IMPACT ANALYSIS: Defining "culture of compliance" is key to this year's FINRA exams

Jan 14 2016 Todd Ehret, Regulatory Intelligence

The Financial Industry Regulatory Authority gave prominent new emphasis to the role of compliance culture when it issued its examination priorities for 2016 last week, making it essential that firms know how to measure and demonstrate that their cultures will pass regulatory muster.

FINRA's annual list of exam priorities outlined three broad issues, supervision, risk management and controls, and liquidity as themes for this year's exams. Other issues included, cyber security, outsourcing, anti-money laundering, sales practices, spoofing and protections of senior investors.

But new to the letter this year was FINRA's emphasis that firms' overall cultures would be under detailed scrutiny. FINRA said it will concentrate on, "firm culture, conflicts of interest and ethics, and the significant role each of these plays in the way a firm conducts its business."

"Nearly a decade after the financial crisis, some firms continue to experience systemic breakdowns manifested through significant violations due to poor cultures of compliance," said FINRA Chairman and CEO Richard Ketchum. "In 2016, FINRA will be looking for firms to focus on their culture and whether it is putting customers first and promoting risk management adaptable to a changing business environment. Our goal is not to dictate a specific culture, but rather to understand how each firm's culture affects compliance and risk management practices. Firms with a strong ethical culture and senior leaders who set the right tone, lead by example, and impose consequences on anyone who violates the firm's cultural norms are essential to restoring investor confidence and trust in the securities industry."

**Principles versus rulebooks**

Firm culture may be difficult to quantify as the concept itself is subjective. Therefore, it is up to senior management and the compliance department to develop a plan and system to measure and document the firm's efforts toward creation of a culture of compliance. Very few firms would readily acknowledge or state that their compliance and ethics culture is sub-par, so creation of a method of measurement is an important task now at hand.

In the exam priorities letter, FINRA defines culture as the "set of explicit and implicit norms, practices, and expected behaviors that influence how firm executives, supervisors and employees make and implement decisions in the course of conducting a firm's business."

Statements like this raise the question, is this a sea-change from what historically has been a rulebook approach to a more real-life, principles-based approach to regulating? It also appears to be following the lead of the SEC and other international bodies such as the Financial Stability Board (FSB) where emphasis on culture and conduct has been prevalent.

Risk culture has been at the forefront particularly in Europe where the FSB called on regulators to actively assess risk appetite framework and risk culture within systemically important financial institutions (SIFIs), including an assessment of boards' effectiveness in overseeing their company's risk culture. The FSB summed up these expectations of financial regulators saying, "while various definition of culture exist, supervisors are focusing on the institution's norms, attitudes and behavior related to risk awareness, risk taking, and risk management, or the institutions' risk culture." The European Union, and UK regulators in particular, have also embraced the concept of "conduct risk" as framework in which a firm's culture is
Although compliance culture may not be exactly the same as risk culture, enough overlap exists that it merits mentioning. The key take away is that it's now here to stay and compliance departments will need to focus on it.

**How to measure "culture"**

In the exam letter FINRA stated that it "will formalize its assessment of firm culture to better understand how it impacts compliance and risk management. It will also complete the review begun in late 2015 regarding incentives and conflicts of interest in connection with firms' retail brokerage business."

FINRA stated it will assess five indicators of a firm's culture:

- whether control functions are valued within the organization;
- whether policy or control breaches are tolerated;
- whether the organization proactively seeks to identify risk and compliance events;
- whether immediate managers are effective role models of firm culture; and
- whether sub-cultures that may not conform to overall corporate culture are identified and addressed.

Creating a documentation process for each of the five items above should be a first step for compliance departments as FINRA clearly now expects members to take actions that mitigate conflicts of interest and promote fair and ethical treatment of customers. A thorough review of all policies, both corporate HR, and compliance, is necessary. Additionally, the creation of a method of measuring each of these areas is important.

FINRA will look for evidence that compliance and risk are valued within the organization. In particular, does a compliance department or compliance officer have the attention of the board or senior management, and does it have the budget and staff to do an adequate job? Evidence of clear lines of communication to the very top of firms is critical.

Evidence of how policy or control breaches are handled will be an interesting topic for firms to tackle. "Material breaches of firm policies and procedures should not be tolerated," FINRA said. Does this mean firms must fire an offender? Or, is documentation, censure or probation, or heightened supervision adequate? Whatever a firm decides, it should be prepared to justify the decision to the regulator.

Most importantly, FINRA is sure to examine whether firms have universal behavior standards and consequences regardless of whether an employee is a small fish or a star producer.

Zero tolerance policies for violating company rules or policies are the easiest to explain and are the most cautious approach for firms as FINRA would not be able to argue the firm is too soft or turning a blind eye. A zero tolerance policy is also likely what the regulator would prefer to see as it makes their job easier although FINRA is not likely to go this far as to dictate or micromanage member firms.

**Employee compensation**

FINRA is sure to also review employee incentive structures, as compensation often is an integral influence on individual behavior and actions. The regulator is sure to examine compensation plans of registered representatives. It is also likely to scrutinize compliance approaches to mitigating conflicts of interest arising through the sale of preferred or affiliated products, or products for which a firm and or individual receives third-party or preferential payments.

A recent [SEC settled case involving JP Morgan](https://www.sec.gov/spotlight/wealth-business-02252018) shows that broker compensation is an area of concern with regulators. The firm paid a $4 million fine to the U.S. Securities and Exchange Commission over a false claim in marketing materials that its private bank unit advisers were paid "based on our clients' performance, not on commission."

The brokers' pay is based on salary and a discretionary bonus, the SEC said in the complaint. Although the brokers, billed as "advisors" did not receive commissions, the claim of compensation based on portfolio
performance was misleading.

Compliance and senior management need to examine closely all compensation practices and be prepared for regulators to do the same. Full and accurate disclosure of commissions, selling bonuses, shared revenues and claw backs are all top priorities.

FINRA’s new emphasis on culture is not ground breaking in itself. Risk and compliance culture have been prominent with other regulatory bodies. FINRA has also never looked favorably on firms that just go through the motions and do not implement and enforce policies. It is unclear how FINRA will analyze and measure the behavioral elements of culture, but has now sent a clear message that they intend to do so with determination in the coming year.

Todd Ehret is a Senior Regulatory Intelligence Expert for Thomson Reuters Regulatory Intelligence. He has more than 20 years’ experience in the financial industry where he held key positions in trading, operations, accounting, audit, and compliance for broker-dealers, asset managers, and hedge funds.