specialized group within the firm, the compliance department, whose officers could devote their time and efforts to producing and updating supervisory and compliance procedures and to ensuring that a firm and its employees operated in accordance with law and regulation and that the supervisors satisfied their supervisory obligations. This meant that, as mentioned above and discussed further below, compliance officers would produce the WSPs dictating how an activity should be conducted, would implement them and would then monitor the firm to see that they were followed.

Since under FINRA rules every firm must have a CCO, the number of brokerage employees now engaged primarily in compliance is, at a minimum, equal to the number of firms. Larger firms are likely to have more compliance officers because their businesses are

45 See NASD, Annual Compliance Certification and Designation of Chief Compliance Officer, Notice to Members 04-79, 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.”).
46 See FINRA Rule 3130(b). The Rule provides a “model” certification for the CEO. See FINRA Rule 3130(c).
47 See generally SECURITIES INDUSTRY ASS’N:  LEGAL & COMPLIANCE DIVISION, WHITE PAPER ON THE ROLE OF COMPLIANCE 1 (Oct. 2005). This compliance model, in fact, is still found in small broker-dealers, which operate with fewer resources than do large firms and where, for cost reasons, firm supervisors and other employees often wear multiple hats, including that of the CCO. See id., at 2-3 (discussing different compliance needs and structure of small firms). Smaller firms may also “outsource” some of their compliance tasks.
49 There is different data on the number of broker-dealers. According to FINRA statistics, which are the most recent, as of July 2013, there are 4,277 member firms, with 162,397 branch offices and 630,650 registered representatives. See FINRA Statistics, <http://www.finra.org/Newsroom/Statistics/> (visited Aug. 16, 2013). As of the end of 2011, the SEC put the number of broker-dealers at 4,708.
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the position of compliance officer or CCO in smaller firms have other jobs and do not devote themselves fulltime to

<http://www.sifma.org>. Approximately a third of employees in the securities industry works in the tri-state area of

New York City area. See

SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 17-18 (discussing the various
compliance structures used).

2 For a description of compliance at Goldman Sachs, see <http://www.goldmansachs.com/careers/why-goldman-

the position of compliance officer or CCO in smaller firms have other jobs and do not devote themselves fulltime to
compliance. See NATIONAL REGULATORY SERVICES, COMPLIANCE COMPENSATION STUDY 5 (2011) (reporting that
even CCOs in major firms spend only half of their time on compliance).

51 See generally SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 17-18 (discussing the various
compliance structures used).

52 See id. If they do so, they should not be under the authority of a branch manager or of a principal in charge of a
business line, but should be reporting to the CCO. See id. at 4.

53 See generally INSTITUTE FOR INTERNATIONAL FINANCE & OLIVER WYMAN, COMPENSATION REFORM IN
WHOLESALE BANKING 2011: ASSESSING THREE YEARS OF PROGRESS 11-12 (Oct. 2011) (describing survey results
of compensation practices in large financial firms for compliance and other control functions). The author was on
the working group assisting in the preparation of this report. Although there is not extensive information available
about compliance compensation, see generally NATIONAL REGULATORY SERVICES, COMPLIANCE COMPENSATION
STUDY, supra note 50, at 5 (providing general survey data on compliance compensation); SOCIETY OF CORPORATE
(indicating average compensation for CCOs in financial services to be approximately $165,000); see also BUREAU
OF LABOR STATISTICS, OCCUPATIONAL EMPLOYMENT STATISTICS, OCCUPATIONAL EMPLOYMENT AND WAGES MAY
2011, 13-1041 COMPLIANCE OFFICERS (reporting the mean annual wage of compliance officers in other financial
services as $83,850), available at www.bls.gov/oes/current/oes131041.htm. The data shows that it is less than
compensation for bankers and brokers, but that the gap has diminished as compensation for compliance officers has
As compliance has become a specialized role, it has taken on the expected features of a professional undertaking, which reinforces its specialization. Traditional individuals learned compliance “on the job.” Although this still occurs, there are now programs where a compliance officer can obtain specialized training in compliance and be “certified.” Indeed, law schools are now entering into the process of training students for compliance positions, also as a result of their perception that compliance offers employment for their students in this difficult employment environment. There are, moreover, compliance consultants, often drawn from the ranks of former regulators, who train compliance officers, who provide on-the-job advice as to how best to perform their work and who even do certain compliance duties for a firm when they can be outsourced. There are societies of compliance professionals, which provide resources and discuss new issues and challenges. There are also professional journals devoted to this activity. Regulators have encouraged this professionalization of compliance. Compliance officers can justly feel that the importance of their task has been recognized and that they have “arrived.”

B. The Basic Tasks of Compliance Officers

As discussed above, compliance is closely associated with, and essentially makes possible, supervision in the broker-dealer because the purpose of supervision is to ensure that a firm and its employees comply with the federal securities laws and regulations, other applicable laws and SRO rules and industry standards. The compliance officer performs this basic compliance function by providing advice, on a daily basis, as to compliance requirements for increased. INSTITUTE FOR INTERNATIONAL FINANCE & OLIVER WYMAN, COMPENSATION REFORM IN WHOLESALE BANKING 2010: PROGRESS IN IMPLEMENTING GLOBAL STANDARDS 22-23 (Sept. 2010) (discussing the narrowing gap between compensation of business employees and those in control functions). Most recently, it has stabilized, which means that, in the ongoing financial downturn, firms are demanding that compliance officers do more tasks. See NATIONAL REGULATORY SERVICES, COMPLIANCE COMPENSATION STUDY, supra note 50, at 2 (noting that compensation for compliance professionals has stagnated since 2008, despite new regulatory demands). 54 There is a rich literature on the transformation of activities into “professions.” See, e.g., MAGALI SARFATTI LARSON, THE RISE OF PROFESSIONALISM: A SOCIOLOGICAL ANALYSIS (1977).

55 One example is the annual FINRA Institute at Wharton that trains and certifies compliance professionals in the Certified Regulatory and Compliance Professional (“CRCP”) Program. See <http://www.finra.org/Industry/Education/UniversityPrograms/FINRAInstitute/> (visited Aug. 16, 2013). The author has been an instructor in this program, teaching primarily the subjects of Supervision and Suitability. The National Society of Compliance Professionals also operates a certification program, the Certified Securities Compliance Professional program. See <http://www.cscp.org/>.

56 The Regulatory Compliance Association offers online education in asset management compliance in conjunction with law schools. See <https://www.rcaonline.org/regulatory-compliance-association>.

57 There are large numbers of these consultant groups. Representative of them are Ascendant Compliance Management, <http://www.ascendantcompliance.com/>, and Frontline Compliance, LLC, <http://www.frontlinecompliance.com/>.

58 Again, the best-known in this respect is the National Society of Compliance Professionals, <http://www.nscp.org/site_home.cfm>.

59 One example is Practical Compliance and Risk Management for the Securities Industry, a journal that is published by Wolters Kluwer. The author is co-editor-in-chief of the journal.

60 For example, in conjunction with FINRA the SEC holds an annual CCO Outreach meeting where Commissioners and staff meet with CCOs of major broker-dealers and investment advisers. From time to time, the SEC has sponsored a program of “outreach” to CCOs in financial firms to promote compliance. See, e.g., U.S. SECURITIES AND EXCHANGE COMM’tS, FY 2011 PERFORMANCE & ACCOUNTABILITY REP. 17.
individual business activities. To accomplish this task, compliance officers must have a good understanding of, and work closely with business employees regarding, a particular activity. A major job of compliance officers is also to produce, and to keep current, the WSPs that FINRA mandates. The WSPs dictate how firm employees should conduct a particular business activity so as to comply with laws and regulations and how the activity should be supervised and monitored. They thus specify, in a step-by-step way, how a broker conducts an activity, how recording or reporting relating to the activity is done, how the designated supervisor oversees the broker engaged in the activity, how additional monitoring occurs by compliance staff, often through the review of transaction records, how problems might emerge and what the broker, supervisor, compliance officer and/or another person should do in response to those problems.

Producing, revising and implementing the WSPs are never-ending tasks for compliance officers. Since the WSPs must cover every securities activity in the firm in the extensive way suggested above and since firms often engage in new business lines and produce and/or sell new products, compliance officers must constantly create new WSPs. They must also refine existing WSPs in response to problems or gaps in them revealed by the firm’s experience, by the testing mandated by NASD Rule 3012 or as a result of issues in them raised by FINRA or regulators in an examination of a firm or because of industry-wide matters. Implementation means that a compliance officer ensures that employees are following the WSPs. This task includes the

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61 See SIFMA, WHITE PAPER, supra note 47, at 3. See also O. Ray Vass, The Compliance Officer in Today’s Regulatory Environment, supra note 48, at 5 (referring to compliance, not pejoratively, as a “‘dumping ground’”).

62 See SIFMA, WHITE PAPER, supra note 47, at 4.

63 Take, for example, a broker recommending an investment to a client, which raises, among other things, “suitability” issues, that is, the broker’s duty, when recommending an investment or a strategy to a customer, to ensure that it is appropriate or “suitable” for him or her. See supra note 41. The WSPs would specify what the basic suitability obligation of a broker is with reference to the law and to FINRA rules. They would explain how a broker satisfies this obligation, i.e., learns about the product and gathers the appropriate information about the client to determine whether the product is suitable for him or her. They would direct the broker to record any resulting transaction as a recommended transaction, as well as information reflecting that he or she satisfied the suitability obligation. In addition, the WSPs should explain how the broker’s supervisor reviews the transaction so as to ensure that the broker met his or her suitability obligation. Moreover, they should set forth additional monitoring by compliance officers and the procedures for the broker, the supervisor and compliance officers to follow in the event of customer complaints regarding the transaction or of the appearance of any other “red flag” about lack of appropriateness of the product for the client. FINRA gives guidance on how a firm should design its compliance procedures with respect to the suitability obligation. See FINRA, Know Your Customer and Suitability, REG. NOTICE NO. 11-25 7 (May 2011) (discussing a firm’s policies on documenting its compliance with the suitability rule); FINRA, Suitability: Guidance on FINRA's Suitability Rule, REG. NOTICE NO. 12-55 4-5 (Dec. 2012) (making recommendations as to supervision with respect to suitability when a broker recommends both an investment product and a non-investment one).

64 See SIFMA, WHITE PAPER, supra note 47, at 4. Compliance might conduct the testing of the system together with the internal audit function, which is designed to test a firm’s internal control procedures. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 9. In a related context, compliance might also engage in some aspects of a firm’s risk management, particularly by assessing its regulatory and reputational risks. See id. at 20. To take a recent example again from the suitability context, the financial crisis revealed many problems in the sale of structured products to retail customers, such as brokers’ lack of understanding about them and the unsuitable nature of them for many investors—which are both suitability issues. Thus, compliance officers of broker-dealers that sold these products had to revise the WSPs regarding the sale of such products to address these problems (e.g., by enhancing the suitability analysis and supervisor oversight when they were sold). See generally SEC OFF. COMPLIANCE INSPECTIONS & EXAMINATIONS, STAFF SUMMARY REPORT ON ISSUES IDENTIFIED IN EXAMINATIONS OF CERTAIN STRUCTURED SECURITIES PRODUCTS SOLD TO RETAIL INVESTORS 7 (July 27, 2011) (discussing suitability issues in connection with the selling of these products, which was revealed through examinations).
distribution of the WSPs, as well as any supplementary documentation such as required reports or forms, throughout the firm to its departments and branches and the training of brokers and supervisors in the procedures. Compliance officers then check on whether in fact the procedures are being followed, often through the production and review of reports on transactions. Today, compliance monitoring is aided by technology, which has greatly automated the reporting and review process.

Compliance officers identify, and then follow up on, compliance problems or “red flags.” Compliance officers are thus responsible, through their surveillance, for finding out that the WSPs are not being followed, which may be due to anything from an innocent mistake, purposeful, but not harmful, noncompliance, to fraud. They often identify problems because, as noted above, they review transaction records and recorded communications and through this review they signal matters warranting further investigation. Compliance officers also detect problems through the routine internal inspections of offices and branches that are part of the supervisory system. In these, they check on compliance with regulations by personnel in the office or branch. Moreover, compliance officers are often the firm personnel who assist FINRA, the SEC and other regulators in regulatory examinations of their firms, and as a result they may discover problems, or at least regulatory concerns, through their interaction with the examiners.

See SIFMA, WHITE PAPER, supra note 47, at 4.
See id. at 4-5. This is often referred to as compliance’s “control,” as opposed to “advisory,” function. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 4. The classic compliance monitoring report is the “exception” report, which lists transactions that are outside certain parameters specified by the WSPs or that are otherwise flagged as suspicious, such as excessive trading or inappropriate concentration of certain products in accounts.
For an excellent discussion of problems inherent in the use of technology in compliance, see Kenneth A. Bamberger, Technologies of Compliance: Risk and Regulation in a Digital Age, 88 TEX. L. REV. 1 (2010). Among these problems, Professor Bamberger identifies values that may be embedded in the technology, but that may be at odds with regulatory policies.

To stay with the suitability example, a compliance officer would check that a broker who recommended a product to a customer, who then purchased it, had indeed gathered and consulted the appropriate information about the customer (or reviewed the information on file about him or her), in accordance with firm procedures, and that the broker had received appropriate training in the product. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 24 (discussing monitoring required by new suitability rule).

See SIFMA, WHITE PAPER, supra note 47, at 5; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 26 (discussing internal investigations). Compliance officers may indicate, for example, that there are problems with a newly opened account, such as a wrong address or missing information, which could be due to an oversight of a broker or to outright fraud. See, e.g., In re Citigroup Global Markets, Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2008013231502 (Aug. 9, 2011), available at <http://www.finra.org/Industry/Enforcement/DisciplinaryActions/FDAS/> (describing how registered sales assistant in branch office set up phony accounts and used them to siphon off customer funds; scheme was not discovered even though the compliance department identified that accounts often had phony addresses and used names of persons who were deceased).

See NASD Rule 3010(c). See also SIFMA, WHITE PAPER, supra note 47, at 5; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 24-25.
Both the SEC and FINRA emphasize the importance of internal inspections, particularly of branch offices. See SEC OFF. COMPLIANCE INSPECTIONS & EXAMINATIONS, IN COOPERATION WITH FINRA, NATIONAL EXAMINATION RISK ALERT: BROKER-DEALER BRANCH INSPECTIONS, Vol. I, Issue 2 (Nov. 30, 2011) (providing guidance and best practices on how an internal inspection should be conducted).

See also SIFMA, WHITE PAPER, supra note 47, at 6; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 26. A broker-dealer is subject to examination both by the SEC and FINRA, on a regular basis, as well as “for
This role of identifying potential violations of the federal securities laws and FINRA and firm rules raises the issue of the responsibilities of the compliance officer within the firm and as part of the regulatory system. As explained above, the compliance officer is generally outside the supervisory structure of the firm. If a compliance officer detects a problem, he or she should alert the supervisor who has authority over the broker or banker in question so that the supervisor can take the appropriate disciplinary action or report the problem up the chain of command in the firm, which could involve a report to FINRA or the SEC. Yet FINRA and SEC officials often appear to expect compliance officers to be their “eyes and ears” in the firm and to be responsible for reporting to them potential legal and regulatory violations. Compliance officers have to walk a tightrope here, which means doing their job of monitoring, following up on problems and ensuring that appropriate supervisors are notified and are taking action (often action suggested by compliance), while not taking part in the disciplinary and supervisory decisions.

Furthermore, compliance officers are educators within the broker-dealer. Part of the supervisory obligation of broker-dealers involves ensuring that the brokers meet their continuing education obligation. In addition, every broker must certify annually that he or she is in compliance with applicable laws and regulations. Compliance officers are generally responsible for this certification (or for monitoring the technology permitting it) and they provide, or arrange for the provision of, the necessary continuing education. That they monitor legal and regulatory developments for WSP purposes allows them also to provide brokers with legal and regulatory updates. They are also likely to be involved in workforce training when new products or a new business line are being introduced, which requires education for brokers about how to sell the products or do the new business in compliance with the law. Education has in fact become a major task of compliance officers. In a related vein, compliance officers promote the “culture” of compliance in the firm by conducting training in professional and ethical standards as well as by producing and administering a code of ethical conduct for the firm.

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72 See supra note 35.
73 See id.
74 See SIFMA, WHITE PAPER, supra note 47, at 10-13 (discussing the issue of the separation of compliance from supervision and recommending that the distinction be maintained, unless specific circumstances suggest that a compliance officer has actual authority over a matter).
75 For a discussion of the continuing education obligations of broker-dealers and their registered representatives, see generally 1 POSER & FANTO, BROKER-DEALER LAW & REGULATION, supra note 49, at 6-56.10 to 6-56.12. These requirements are set out in FINRA Rule 1250. Generally, a broker must fulfill a continuing education requirement every three years.
76 See NASD Rule 3010(a)(7).
77 See SIFMA, WHITE PAPER, supra note 47, at 4.
78 See id. at 7.
79 See SIFMA, WHITE PAPER, supra note 47, at 7; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 27-28. In addition, compliance officers have many specialized functions as well: among other things, they oversee the screening process and background checks for employees, as well as their licensing and qualifications; they establish and oversee anti-money laundering and Foreign Corrupt Practices Act programs; they establish control programs for the safeguarding of customer nonpublic personal information; and they oversee procedures designed to prevent insider trading and other conflicts of interest. See generally SIFMA, WHITE PAPER, supra note 47, at 5-6;
In sum, the overall picture of a compliance officer that emerges from the above review is that of a position that is intertwined with every securities business of the firm and with each employee. As a central task, compliance officers must establish, test, revise, educate brokers concerning, monitor compliance with and identify and report on problems with WSPs. The role of compliance has grown in broker-dealers as the number of WSPs has expanded. Yet compliance officers do so much more, from advising on compliance involving daily business matters, educating brokers to maintaining regular contact with regulators. Compliance is now well established in broker-dealers and the status of compliance officers in both firms and among regulators is growing. However, this positive picture obscures several fundamental problems with the current orientation of compliance, so it is appropriate to turn a critical eye to it.

III. Problem with the Current Orientation of Compliance

A. The Origin, Purpose and Consequences of External Compliance

In one of his most well-known books, Discipline and Punish, the French historian and philosopher Michel Foucault used the model of the prison as a symbol for the new kind of punishment that emerged out of the Enlightenment. He discussed how reformers of this period believed that prisoners could be controlled and in some cases rehabilitated through a discipline that contrasted with medieval punishment, which was brutal and was used to display publicly the power of the sovereign. Foucault showed how this new discipline was applied to the minute details of conduct so as to dictate every movement of the prisoner and how he or she would be watched to ensure conformity with the discipline. This process was designed to transform both the body and even the mind of the prisoner so that he or she would be literally “re-formed” in order to become a productive person who, if possible, could return to society. Foucault used the vivid image of the “panopticon,” which was a prison construction, often with prison cells arranged in a circle around a central monitoring tower, where each prisoner could be viewed at all times.

Foucault explained that, through his discussion of the discipline in the prison, he was identifying a kind of social control or power that was based upon the Enlightenment’s faith in reason’s ability to remake individuals and society: this was the “soft” power of physical and mental control that reformers, in the exercise of their reason with particular goals, would exert over those in need of direction. As he explained, the use of this power migrated out of the prison into other social activities when its proponents realized its value. Foucault highlighted the example of the assembly line and other “mechanized labor” in a factory, where managerial scientists calculated and shaped the motions of employees to make them as productive as possible. The use of the new discipline transformed education as well, as educational reformers

SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 24-26. These functions are too numerous to discuss here.

80 See MICHEL FOUCAULT, SURVEILLER ET PUNIR: NAISSANCE DE LA PRISON 80 (1975).
81 See id. at 126-32.
82 See id. at 201-204.
83 See id. at 133-34.
84 See id. at 139-40.
85 See, e.g., at 146-47.
employed it to train and to form children and young adults, both physically and mentally, for the labor that would be needed in society. 86

With the risk of making a too vivid analogy, broker-dealer compliance appears to be an activity that reflects Foucault’s analysis of the new form of disciplinary control. This is, in fact, not surprising, since in his view the techniques of control and productivity infiltrated major productive social activities. The typical broker, the “subject” of the supervisory system and thus of compliance—and not unlike Foucault’s prisoner, has his or her actions and words dictated by compliance procedures and monitored by compliance officers. As noted above, WSPs specify how a broker must conduct himself or herself, and even what he or she should say, with respect to a given securities activity. 87 His or her actions and communications are both recorded and reviewed, sometimes in real time, by his or her immediate supervisor and also by compliance officers. From Foucault’s perspective, therefore, compliance procedures “form” a broker by controlling his or her conduct and by subjecting him or her to scrutiny—in sum, the broker is surrounded by a web of control and surveillance. As broker-dealers have come to use technology in this monitoring, moreover, the scrutiny to which a broker is subject has become real-time in nature.

This use of Foucault’s insight concerning soft power is not intended to ignore the obvious. The current all-encompassing discipline and monitoring of broker-dealer employees by compliance officers owes much to the enhanced oversight of employee activities that has always typified control in the financial sector. Since brokers, like bankers, insurance brokers and commodity firm employees, deal with cash and personal property that can be easily stolen or misused, they have always been subject to particular scrutiny. 88 Moreover, as is well known, retail investments are subject to heightened protection under the federal securities laws since our economic system would be greatly harmed if investors had no confidence that their assets would be safe in the hands of financial firms, like broker-dealers. 89 They would simply refuse to invest, which would result in funds not ending up in the hands of entrepreneurs and their new and higher valued enterprises. Therefore, it is not surprising that employees in broker-dealers are subject, through SEC and FINRA regulation, to a detailed legal and regulatory, and thus a compliance, framework. 90 In addition, as the financial sector has developed over time and as the regulation of it has grown, particularly in response to scandals, this framework and its accompanying compliance obligations have grown more complex. Moreover, as Foucault himself emphasized, a main purpose of the “new” disciplinary power is efficient production in whatever domain it is applied to. Thus, the WSPs are designed to make a broker more efficient and productive, within the boundaries of law and regulation. Finally, Foucault’s account of the transformation of modern production is, of course, one among many, with other scholars and historians calling

86 See, e.g., at 148-49.
87 See supra text accompanying notes 62-63.
88 For example, many early cases on the fiduciary duties of directors involve the failure of bank directors to supervise employees who steal money from customers. See, e.g., Litwin v. Allen, 25 N.Y.S.2d 667, 677-79 (N.Y. Sup. Ct. 1940).
90 From the Foucault perspective, this important social activity, public investment, is exactly where the disciplinary power would be used.
attention to hierarchical techniques and other disciplinary features that came into widespread existence with industrialization in the modern era.  

Foucault suggested, however, that this all-pervasive discipline and surveillance were unlikely ever to be fully achieved. First, these techniques of control could not hope to capture all the complex conduct and attitudes of human beings; this made the panopticon an unattainable ideal. Second, individuals resisted the techniques imposed upon them. Social psychologists and organizational scholars offer related criticisms about the effectiveness of this “top-down,” panoptical approach. They acknowledge that the surveillance is effective and indeed necessary: psychological studies show that individuals pay particular attention to rules and generally do not misbehave when someone is watching them. However, they, too, argue that this approach is difficult to put into practice in a way that it would successfully monitor all employee conduct at all times. They also suggest that such extensive oversight is not the most effective method of producing legally and ethically compliant conduct among firm employees, and may even have the unintended opposite result.

This counterproductive result could occur in the following way. Except on routine matters, the performance of financial activities in broker-dealers, such as providing investment recommendations, demands the exercise of considerable discretion and expertise by the broker: indeed, the use of this discretion is what makes him or her a valued and productive employee. Admittedly, each employee in a broker-dealer today understands that he or she is in a highly regulated industry where compliance is a fact of life. Nonetheless, the compliance system embodied by the WSPs could well appear to them to be something external, and not reflective of their own self-identity and self-definition, which are centered on their productive securities activities and the business groups where they conduct these activities. After all, broker-dealers are profit-making firms in the highly competitive, profit-focused financial industry. That compliance, with its monitoring, reporting, recordings, reviews, inquiries and inspections, is the domain of non-productive, non-business personnel and is costly inevitably reinforces in the employee’s mind the distinction between the securities business and the compliance function, and between those who work in both sectors. Additionally, brokers know that compliance officers report problems to their supervisors and to senior management, as well as are the “eyes

91 See, e.g., DAVID S. LANDES, THE WEALTH AND POVERTY OF NATIONS: WHY SOME ARE SO RICH AND SOME SO POOR 204 10 (1999) (discussing the transformation of labor relations spurred on by technological changes); ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 415-54 (1977) (discussing the transformation in management and its elaborate hierarchies of oversight and control that made the large business firm possible). Moreover, there has been work discussing how workplace “culture” has been used as a way both to motivate and to control employees in knowledge fields. See, e.g., GIDEON KUNDA, ENGINEERING CULTURE (Revised ed. 2006).

92 See FOUCAULT, SURVEILLER, supra note 80, at 35, 315 (suggesting the resistance to the all-encompassing disciplinary power).

93 See Weaver & Treviño, supra note 4, at 329-30.

94 See id. at 323. This remark reflects a view that individuals have multiple “selves” or identities, which they adopt when they work in groups that they identify with. A productive broker would generally adopt the identity offered by his or her group of other brokers and securities personnel, at least while working within the securities business. 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.”).

“and ears” of the SEC and FINRA. From the broker’s perspective, this reporting mission of compliance officers further separates brokers from them, especially since internal disciplinary, regulatory or FINRA actions can threaten a broker’s livelihood.96

Since, therefore, brokers will view compliance as external to their central business identity, even while they recognize that it is part of their job, there is equally a risk that they will deal with the WSPs and compliance policies in a routine, “check-the-box” way. In the worst case, they might even feel justified in evading or gaming compliance restrictions or trying to co-opt compliance officials, especially when they are acting in accordance with their self-identity, which is formed by the attitudes of their business group and peers.97 Since the WSPs embody the policies of the federal securities laws and regulations, as well as FINRA professional and ethical standards, brokers’ alienation from them means that the law, regulation and standards, as well as their policies, have become separated from a broker’s main activities and, indeed, his or her identity. In the parlance of social psychology and organizational studies, the law and policies “fade” when brokers and other employees involved in the securities business make important decisions or take other actions.98 This fading in fact can produce exactly the opposite of compliant conduct, for a broker’s decision-making and behavior are then based primarily upon other motivations, such as the self-interest and group interest that define the individual’s self-identity as a securities professional.99 In addition and more subtly, by following the letter of the

96 A broker can be disciplined by his or her firm. If a firm has knowledge that, among other things, a broker has been involved in a securities violation or other regulatory violation, it is obligated to report this to FINRA. See FINRA Rule 4530. A broker is likely to be disciplined by FINRA for any such violation, since FINRA acts a first line of defense with respect to broker-dealers. The SEC may also bring an enforcement action against a broker. The disciplinary action from either FINRA or SEC enforcement proceedings ranges from fines, to suspensions from practice to industry bars. See generally 1 FANTO & POSER, BROKER-DEALER LAW & REGULATION, supra note 49, at 14-1 to 14-60.
97 FINRA and SEC disciplinary actions bear witness that this kind of cooptation occurs, when brokers enlist compliance officers in their wrongdoing. See, e.g., In re Melhado, Flynn & Associates, Inc., et al., Exchange Act Release No. 64,467, FED. SEC. L. REP. (CCH) (May 11, 2011) (recounting a settlement involving a Director of Compliance Coordination who assisted the scheme of the CEO of a broker-dealer and of an investment adviser who “cherry picked” trades so as to allocate profitable ones to the firm’s proprietary account, and later to favored hedge fund clients, at the expense of other advisory clients). In an absolutely worst case, where they think that they can do it without detection or with impunity, brokers simply ignore the WSPs and compliance altogether. See Tammy L. MacLean & Michael Behnam, The Dangers of Decoupling: The Relationship between Compliance Programs, Legitimacy Perceptions, and Institutionalized Misconduct, 53 ACAD. MGT. J. 1499 (2010) (presenting evidence from a broker-dealer firm that, when a firm uses compliance as “window dressing” and divorces it from business practices, employees are prone to dismiss it and engage in more misconduct, which becomes institutionalized).
98 See supra note 7 (discussing the phenomenon of fading).
99 That is, if legal and regulatory policies and professional and ethical standards do not come to the fore in decision-making, other goals, needs and desires motivate thought and conduct. Given that self-interest is explicitly championed as the norm determining conduct in the financial industry, which norm would include the group interest of a collection of brokers in a business group all working for their collective self-interest, it is likely that self-interest will be the primary motivation for the broker. For a personal account of the loss of the client focus in favor of the self-interest of bankers, see JONATHAN A. KNEE, THE ACCIDENTAL INVESTMENT BANKER: INSIDE THE DECADE THAT TRANSFORMED WALL STREET 222-30 (2006). Psychologists explain that, if the rational, reflective self (often referred to as “system 2”) is not motivated to consider a particular subject, the automatic or instinctual self (referred to as “system 1”) reacts, and this system is oriented to self-interest. 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”); Yuval Feldman, “Behavioral Ethics Meets Behavioral Law and Economics” 8 (2013 draft) (discussing “the automaticity of self-interest”). Groups and even organizations can embrace the “self” orientation as their norm or as part of their
WSP routines, brokers may feel that they have satisfied their legal and professional obligations, which satisfaction liberates them to act even more opportunistically, and possibly unethically, in their business dealings.  

The SEC and FINRA, and even the leaders of the brokerage industry, recognize that the compliance model of all-encompassing WSPs and the resulting surveillance are inadequate for effective compliance, although they do not appear to perceive the negative effects of external compliance. They do exhort firms and brokers to espouse a “culture of compliance,” which, as discussed below, refers to a different kind of compliance approach, what will be characterized as an internal, rather than an external, model of compliance. After all, a basic FINRA professional standard is echoed in Rule 2110, which refers to conducting business with “high honor and in accordance with just and equitable principles of the trade.” Yet, despite the references to the culture of compliance, the panopticon approach remains dominant and continues to grow as there is a constant demand for new WSPs in response to new law and regulation and to SEC and FINRA enforcement and pronouncements. Thus, the dominant approach effectively drowns out the regulatory exhortations for a culture of compliance.

B. The Reinforcement of the Current Compliance Orientation

The financial crisis was, among other things, the result of a failure of compliance in broker-dealers. Legal, regulatory and ethical policies were pushed into the background, or faded, in broker decision-making while other human motivations, chiefly self-interest, crowded them out. To take one prominent example, broker-dealers were heavily involved in the securitization of subprime loans and the sale of the resulting mortgage-backed securities. They also created the variations of these securities, including the collateralized debt obligations.

organizational culture. See generally Albert Bandura, Social Cognitive Theory: An Agentic Perspective, 52 ANN. REV. PSYCHOL. 1, 15 (2001) (“Social structures are created by human activity, and sociostructural practices, in turn, impose constraints and provide enabling resources and opportunity structures for personal development and functioning.”).

See Daylian M. Cain, et al., The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest, 34 J. LEG. STUDIES 1(2005) (discussing, among other things, the “liberating” effects of disclosure).

See, e.g., SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 27 (citing calls for a “culture of compliance” by various SEC officials).

See FINRA Rule 2010 (“A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.”).

Now, several years after the onset of the crisis, there have been countless studies of it and much analysis of its causes, which analysis is continuing. See, e.g., THE PANIC OF 2008, supra note 12 (collection of essays on the topic); RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM, supra note 13 (same). Some blame the crisis on the flow of easy capital into this country during the pre-crisis years, while others focus on the political policies that encouraged home loans to low-income borrowers who had no means of repaying them. See THE FINANCIAL CRISIS INQUIRY REPORT, supra note 11, at xxv-xxvii (summarizing the debate and providing its own views). The only general agreement is that numerous parties, from politicians, bankers, regulators, investors and compliance officers, contributed to the crisis. See id. at xviii-xxiii (surveying responsible parties).

Social psychologists have written about a “calculative mindset,” which, when activated in a given context, leads individuals to focus on their self-interest at the expense of the effects of their conduct on others and on the ethics of their conduct. See Long Wang & J. Keith Murnighan, On Greed, 5 ACAD. MGT. ANNALS 279, 295, 301 (2011). Such a mindset is more in the nature of an emotionally-charged self-oriented focus, and the mental effort associated with it would be less complex than moral reasoning. See id. at 298, 301. See also Long Wang, et al., “The Ethical and Social Consequences of a Calculative Mindset” 8 (Mar. 2011 draft) (reciting results of experiments showing that triggering a calculative mindset produces more self-interested conduct at the expense of social and ethical values).

See THE FINANCIAL CRISIS INQUIRY REPORT, supra note 11, at 68-72.
which were securities on pools of other mortgage-backed securities, and the synthetic instruments that mirrored their performance.\textsuperscript{106} As is now well-known, the firms also made markets on these various instruments and designed specialized investments in them for sophisticated parties.\textsuperscript{107} A sponsor of a securitized pool had the legal obligation to ensure that the assets, i.e., the mortgages or asset-backed securities, were properly valued.\textsuperscript{108} Broker-dealers marketing the securities had an obligation to provide adequate disclosure of the risks associated with them.\textsuperscript{109} However, in many cases, firms did not do the proper valuation or make disclosure that would have adequately revealed those risks.\textsuperscript{110} Moreover, brokers were supposed to understand the products, for, without this understanding, they could not legally sell them to any customer.\textsuperscript{111} Again, brokers often had little understanding of what they were selling and, in the worst cases, they sold products simply to offload them from a broker-dealer’s books.\textsuperscript{112} At times, these activities involved a direct violation of securities laws or regulations, or SRO rules; at other times, they fell into the grey area of running counter to professional or ethical standards.\textsuperscript{113} Since compliance’s mission was to ensure that all these activities were done in accordance with law, regulation and professional standards, these illegalities and other problems represent a wholesale compliance failure.

Despite this failure, the existing external compliance model has been reinforced and extended. The maintenance of the status quo is not surprising, for, in the immediate response to the financial crisis, legislators, regulators, SROs and financial firms followed the typical strategy of trying to fill evident gaps in regulation and self-regulation of the financial sector that the crisis had exposed.\textsuperscript{114} To take one example, the issuance of asset-backed securities and the conduct of the investment banks involved in this process are now regulated in more detail, including by demanding that the banks avoid conflicts of interest in the sales of the products and by enhancing

\textsuperscript{106} See id. at 127-34.
\textsuperscript{107} These were derivatives based upon the mortgage-backed securities or their offspring. See id. at 50-51 (discussing basic credit-default swap). The involvement of investment banks in designing products, which they both sold to investors and took an opposing position on, came particularly to light in the hearing on Goldman Sachs before the Senate Permanent Subcommittee on Investigations, held on April 26-27, 2010. See SEN. PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 376-635(Apr. 13, 2011) (detailing Goldman’s conflicts of interest in designing derivative securities). A low level Goldman officer, Fabrice Tourre, involved in one such product was found to have violated the securities laws. See Justin Baer, et al., ‘Fab’ Trader Liable in Fraud, WALL ST. J., Aug. 2, 2013 (online edition).
\textsuperscript{108} See THE FINANCIAL CRISIS INQUIRY REPORT, supra note 11, at xxii.
\textsuperscript{109} See WALL STREET AND THE FINANCIAL CRISIS, supra note 107, at 322-24 (summarizing these obligations).
\textsuperscript{110} See id. at 318-20 (summarizing these and other failings).
\textsuperscript{111} See supra note 41 (summarizing suitability obligations).
\textsuperscript{112} See, e.g., In re Richard Cody, Exchange Act Release No. 64,568 (May 27, 2011) (recounting facts of FINRA disciplinary action, upheld by the SEC, where a broker sold mortgage-backed securities to retail customers without having any understanding of this product).
\textsuperscript{113} This would include, for example, taking advantage of a client while not literally violating a regulation. See, e.g., WALL STREET AND THE FINANCIAL CRISIS, supra note 107, at 425-430 (discussing Goldman Sachs’s “short squeeze” on counterparties).
\textsuperscript{114} The major response is obviously Dodd-Frank, a detailed summary of which is beyond the scope of this Article. A glance through some of its titles, however, shows that it was clearly designed to fill in gaps, or at least perceived gaps, in the regulation: title II (instituting an “orderly liquidation authority” for large financial firms; title VII (among other things, bringing within regulation swaps); title IX (among other things, improving the process of the sale of asset-backed securities); title XIV (reform of mortgage origination). It is natural that, in a first response to a crisis, individuals will use methods or tools with which they are familiar and that they have employed in the past. Cf., Christine Jolls, et al., A Behavioral Approach to Law and Economics, in BEHAVIORAL LAW AND ECONOMICS 48-49 (Cass R. Sunstein, ed., 2000) (observing that government officials could fall victim equally to behavioral biases).
disclosure of them.\textsuperscript{115} All of this lawmaking, with its accompanying growth in SEC regulations and FINRA rules, resulted in more work for compliance officers because they have to translate the rules and regulations into WSPs with accompanying monitoring, reporting and inspections.\textsuperscript{116} Dodd-Frank and the SEC also used the existing model of compliance as it brought previously unregulated financial participants under regulation. For instance, a significant part of that legislation involved the regulation of the swap markets and major participants in them.\textsuperscript{117} Swap dealers are now regulated in a manner that, understandably enough, parallels, and is modeled on, that of broker-dealers.\textsuperscript{118} As a result, a swap dealer must have a supervisory structure and record-keeping, which naturally demand a compliance function.\textsuperscript{119}

In addition, after the crisis regulators and SROs enhanced their oversight of financial firms and their enforcement, which increases the job of compliance officers. They have done this in response to criticism that they failed to detect and to punish the abuses that were at the origin of the financial crisis.\textsuperscript{120} Both the SEC and FINRA revamped their examinations of broker-dealers with, among other things, the involvement of more specialist examiners, the sharing of information among their divisions (including the enforcement division) and more examinations targeted at firms presenting the highest risk.\textsuperscript{121} The SEC formed prosecutorial groups targeting particular kinds of financial institutions and specific abuses.\textsuperscript{122} All of this examination and enforcement activity demands the attention of compliance officers, who generally are the “point person” for the firm in regulatory examinations and who assist legal officers in responding to enforcement inquiries.\textsuperscript{123} Moreover, this aggressive attitude of the SEC and FINRA examiners and enforcement personnel enhances the link of compliance officers with


\textsuperscript{116} Compliance officers, like anybody else, have finite time and resources. The more they need to write new WSPs, the less time they have for other activities. \textit{See} Vass, \textit{The Compliance Officer in Today’s Regulatory Environment}, supra note 48, at 10.

\textsuperscript{117} This is in title VII of Dodd-Frank, 124 Stat. 1658-1802 (sections 721-774). Swap regulation was divided between the Commodity Futures Trading Commission and the SEC, depending upon the nature of the underlying asset that was the subject of the swap.

\textsuperscript{118} \textit{See} 1 \textit{POSER & FANTO, BROKER-DEALER LAW & REGULATION, supra} note 49, at 5-40 to 5-44.

\textsuperscript{119} Indeed, new section 15F(k) of the Exchange Act dealing with security-based swap dealer regulation mandates that such a dealer have a Chief Compliance Officer to implement the compliance function in the dealer. \textit{See} \textit{15 U.S.C. § 78o-8(k)}.

\textsuperscript{120} \textit{See} \textit{THE FINANCIAL CRISIS INQUIRY REPORT, supra} note 11, at xviii (faulting financial regulators with not having prevented the crisis).

\textsuperscript{121} The requirement to enhance examinations came indirectly out of the financial crisis, for it was motivated by the SEC’s failure to detect the Bernard Madoff scandal, which was revealed when his Ponzi scheme collapsed during the crisis. The SEC’s enhancement of examinations was mandated by Congress in Dodd-Frank section 929U, which, among other things, added a new section 4(h) of the Exchange Act, 15 U.S.C. § 78d(h). This provision required specialized examiners for the SEC’s Division of Trading and Markets, which oversees broker-dealers. On the SEC’s risk-based examination system, see U.S. SEC. & EXCHANGE COMMISSION, FISCAL YEAR 2012 AGENCY FINANCIAL REPORT 3 (2013). On FINRA’s enhancement to its own examinations in reaction to the scandal, see \textit{REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA’S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES 6-8} (Sept. 2009).


\textsuperscript{123} \textit{See} \textit{supra} text accompanying notes 71.
regulators, which, as noted above, further separates them from the securities business in the eyes of brokers.\textsuperscript{124}

This reaffirmation and extension of the external model of compliance is a lost opportunity to think critically about the current orientation of compliance, and it may have adverse consequences for finance and the economy. The financial crisis revealed the dangers emanating from large financial firms involved in capital market activities, particularly the economic downturn and political instability that flow from the collapse or near collapse of these institutions.\textsuperscript{125} Compliance, of course, cannot change financial firms, but it has the opportunity to play a critical role in reducing the instability and other externalities arising from them. This may be because no one else can fulfill its particular role. As often happens after a crisis, legislators, regulators and SROs show a renewed zeal for law creation and enforcement, but their efforts eventually wane. Legislators become distracted with other, more pressing concerns. As for regulators, like the SEC, they have limited resources in this time of scarcity and their budgets are not growing and unlikely to grow.\textsuperscript{126} Despite their reforms, they cannot realistically be counted on to identify ahead of time significant problems in financial firms, for they always remain outside the firms. FINRA can improve, and has improved, its oversight over broker-dealers, but, while it is closer to these firms, its examiners and enforcement staff are not in them on a day-to-day basis.

Compliance officers, by contrast, are omnipresent in the firms and are specifically charged with legal, professional and ethical compliance. Most importantly, they actually see what is occurring in the firms. They are thus particularly well situated to alert supervisors and senior executives to growing problems, such as occurred with the subprime loans and their securitization, that may eventually infiltrate the financial industry and gradually grow into a

\textsuperscript{124} Indeed, the SEC’s recently adopted whistleblower rules, which allow a whistleblower to bypass internal reporting to report firm problems directly to regulators, particularly puts pressure on compliance officers to pass along to supervisors potential firm issues before a regulator learns about them from a whistleblower. See Regulation 21F, 17 C.F.R. §§ 240.21F-1 to 21F-17. This regulation was promulgated pursuant to Section 922 of Dodd-Frank, codified at 21F of the Exchange Act, 15 U.S.C. § 78u-6.

\textsuperscript{125} Serious economic downturns generally follow the collapse of a financial system. See CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 3-20 (2009). The financial sector has become large and concentrated in the United States, see JOHNSON & KWAK, 13 BANKERS, supra note 9, at 189-222, prone to boom and bust cycles, see HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY 219-45 (1986) (explaining how financial firms lead to “boom and bust” cycles through their financing activities, which he calls “Ponzi” finance), and with the tendency to internalize its profits and to externalize its losses on others, chiefly U.S. taxpayers. The ownership structure of financial firms, which are in corporate, not partnership, form and where employees have no long term connection to them, contributes to this characteristic of firm employees capturing the profits, but not taking the losses, since they have often left firms before the adverse outcomes of their activities appear. See generally Gian Luca Clementi, et al., Rethinking Compensation in Financial Firms, in RESTORING FINANCIAL STABILITY, supra note 13, at 197-214. The financial firms have created political instability because they helped create a growing wealth disparity in this country and because they are perceived as being aligned with the political elite that, together with them, profit at the expense of most citizens. See supra note 14. See also RAGHURAM G. RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY 183-201 (2010) (discussing ways to address inequality in the United States, that has been produced by participation in financial firms and political insiders). Their influence over politicians reaches those of all political parties. See, e.g., CHARLES GASPARINO, BOUGHT AND PAID FOR: THE UNHOLY ALLIANCE BETWEEN BARACK OBAMA AND WALL STREET ix-xi (2010) (listing campaign donations from major financial firms and individuals for 2007-2010).

\textsuperscript{126} For a description of the SEC’s lack of adequate financial resources for its mission in recent years, see U.S. SEC. & EXCHANGE COMMISSION, STRATEGIC PLAN: FISCAL YEARS 2010-2015 6-7 (2010).
systemic problem.\textsuperscript{127} Being involved with compliance and assisting in the supervision of every broker and securities activity in a broker-dealer, a compliance officer is perfectly positioned to identify problems before they are transformed into larger, potentially systemic issues.

Furthermore, given the sheer number of new laws and regulations imposed upon broker-dealers as a result of the most recent financial crisis, it is doubtful whether they could survive the regulatory response to another major crisis and still remain in their present form. That is, the laws, regulations and standards affecting broker-dealers have become so numerous that it takes considerable time, effort and costs for a firm, even with the help of compliance officers, to ensure that they are followed. This leads to the elimination of smaller firms, which cannot afford the regulatory burdens, and inhibits firms from entering into new activities. The vibrancy, flexibility and competitiveness of the financial industry are thus undermined. Highly visible, well-functioning compliance officers, who helps firm employees make decisions animated by legal policies and professional and ethical standards, could save finance from this fate. Their activity could convince legislators, regulators and, most important of all, the public that financial firms are dedicated to a public mission, not simply in the business for their own self-interest, and thus in need of fewer rules of conduct. An effectively functioning compliance may well be critical for ensuring the survival of the financial industry and the benefits that come with having active competition among private financial firms. However, for compliance to help firms reduce their risks and stay viable requires that its current external orientation be altered.

IV. The Reform of Compliance

A. Reorientation from the External to Internal Approach

This Part argues that compliance in broker-dealers must reorient its approach from the current external disciplinary model discussed above to an internal perspective. This does not mean that it must abandon its role of producer, monitor and enforcer of the WSPs. The external approach is necessary to prevent and detect major legal and ethical violations and is mandated by law and regulation, as explained earlier.\textsuperscript{128} Yet compliance cannot rely only upon this approach, which results in an ever increasing number of WSPs, with the compliance burden that this entails, which produces the resistance, gaming or routine following by brokers and which exacerbates the distinction between compliance and the securities business. Moreover, the goal of the panopticon—to watch everyone at all times—is unachievable.\textsuperscript{129} Rather, compliance must develop and promote another existing approach, which is internal compliance.

The basic purpose of internal compliance is what the term implies: it is to have brokers comply as a result of internal motivations, rather than because of pressures from external rules and from the monitoring by compliance officers. Naturally, brokers “internalize” the laws,

\textsuperscript{127} The notion of this kind of problem or risk as a “virus” is useful here. This term comes from KATHLEEN C. ENGEL & PATRICIA A. McCoy, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011). Systemic problems often start small in a marginal firm or outside the center of activities in a major firm, which means that they are invisible to regulators, SROs and even senior executives in the firms. The problem then gradually infiltrates other firms and activities.

\textsuperscript{128} Psychologists explain the importance and effectiveness of external oversight on compliance. See supra note 93.

\textsuperscript{129} Of course, with advances in technology it is conceivable that nearly every word and action of a broker could be captured in some way and thus monitored in real time. But this kind of monitoring will still be costly and human ingenuity can find a way to game it.
regulations and standards in their minds and generally organize their conduct in accordance with them, for one goal of the external approach is to produce this internal effect. Moreover, the laws, rules and standards are intertwined with how the securities business is conducted today. However, the internal compliance espoused here is of a different order from this mental acceptance of the constraints of law and regulation. Under it, brokers would use the goals and policies of securities regulation and FINRA professional standards in their decision-making and thus in orienting their conduct. Psychologists tell us that a person’s beliefs and actions will best reflect such goals, policies and standards if the person—a broker in this case—understands them as being implicated in his or her everyday work decisions and conduct. Another way of saying this is that the goals, policies and standards come to mind in decision-making because they are part of his or her self identity, and that they thus contend with, and even suppress, other motivations, such as the self-interest that may characterize his or her business identity and that of the business group. This internal approach is particularly important for compliance in knowledge-intensive tasks, like brokerage, where, to be productive, an employee must be given considerable discretion in how to perform the job at hand. Again, the external approach can inhibit or hinder the exercise of discretion, while the internal approach will use discretion for the purpose of compliance.

The internal approach is already part of compliance, which is why this would be a reorientation or a reemphasis in this field. When talking about effective compliance, compliance officers often refer to a “culture of compliance” in their broker-dealer firm or to the fact that the firm has a certain “tone at the top.” These words, if not empty, must refer to a way of thinking about or a perspective on compliance that reflects attitudes which have been internalized by the firm’s employees. In other words, in a firm with a “good” culture compliance officers say that they can trust the brokers and supervisors generally to make legal and ethical decisions and thus to conduct themselves in line with the firm’s goals of customer service and benefit, which in turn reflect the law and professional standards. In such a firm, a compliance officer can rely upon the brokers themselves to be compliant on their own and to enforce compliance among one another. Compliance officers are called in when there are new issues

130 To use again the example from suitability, in recommending securities or strategies to a customer, a broker finds those “suitable” to the customer in light of his or her investment holdings and goals, time horizon for investing, liquidity needs, risk tolerance, etc. The overarching goal, policy and standard here are customer service and benefit, not maximizing profit for the broker or the firm. Another, even broader principle applicable in these circumstances is to foster customer trust, and therefore involvement, in the securities markets, which allows for an efficient use of capital in the society.
131 See Weaver and Treviño, supra note 4, at 320-21 (discussing a values-based orientation, as opposed to a compliance one, which motivates employees by appealing to the congruence of the organizational values and those of employees).
132 See BAZERMAN & TENBRUNSEL, supra note 7, at 153-54 (discussing the power of the “want” self). In psychological terms, these other motivations, particularly those centering on the self, are often “implicit” or automatic, and thus powerful. See generally John A. Bargh & Tanya L. Chartrand, The Unbearable Automaticity of Being, 54 AMERICAN PSYCHOLOGIST 462, 468-69 (1999).
133 See supra text accompanying note 101. See also SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 5 (“At the same time, Compliance’s strongest contribution may be to help the business shape appropriate standards and adopt practices that promote the right behaviors from the very start.”). See also TAMAR FRANKEL, LEGAL DUTIES OF FIDUCIARIES 312 (2012) (discussing importance of leaders in the culture of legal compliance).
134 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) (finding that the characteristics of the organization, such as its ethical culture and climate, have a considerable influence on unethical decisions in the firm with ethical climate meaning the broad organizational procedures, policies and practices with
or problems, if the compliance issue is not obvious and brokers need to discuss it with a compliance specialist or if a broker just wants confirmation about his or her approach.

To create this internal compliance, a compliance officer needs to ensure that the goals and policies of securities laws and professional standards are always in the foreground of a broker’s mind when he or she is making business and client decisions—in other words, that they do not “fade” in a given decision. This purpose changes the nature of the compliance officer’s position from being only a monitor of employee performance of WSPs to being an advocate and educator for the policies and standards behind them. This means someone who would help identify the goals, policies and standards for decision-making with respect to a particular broker-dealer activity, whether it be trading, advising, managing accounts or selling products. A compliance officer is well suited for this role because he or she is close to decisions that happen at every level of the firm and has historically been an advisor to brokers. Moreover, compliance’s connection to the granular nature of decision-making in financial firms ensures that a compliance officer is also available to respond appropriately to broker inquiries about the application of policies and standards on specific issues. Furthermore, in everyday decision-making, and in advice on it, compliance officers can present to other employees a model of thinking and conduct—to act as a kind of moral compass, which itself has been shown to be significant in reducing illegal and unethical conduct and organizational conflict in firms.

moral dimensions and values, and ethical culture meaning a narrower concept of an organization’s systems, procedures and practices for guiding and supporting ethical conduct). Interestingly, the literature cited by the authors suggests that the existence of a code of conduct, the paradigm of the external compliance system, has little deterrent effect on unethical conduct, see id. at 13.

135 The view of human decision-making accepted here is that conscious, deliberative reflection (System 2) can override automatic (System 1) and other motivations, so long as a space and time are given to the former. See supra note 7 (on ethical fading). See Kish-Gephart, et al., supra note 134, at 20 (finding that unethical conduct is reduced when certain characteristics of the moral issue involved are highlighted, in particular the magnitude of the consequences of the conduct, their probability, the proximity of the victim and the foregrounding of social norms). See also Mark N. Bing, et al., An Experimental Investigation of an Interactive Model of Academic Cheating Among Business School Students, 11 ACADEMY MGT. LEARNING & EDUC. 28, 39 (2012) (showing that cheating by students declines when they are reminded of their school’s ethics codes and specifically instructed on how prohibited conduct is detected and punished); Guido Palazzo, et al., Ethical Blindness, 109 J. BUS. ETHICS 323 (2012) (discussing how “ethical blindness” is created, which means that a person adopts a rigid perspective, often as a result of complex causes, including organizational and institutional ones, that closes out other frameworks, such as ethics). Of course, as will be discussed below, illegal and unethical conduct can occur as a result of deliberative reasoning.

136 A compliance officer can trigger the legal and ethical aspects of an employee’s decision-making by raising the legal and ethical issues in his or her conversation with the employee. See Brian C. Gunia, et al., Contemplation and Conversation: Subtle Influences on Moral Decision Making, 55 ACADEMY MGMT. J. 13, 17, 22 (2012) (finding that this kind of conversation, as opposed to conversation focusing on self-interest, leads to more ethical decisions). On the other hand, acting on self-interested impulses, and conversing on a self-interested basis, can “prime” future decisions to follow the self-interest motivation. See id. at 27. In other words, conversation here is used to counteract decision-making that is “primed” by automatic motivations.

137 In a related vein, social psychologists have demonstrated that leaders who have internalized moral values and who give public expression to them help produce organizations that have less unethical conduct and less inter-organization conflict (i.e., among members). They hypothesize that this may be due to the fact that organization members model their conduct on the leader, who generally typifies the “ideal” of the group. 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. MGT. J. 151, 153-54 (2012). This is a social identity approach, where a group or organization’s identity, which its members accept, is greatly formed by its leaders. However, it is by no means certain that ethical leaders alone will create a culture of values or a beneficial social identity in broker-dealers. See Joel Gehman, et al., Values Work: A Process Study of the Emergence and Performance of Organizational Values
The internal approach faces daunting challenges as to its implementation. This approach sets for itself the task of creating a complex personal and social identity for brokers, which would value deliberation on legal policies and ethical standards and which must push aside or at least check other individual and group identities at odds with it, such as an individual’s and a division’s singleminded pursuit of profit. To accomplish this task, compliance must use the guidance of psychologists, social psychologists and organizational theorists, as well as even neuroscientists, about how best to encourage the creation of this identity, as well as individual attributes, that will together lead to internal compliance. Scholars in these disciplines offer guidance on how to create legally compliant and ethical individuals and organizations. Their learning must be used to help train compliance officers, who, without pretending to be psychologists, must understand the goal that they are trying to achieve and know the methods and techniques for achieving it that have been empirically established. Shifting the emphasis from external to internal compliance will not happen overnight, and compliance officers have to recognize the psychological effectiveness of, and thus the need to maintain, an external control system as a check on illegal and unethical conduct. Indeed, the complexity of human thinking and behavior demands this external check, so that brokers do not override their ethical self. In

Practices, 56 ACAD. MGT. J. 84, 108 (2013) (rejecting the view that organizational values come from the “top down” and are relatively stable, but arguing instead that, constantly subject to change and refinement, they emerge locally and “through discussions, negotiations, and ongoing network reconfigurations that values practices are performed.”). See supra note 135.

See, e.g., BAZERMAN & TENBRUNSEL, supra note 7, at 152-65 (discussing ways to improve ethical decision-making in oneself and in organizations). Awrey, Blair and Kershaw use the work of organizational theorists to discuss how conduct in financial firms can be made more ethical and “other regarding,” essentially by having processes devoted to raising ethical concerns in this conduct. They discuss some of these processes in the context of U.K. financial regulation. See Dan Awrey, et al., “Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?” LSE Law, Society and Economy Working Paper 14/2012.

To take one example, compliance officers could learn techniques for screening brokers to detect those who might have a propensity for ethical or unethical conduct. As Giacalone and Promislo observe in the academic context, it is useful to be aware of how individuals possess a mindset prone to or primed for ethical failings, so that educators can address it. See Giacalone & Promislo, Broken When Entering, supra note 19, at 94-95. Compliance officers would also need to learn techniques for triggering ethical thinking in decision-making. Some of these techniques are as easy as raising ethical or legal issues before a decision is made. See, e.g., BAZERMAN & TENBRUNSEL, supra note 7, at 156-57. Even automatic, rather than deliberative, processes could be used by them to create ethical conduct. Significant research is now being done on how to “prime” or trigger ethical conduct, particularly in high performance, cognitively intensive settings. See generally David T. Welsh & Lisa D. Ordóñez, Conscience without Cognition: The Effects of Subconscious Priming on Ethical Behavior, ACAD. MGT. J. (forthcoming 2013). Among other things, Welsh and Ordóñez observe that people act ethically in order to maintain their self-concept as an ethical person and that the key to motivating ethical conduct is to cause them to see a decision or conduct as raising the ethical decision framework. They find that, in high cognitive activities with demanding performance goals, subconscious priming, which operates almost automatically (e.g., through the use of symbols, images, stories, etc. in the workplace) and does not use much of an individual’s cognitive resources, may be best in triggering ethical decision-making, particularly where constant monitoring is unavailable.

The reference here is to, among other things, emerging research that conduct by individuals in financial firms may be influenced by hormones, such as testosterone, which promotes risk-taking, or cortisone, which decreases it. It is thus possible that neurobiological influences could override ethical decision-making, which would require an external system to guard against such conduct. See John M. Coates, et al., From molecule to market: steroid hormones and financial risk-taking, PHIL. TRANS. ROYAL SOC. B. (BIOLOGICAL SCIENCES) 365 331-43 (2010) (discussing the influence of such hormones and ways to guard against their negative effects). Moreover, simply triggering the deliberative self to focus on legal policies and ethical standards may not be enough to produce ethical decisions, since, in certain circumstances, individuals can use deliberative cognitive processes to override ethical values (i.e., to convince themselves that they do not matter), a process known as “moral disengagement.” See Dean
sum, the challenge of compliance is to achieve a reorientation towards an internal system while maintaining an external one that does not squeeze out other approaches.

This reorientation would require a significant change in the perspective of regulators, like the SEC, or SROs, like FINRA. In particular, FINRA would have to alter its approach of responding to every new problem or development in the brokerage industry by requiring a broker-dealer to add new WSPs. It would be difficult as a policy and organizational matter for FINRA to change its rules-based orientation, for this approach has for a long time characterized all of its dealings with broker-dealers. To take one example, its examiners demand tangible proof, in the form of WSPs, a firm’s records of compliance with them and the hierarchy of supervisors, for a firm’s supervision of a given business activity or broker. By contrast, if an examiner were to evaluate whether a firm had in place adequate internal compliance and a customer-centric culture, he or she would have to spend considerable time in the firm to see how supervision and compliance operated in practice. In addition, FINRA’s member firms also benefit from FINRA’s espousal of the external approach and may resist any change to it. After all, broker-dealer executives can delegate the responsibility for compliance to the compliance officers, whose success or failure can be easily measured by the number of WSPs and their enforcement, as well as the absence of significant enforcement actions against the firm and its employees. Even if a problem occurs in a firm, the firm and an executive can often rely upon the existence of a compliance system as a defense to supervisory liability. By contrast, as the psychological literature suggests, internal compliance in a firm will require significant commitment from and involvement by top management.

A. Shepherd, et al., “I Care About Nature, but ...”: Disengaging Values in Assessing Opportunities that cause Harm, ACAD. MGT. J. (forthcoming 2013) (in a study of entrepreneurs, finding that those with high views of their own abilities, operating in a highly competitive environment, override their own environmental values; suggesting that in such environments, strong legal frameworks may be necessary to prevent violations). On how moral disengagement occurs, see generally Albert Bandura, et al., Mechanisms of Moral Disengagement in the Exercise of Moral Agency, 71 J. PERSONALITY & SOC. PSYCHOL. 364 (1996) (discussing the classic processes of moral disengagement: justifying detrimental action (i) by classifying it as moral, (ii) by diffusing the responsibility for it, (iii) by disregarding or distorting its consequences and (iv) by blaming the victims for one’s actions). Indeed, Bandura explains that, under social cognitive theory, improper conduct is regulated by social (i.e., external) sanctions, as well as by “internalized self-sanctions.” See id. at 372. Thus, external sanctions can be useful in light of the risk of disengagement of the self-sanctions. See Weaver & Treviño, Compliance and Values Oriented Ethics Programs, supra note 4, at 329-30 (finding that a compliance-based approach (what I have termed an external approach) deters unethical and illegal conduct, but produces less of a commitment to an organization’s values than does a values-based approach, which leads them to believe that it is effective only when coupled with a meaningful values-based approach).

142 On SEC and FINRA examinations, see generally Matthew C. Dwyer, Preparing for Broker-Dealer Examinations, 5 PRAC. COMPLIANCE & RISK MGMT. FOR THE SEC. INDUSTRY 21 (May-June 2012).
143 Now an examiner might simply demand to see a firm’s Code of Ethics and any statements by senior executives about the importance of ethics.
144 See FINRA Rule 2010 (which refers to “standards of commercial honor and principles of trade”).
external supervisory system.\textsuperscript{145} Another argument will likely appeal to FINRA’s membership, but not necessarily to FINRA itself: that the turn to internal compliance will reduce the regulatory burden on broker-dealers as there will be less need for WSPs and the accompanying FINRA oversight. Since, as Professors Birdthistle and Henderson have shown, FINRA has evolved from an SRO into a quasi-governmental agency, it has an institutional interest in maintaining the current situation, which gives it a reason for existence.\textsuperscript{146}

Moreover, FINRA is unlikely to reorient the current compliance orientation on its own, especially since, as an SRO, it is subject to SEC oversight.\textsuperscript{147} Thus, the change would require convincing the SEC to allow FINRA to promote the internal approach, as well as to do the same itself. The SEC should be receptive to the compliance reorientation since it offers a policy-based approach in much of its own regulation of broker-dealers, which echoes the statutory framework of the Exchange Act that offers general mandates, rather than detailed rules, in this area.\textsuperscript{148} It is true that the duty of supervision, as well as the defense to a failure to supervise, which is the foundation upon which the external supervisory and compliance orientation has been built, is driven by avoidance of SEC prosecution and thus reinforces external compliance.\textsuperscript{149} However, the defense is arguably broad enough to include both the internal approach to compliance and a detailed supervisory system with WSPs. The SEC could interpret an effective supervisory system as one that must have, as one component, internal compliance.

The challenge will be convincing the SEC to allow FINRA to promote the reemphasis on internal compliance. Yet it is one thing for the SEC to publicize the culture of compliance, as it does today, when it can rely upon FINRA to require a heavily rule-based external compliance approach from firms; it is another thing for the SEC to take the same approach without the protection of FINRA’s detailed rule-making and rule monitoring. The SEC would be concerned about being perceived as being too soft on the securities industry by approving this FINRA reorientation toward internal compliance and by deemphasizing the latter’s rule enforcement. The SEC would fear the occurrence of a situation, like those in the past,\textsuperscript{150} where investors were harmed by conduct not explicitly forbidden or addressed by rules. Critics would accuse the SEC of having forgotten these past failings of self-regulation or of just being too accommodating to broker-dealers and to the securities industry.\textsuperscript{151}

Therefore, it is unrealistic to expect that, just by appealing to its commitment to a culture of compliance, the SEC will be convinced to approve much lessening by FINRA of its external compliance approach, especially since the SEC occupies a difficult political position—short of

\textsuperscript{145} This “gradualist” approach, or an approach that simply shifts the emphasis in compliance, may be more psychologically acceptable to FINRA executives as it is to most people.

\textsuperscript{146} See William A. Birdthistle & M. Todd Henderson, \textit{Becoming The Fifth Branch}, 50-52 (discussing the “public choice” explanation for why FINRA likes the current situation).

\textsuperscript{147} See supra notes 1-2.

\textsuperscript{148} Again, an obvious example is the requirement of the supervisory system which, as discussed above, is a general defense in the Exchange Act, but extremely detailed broker-dealer mandate in FINRA rules. See supra text accompanying notes 23-46.

\textsuperscript{149} See supra text accompanying notes 26-35.

\textsuperscript{150} See supra note 42 (discussing case that led to FINRA’s imposition of a rule requiring the testing of supervisory systems, with particular attention to specific issues like the safeguarding of customer assets).

\textsuperscript{151} See generally 1 POSER & FANTO, \textit{BROKER-DEALER LAW AND REGULATION}, supra note 49, at § 1.01 n.3 (listing these failures).
resources but blamed for any scandals in the securities markets.\footnote{152 See U.S. SEC. & EXCHANGE COMMISSION, STRATEGIC PLAN, supra note 126, at 6-7 (discussing the SEC’s budgetary constraints). On being blamed for scandals, see supra note 121 (discussing the blame placed on the SEC for Madoff).} Moreover, the SEC could contend that it has now struck the right balance between internal and external compliance by itself promoting the culture of compliance while leaving to FINRA the imposition of detailed supervisory rules that engender the external compliance system. However, the SEC must understand that the balance is illusory, that the domination of the external approach squeezes out the internal and, therefore, that it needs to alter the orientation if compliance is to succeed in its mission. The important question becomes then what will convince the SEC even to take the initial steps, apart from persuading it of the theoretical merits of the internal approach in producing compliant conduct.\footnote{153 If the SEC were to emphasize the internal approach, this emphasis might provide the brokerage industry with an important example of the SEC’s appreciation of the predicament of broker-dealer firms that must deal with the costs associated with a seemingly unending number of WSPs. The issue has been particularly highlighted by court cases striking down SEC rules because the SEC has done an inadequate economic analysis of the costs associated with them. See, e.g., Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (striking down SEC rule requiring public companies to allow certain large shareholders to nominate directors on the company’s annual proxy statement). But the only way in which this would be a meaningful gesture to the industry, as opposed to the SEC’s current lip service to the culture of compliance, would be the promise that, as the internal approach takes hold, the number of rules would decrease, or at least would not grow.} It would be worthwhile, then, if the SEC, as well as FINRA, could be provided with ways of measuring the effectiveness of the internal approach, which would provide them with tangible signs of its benefits.

B. The Conditions to the Reorientation

1. Measurements of the Value of the Internal Approach

One would expect that, over time, the overall incidents of illegal and unethical conduct would decrease in the brokerage industry, if internal compliance took hold. This decline could be measured by the number of SEC and FINRA disciplinary actions aimed at individuals, as well as customer complaints and arbitration actions that had merit.\footnote{154 FINRA provides basic annual data on investor complaints and disciplinary actions that FINRA enforcement has brought. See http://www.finra.org/Newsroom/Statistics/. The SEC provides annual data on enforcement actions in its SELECT SEC AND MARKET DATA: FISCAL 2012, available at <http://www.sec.gov/about/secstats2012.pdf>.} Accordingly, one could persuade the SEC and FINRA to promote the internal approach by arguing that its effect could be empirically measured over time. The problem here, however, would be causation, for, as mentioned above, the internal approach is not replacing the external approach, but would be supplementing it. Thus, any decrease in legal, rule and standard violations could be due to the enhanced effectiveness of the external system, as well as renewed FINRA and SEC enforcement, or its threat. On the other hand, it could also be the result of application of the internal approach. In any event, causation for the decline in disciplinary actions is likely to be muddied and difficult to establish, and the decline might take considerable time to appear. Thus, these statistics would not be useful in justifying to the SEC and FINRA that they can measure the effectiveness of the reorientation to the internal approach.

Since the ultimate goal of internal compliance is to change the culture of a broker-dealer so as to prevent misconduct and to promote customer-oriented behavior, the better measure of its effectiveness would be the decline in instances of widespread misconduct and questionable
practices in firms. In other words, if the internal approach takes hold in firms, one would expect to see fewer instances of institutional misconduct. These are not situations where the rules or ethical standards are inadequate, but where they are ignored or gamed throughout an organization or a significant part of it. They are also those that are most damaging to the securities industry because they generally reveal abuses of numerous customers because employees and even supervisors put their own self-interest over customer interest. As noted earlier, the external approach is not effective in addressing this phenomenon, because monitoring cannot be omnipresent and because, where there is a weak culture and widespread acceptance of illegal and questionable conduct, external monitoring is generally gamed or simply ignored.

To persuade the SEC and FINRA to promote the internal approach through a pilot program of some sort, one could argue to them that there will be a way to measure its effectiveness by tabulating the instances of institutionalized misconduct in the securities industry. Again, these would be cases where an entire firm, or a significant part of it, such as a branch or a division, is engaged in the misconduct. It would not involve legal, rule or ethical violations by a few individuals, or even in a small, few person broker-dealer, even if the violations were serious in nature. It would also include instances where the problem appeared in a number of firms or was even industry-wide. These cases are generally typified by a charge of failure to supervise leveled against the firm and its top executives for numerous violations, and even widespread corruption, in an entire firm or in a significant part of it. The cases can also be brought to light as a result of numerous customer complaints directed at many firm employees, as opposed to at just one “rogue” broker.

As mentioned above, the SEC and FINRA now provide general statistics on their enforcement actions, as well as their results, and FINRA similarly tabulates customer complaints in arbitration. More significantly, FINRA’s disciplinary actions are available online, and the SEC publishes its individual enforcement proceedings on its web site. From this information, it is possible to arrive at an annual assessment of institutionalized misconduct in the brokerage industry. It should then be possible to compare this assessment from year to year, as controlled for other factors, such as the number of broker-dealers and branches. It would be proposed that the SEC and FINRA evaluate the success of the internal approach over at least ten years in a pilot program of supporting this approach. The data in the initial years of the program will not reflect the success (or lack thereof) of the internal approach, because institutional misconduct does not happen overnight and because the internal approach needs several years to take hold in

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155 Institutionalized misconduct clearly appeared in many of the firms involved in the packaging and selling of mortgage-backed securities. See supra text accompanying notes 105-113.

156 A recent example, although in an investment adviser, not a broker-dealer, is the SEC’s charge of failure to supervise against Steven A. Cohen, the owner of S.A.C. Capital, because of the allegation of widespread insider trading in his firm. See In re Steven A. Cohen, Investment Advisers Act Release No. 3634 (July 19, 2013), available at <http://www.sec.gov>.

157 FINRA’s disciplinary actions are available at <http://www.finra.org/Industry/Enforcement/DisciplinaryActions/FDAS/>. In addition, FINRA publishes monthly descriptions of disciplinary resolutions for that month, which in turn hyperlink to the actual decision on its web site database. The SEC’s litigation part of its web site, <http://www.sec.gov/litigation.shtml>, has links to SEC decisions, litigation releases and results of administrative proceedings, among other things, which, together, provide access to individual decisions.

158 That is, the number of broker-dealer firms has been declining, while the number of has declined, but then recently increased. See <http://www.finra.org/Newsroom/Statistics/>.
firms as a result of FINRA’s and the SEC’s efforts (to be discussed below). Thus, the data in years 6-10 will be more indicative of the success of the approach than that in years 1-5.

The SEC and FINRA should also commission a survey of brokerage employees to elicit “soft” information about the effect of the adoption of the internal compliance approach. They should do a survey before undertaking to promote the internal approach, as a way of establishing a benchmark for the current situation of compliance in the brokerage industry. They could then conduct the same survey at regular intervals, say every five years, to measure the progress of the adoption of the internal approach in firms. Care would have to be taken to break down this data in accordance with firm size because smaller firms will likely find the adoption of the internal approach more challenging, given that they are in a more precarious economic position, and the temptation to push aside legal and ethical standards for profits will be greater in them. Similar surveys should also be done for brokerage clients, both retail and institutional. If the internal approach is succeeding, one would expect that employees would reflect that compliance is an important part of their firm’s culture and that customers would echo that firms and brokers are increasingly customer-centered.

These ways of being able to measure the value of the internal compliance approach may persuade the SEC and FINRA to promote it, at least in a pilot program, and then ultimately to adopt it as a part of broker-dealer compliance. However, there is little possibility that the data will show a decline in institutional misconduct unless they actively support its implementation in broker-dealers, as opposed to today’s situation of giving lip service to the culture of compliance while reinforcing the external approach. It is time then to turn to a discussion of how they can promote internal compliance.

2. Initial Steps by the SEC and FINRA to Promote Internal Compliance

The question arises whether FINRA and particularly the SEC should adopt the reorientation toward internal compliance through an official notice and comment procedure. Since, as noted above, the reorientation is only that, i.e., a reordering of existing compliance approaches, both the SEC and FINRA are arguably not doing anything fundamentally new here, not unlike what happens when they decide to give special examination or enforcement attention to a particular problem or area of financial activity. They are thus within their authority to engage in this reorientation as an interpretive policy matter, which would not demand any notice and comment. However, it may be advisable for the effectiveness of the reorientation itself and for dealing with any opposition to it for them to accomplish it through a notice and comment procedure. This procedure would have the SEC and FINRA highlight internal compliance, explain its orientation and suggest the ways in which it could be accomplished in a firm. It also has the advantage of allowing broker-dealers and other interested parties to raise problems or issues with it and its implementation that might not otherwise be known. Moreover, since

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159 See Niki A. Den Nieuwenboer & Muel Kaptein, Spiraling Down into Corruption: A Dynamic Analysis of the Social Identity Processes that Cause Corruption in Organizations to Grow, J. Bus. Ethics (forthcoming) (discussing research methods for identifying organizational corruption, including surveying employees about the organizational norms and scope for misconduct in their firms).

160 The SEC has commissioned similar such studies in the past. See, e.g., Angela A. Hung, et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, Rand Institute for Civil Justice (2008) (among other things, investigating how well investors understood the duties of their financial advisors).

161 This procedure is required by a federal agency when it issues a “substantive,” as opposed to an interpretive, rule or policy. See 5 U.S.C. § 553.
internal compliance could involve new costs to broker-dealers, as compliance officers spend more time on advising employees or designing ways of triggering ethical conduct, the costs must be justified by the SEC and FINRA in terms of the benefits of having more compliant firms, as measured in the ways discussed above.\footnote{In particular, if the SEC’s support for internal compliance is considered substantive, it would be under a legal obligation, among other things, to evaluate its effect upon smaller broker-dealers. \textit{See} 5 U.S.C. § 603.
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The recommended approach to adopting this reform would be to have FINRA, rather than the SEC, propose the reorientation through a new rule, or an amendment to an existing rule. This makes sense because the emphasis on internal compliance is an ideal subject for FINRA action, given that it concerns the internal governance and supervision of broker-dealers. Although there are several possibilities for the rule, the best approach is to have FINRA propose an additional supplementary material to FINRA Rule 3130, which, as noted earlier, has the CCO requirement for firms and the CEO’s certification as to compliance after consultation with the CCO.\footnote{See supra note 45.}

This Rule now includes supplementary material that, among other things, describes the importance of compliance processes, the role of the CCO and the responsibility for compliance.\footnote{See FINRA Rule 3130.03, .05 & .06.}

\section{11 Internal Compliance.} An important task of the CCO and the other compliance officers is to promote internal compliance in a member. Internal compliance means that associated persons use the goals and policies of federal securities regulation and FINRA professional standards and ethics in their decision-making and thus in orienting their conduct, in addition to their compliance with federal laws and regulations and FINRA rules (external compliance). For this purpose compliance officers would be expected to assist associated persons to make decisions and otherwise to conduct themselves in accordance with these policies, standards and ethics. This assistance would include providing advice on compliance to associated persons, conducting appropriate training on legal, professional and ethical obligations and otherwise creating an environment in a firm conducive to appropriate decision-making and conduct. The goal of internal compliance is to have associated persons who would be legally, professionally and ethically compliant without the constant oversight of compliance officers and their supervisors.

Having FINRA issue the addition to Rule 3130’s supplementary material allows, at a minimum, for a two-stage comment process. First, broker-dealers and other interested parties could offer comments to FINRA’s proposed addition, which would be issued in a regulatory notice.\footnote{Occasionally, FINRA will issue several regulatory notices as to a particular proposal, if such receives significant comments and if, as a result, FINRA must reissue it to take into account changes suggested by commentators.}

Second, before approving FINRA’s rule change, the SEC would put the supplementary material out for further comment.\footnote{The notice and comment period of a proposed FINRA rule is governed by 15 U.S.C. § 78s(b) and by 17 C.F.R. § 240.19b-4. The understanding here is that the new supplementary material would not be a “stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule.” \textit{See} 15 U.S.C. § 78s(b)(3)(A) (for rules taking effect immediately upon filing).}

In the SEC’s request for comment, as well as in its eventual approval of it, the SEC can underline the importance of internal compliance in broker-dealers and put its weight clearly behind the approach.
In addition to proposing the new supplementary material, FINRA and SEC officials must take additional actions to promote the reorientation from external to internal compliance. FINRA would do what it typically does whenever it is setting forth a new rule or policy: its senior officers would publicize internal compliance in their speeches in various industry fora and on FINRA’s web site, and FINRA examiners would make it an examination priority. Moreover, as a result of examinations FINRA might well issue a report about the practices in different firms with respect to their creating internal compliance, as a way of highlighting particularly successful models used by firms. Furthermore, behind every FINRA rule and thus its requirement for specific WSPs are the goals, policies, standards that the rule is intended to promote. Indeed, FINRA officials often refer to the policies in their speeches, as do their regulatory notices. Whenever it issues a notice, therefore, FINRA should ensure that the policies do not recede into the background when it turns to a description of the rules and the way in which compliance with and supervision of them are to be implemented by firms. Rather, explaining and promoting the policies should become a major point of the notice, as well as in the publicity and follow-on explanation surrounding it. The notice should thus direct compliance officers to bring the policies and standards to the foreground in particular business decisions targeted by the rules, and it should make suggestions as to how this might be accomplished. SEC officials could do the same, emphasizing the importance of internal compliance in their speeches, in their approval of FINRA rules and in any general pronouncements on broker-dealer conduct.

FINRA and the SEC must also rethink the role of the compliance officer as a part of the firm’s reporting system of violations to FINRA and the SEC, as well as to the DOJ. As noted above, a compliance officer monitors employees for compliance, follows up on red flags and reports legal, regulatory and ethical violations to supervisors. The supervisors then take action to address any violations and to prevent further ones, which may include reporting to FINRA and possibly to the SEC and the DOJ. The reporting of violations shows the effectiveness of the supervisory system and, as discussed above, is a defense for the supervisors and the firm against

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167 For example, each year FINRA sets forth its examination priorities for the upcoming examinations. See, e.g., Letter of Daniel M. Sibears, Executive Vice President, Member Regulation Programs (Jan. 11, 2013).

168 For example, FINRA and the SEC issued a joint guidance on effective practices for internal inspections of branches. See, e.g., FINRA, Branch Office Inspections, Reg. Notice No. 11-54 (Nov. 2011) (attaching a copy of the joint FINRA-SEC risk alert on the topic).

169 In its release on the new suitability rule, for example, FINRA referred to the policies behind the rule. See FINRA, Know your Customer and Suitability, Reg. Notice No. 11-02, supra note 63, at 1 (“The know-your-customer and suitability obligations are critical to ensuring investor protection and promoting fair dealing with customers and ethical sales practices.”).

170 Again, to take the suitability example, in its initial rule release, FINRA spent considerable time discussing the new rule, its technical differences from the old and issues relating to implementation, but little time on the policies. Certainly, compliance officials, firms and brokers need to understand how to implement the rule. See id. But if FINRA itself puts little emphasis on the policies of investor protection and fair dealing as orienting the application of the rule, it is likely that firms and compliance officers will take the same approach in its implementation. And the rule soon becomes a set of steps to follow, rather than an effort to serve the client.

171 As the SEC’s examination of broker-dealers is less extensive than FINRA’s and more targeted to risky firms, the SEC also establishes examination priorities, and internal compliance could become one. See SEC OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS. EXAMINATION PRIORITIES FOR 2013 (Feb. 21, 2013).

172 See supra text accompanying notes 68-71.

173 See supra text accompanying notes 73-74.
a charge of supervisory liability for the violation. In addition, FINRA and SEC enforcement officials, as well as federal prosecutors, take a more accommodating position towards a firm with respect to its own liability when it reports violations and assists them in the investigations of them.

Indeed, if a broker-dealer is a public firm, compliance officers may feel particular pressure to start the reporting process, since a relatively new law and regulation governing whistleblowers allow the latter to bypass internal reporting and since a firm wants to avoid a situation where an employee or someone else, rather than the firm itself, reports to regulators or prosecutors a violation taking place in the firm.

Yet having a compliance officer as part of the reporting structure for violations and ultimately a participant in enforcement conflicts with his or her role as a promoter of internal compliance. This latter role requires that a compliance officer be a close advisor to employees and be trusted by them so that they are willing to raise difficult matters with the officer. As has been well analyzed, that function is undermined by a perception that a compliance officer’s goal is to protect supervisors and the firm by providing information about employees to supervisors and ultimately to regulators and prosecutors.

Fearing that any information shared with compliance officers will be reported “up the chain,” employees will be less open, and reluctant to consult, with them. Indeed, social psychologists emphasize that the most effective diffusion of models of ethical conduct and decision-making comes from those whom we perceive to be part of our social group. In sum, the reporting and potential enforcement role of the compliance officer thus reinforces his or her position as part of external compliance.

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174 See supra text accompanying notes 29-30. In addition, under the Exchange Act control liability would arise under Section 20(a), 15 U.S.C. § 78t(a), but the controlling party has a “good faith” defense, which can be satisfied in the same way as the defense to supervisory liability—having an effective supervisory system.

175 This generally means that the prosecutor or the enforcement official does not prosecute the firm or defers prosecution because of the firm’s cooperation in investigating the misconduct by its employees. See generally SEC DIVISION OF ENFORCEMENT, ENFORCEMENT MANUAL (Mar. 9, 2012) (setting forth policies relating to and grounds for entering into cooperation, deferred and non-prosecution agreements); DEPT. OF JUSTICE, PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ENTERPRISES §§ 9-28 (credit arises from cooperation, which means, among other things, disclosure of the relevant fact and taking of remedial action); FINRA, FINRA INVESTIGATION: FINRA PROVIDES GUIDANCE REGARDING CREDIT FOR EXTRAORDINARY COOPERATION, REG. NOTICE NO. 08-70 (Nov. 2008) (defining such cooperation as (1) self-reporting of violation, (2) extraordinary steps to fix deficient procedures or systems, (3) extraordinary remediation to customers, or (4) providing substantial assistance to FINRA investigations).

176 The whistleblowing provision is pursuant to Section 21F of the Exchange Act, 15 U.S.C. § 78u-6, added by Section 922 of Dodd-Frank. The SEC implemented this provision is Rule 21F, 17 C.F.R. §§ 240.21F-1 to 21F-17.

177 See generally John Hasnas, Managing the Risks of Legal Compliance: Conflicting Demands of Law and Ethics, 39 LOYOLA UNIV. CHICAGO L. J. 507, 517 (2008) (noting conflicts between command and control and self-regulatory approach). See also SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 30 (cautioning regulators against “deputizing” compliance officers as their agents); Vass, The Compliance Officer in Today’s Regulatory Environment, supra note 48, at 10 (“To the greatest extent possible, regulators should avoid directly using the work product of Compliance personnel in proceedings against firms or their officers or employees. If firms’ officers or employees perceive this to be likely, they may react to Compliance initiatives and inquiries with suspicion and reluctance to provide complete cooperation and candid responses.”).

178 See, e.g., Francesca Gino, et al., Contagion and Differentiation in Unethical Behavior, 20 PSYCHOL. SCI. 393, 394 (2009) (finding that cheating is significantly influenced by a person’s social identification with the cheater (i.e., if the cheater is part of one’s social group), with the opposite happening if the cheater is perceived to be an outsider; thus emphasizing the importance of the peer group in ethical conduct).

179 The issue of reporting to authorities raises an issue beyond the scope of this article, which has been ably dealt with by other scholars—the dangers of an increased role of enforcement in the regulation of financial and other firms, as evidenced by the increased criminalization of business conduct. For an early and valuable work on this subject, which is timely today, see ROBERTA KARMEL, REGULATION BY PROSECUTION (1981).
There is no question that the SEC and FINRA (and the DOJ) will always expect broker-dealers and their employees, and thus compliance officers, to report to them serious violations of the law. Therefore, just as a firm must maintain its external compliance for psychological deterrence, it must have compliance officers report to supervisors, with further reporting to FINRA and the SEC. But, to promote the reorientation toward internal compliance, the SEC and FINRA could emphasize that, in general, discipline is the responsibility of supervisors in the firm, rather than compliance. At a minimum, the SEC should clarify that, in the absence of very special circumstances, compliance officers are not supervisors, which would clearly disassociate the former from the latter role and its disciplinary implications. In addition, both the SEC and FINRA should state that compliance does not typically have an enforcement role with respect to potential violations of the law, regulation or professional standards (other than calling supervisors’ attention to problems or “red flags”); that role lies with another firm control function, such as legal. Admittedly, if, as a result of his or her monitoring, a compliance officer reports a potential violation to a supervisor, he or she is starting the enforcement process. However, the goal here is to eliminate the factors that tie the officer too closely to external compliance, while recognizing that the compliance officer has the typical reporting obligation of any employee.

The SEC and FINRA must also demonstrate that firms are rewarded for successfully implementing internal compliance. The most concrete measure that they can take is to take into consideration a firm’s internal compliance when they are considering whether to bring, or actually bringing, a supervisory liability charge against it. The SEC and FINRA, as well as the DOJ, have policies in place to reward a firm for its supervisory system when evaluating its supervisory liability, and they assert that they pursue a supervisory liability charge only when there are specific grounds for it. It would be particularly useful as a way of promoting internal compliance if, in specific enforcement actions other than in cases of widespread misconduct, the SEC and FINRA gave some credit to the firm, as well as to firm supervisors, for its internal compliance. The credit approach can be done without undermining external compliance, the failure of which may be the basis for the supervisory liability (e.g., the absence of a WSP, the failure to carry out specific procedures of a WSP) and which will have to be corrected. The credit would take the form of lessening the penalty for the supervisory violation based on a failure of external compliance. In awarding credit for internal compliance, if it is appropriate, the SEC and FINRA can take the opportunity to highlight features of a targeted firm’s internal compliance that justified the credit (or its denial), which will further guide firms on its implementation.

prosecution thus “crowd out” other forms of regulation of conduct in a firm. See generally Miriam Baer, Organizational Liability and the Tension Between Corporate and Criminal Law, 19 J. L. & POL’Y 1 (2010).

See supra note 35.

Firms themselves must try to separate clearly these roles, which can be challenging since some compliance personnel also function as legal officers. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 48, at 8-9.

See supra note 175.

Indeed, as discussed earlier, it was through its administrative decisions that the SEC indicated to firms what would constitute an adequate compliance system. See supra text accompanying notes 32-35.
V. Conclusion

This Article argues for a reorientation in the role of the compliance officer in broker-dealers as a way to promote internal compliance among employees in financial firms and, ultimately, to create more investor confidence in broker-dealers and in the financial system. Part II first discussed the history and evolution of compliance, with reference to its statutory, regulatory and FINRA basis, which was designed to assist supervisors and the firm in their statutory duty to enforce the federal securities laws and regulations and industry standards. It then reviewed the current state of compliance and the typical tasks of compliance officers, who produce detailed WSPs, who monitor firm employees for compliance with them and who report any violations within the supervisory structure of the firm.

Part III first discussed the problems with this external approach. It explained that this approach is an example of the techniques of “soft” power and control that emerged from the Enlightenment and that have been used in many domains both to control individuals and to make them more productive. Yet this “panopticon” perspective not only provokes resistance from the subject of the discipline, but also presents an unattainable model of total oversight and control of individuals. The Part next explained how the external approach, while necessary as an outer bound to prevent illegality and ethical abuses, is not psychologically effective if it is the sole or even the major model of compliance, particularly in financial services, since financial professionals need to have discretion to make decisions on behalf of customers and otherwise to be productive. External compliance, albeit an integral part of the securities business, risks being seen by business employees as external to their business identity, which can lead them to feel justified in ignoring or gaming the laws, rules and standards that compliance enforces—the very opposite of the intended purpose of compliance. In addition, it squeezes out other approaches, despite the pronouncements by the SEC and FINRA in favor of the culture of compliance. Moreover, as the Part showed, this estrangement of compliance from the business of broker-dealers can produce adverse consequences because the recent financial crisis revealed problems in firms with detailed compliance systems. Despite these problems with the external orientation, however, Congress and the SEC are reinforcing and extending the model of external compliance, which threatens the financial industry with excessive regulatory burdens and will lessen the vibrancy, flexibility and competitiveness of financial firms.

Part IV argued for a reorientation toward internal compliance in broker-dealers and suggested how the change can be achieved. Instead of being only the producer and monitor of compliance with WSPs, compliance officers must emphasize their role as a counselor and promoter of a compliance culture, which means foregrounding the policies behind the securities laws and regulations and professional and ethical standards. In doing this compliance officers would play a major role in changing the decision framework for business employees so that these policies and ethics do not “fade” in business decisions. The Part reviewed ways in which compliance officers can promote this internal compliance and also contended that this changed emphasis requires the assistance of FINRA and the SEC. This Part recognized that FINRA and SEC would resist this change, which is contrary to their established approach and which risks making them seem soft towards the securities industry.

Part IV concluded by arguing that this resistance might be overcome by showing the SEC and FINRA ways to measure the effectiveness of the internal approach, which could then be tried
in a multi-year pilot program. It recommended that, after a suitable period of initiation, FINRA and the SEC evaluate whether instances of institutionalized misconduct in firms, branches or significant divisions declined, for this kind of misconduct should be reduced by internal compliance. The Part also recommended that they conduct surveys of brokerage employees and customers as to whether the culture of firms changed as a result of reorienting compliance towards an internal approach. The Part then recommended that FINRA propose the reorientation in new supplementary material to an existing supervisory rule, which will provide the reorientation with express regulatory authority, as well as allow potential problems with the approach to surface. The Part then discussed how FINRA and the SEC could promote internal compliance, for example, by emphasizing policies in their rule-making. Finally, the Part made several suggestions about how FINRA and the SEC could lessen the enforcement role of compliance, which is an impediment to internal compliance, in particular by clearly separating compliance from supervision and by giving firms credit for internal compliance in enforcement decisions.

This Article recognizes the growing importance of compliance in broker-dealers while arguing that a continuation of the current external approach needs to be reoriented towards an internal one. Under the external approach, WSPs will be piled upon other WSPs until they either overwhelm the financial sector or, what is more likely, they are simply disregarded or followed in a routine, meaningless way. Compliance, as currently configured, has the unique advantage of being present throughout the financial firm, at all layers and in every business. In a time of government deficits and thus of regulatory limitations, compliance is available to help achieve the goals and policies of the laws, regulations and professional standards governing broker-dealers, which are ultimately social ones. But compliance has to be reoriented to promote internal compliance if it is to have this valuable effect.