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Refining Compliance Within Large Banking Organizations in a Post SR 08-8 World

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REFINING COMPLIANCE WITHIN LARGE BANKING ORGANIZATIONS IN A POST SR 08-8 WORLD

Today, compliance is on the minds of just about every congress person, regulator, lawyer, and financial service professional. Although not every financial corporation can follow in the footsteps of JPMorgan and hire 3,000 employees and spend $1.5 billion to overhaul its compliance function, the entire financial sector is retooling compliance programs to meet the evolving demands of a variety of federal, state, and even international regulators.[1]

INTRODUCTION

After one of the worst financial crises since the Great Depression, compliance has become one of the most sought after areas on Wall Street.[2] Demand for compliance expertise has started to increase rapidly, as organizations have had to strengthen and build more effective compliance programs.[3] Given the requirements of Sarbanes-Oxley,[4] Dodd-Frank,[5] and the continued regulatory pressure on the markets and banking institutions, companies will need to ensure adherence with the relevant rules and regulations in order to grow, merge, and prosper.[6]

Compliance has been in the spotlight during various scandals that have affected large banking organizations. In September 2013, JPMorgan disclosed it was hiring an additional 2,000 compliance officers to work on various compliance issues regarding the "London Whale" trading scandal.[7]

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1. Victoria Rivkin, *After the Fall: The Rising Need for Compliance Lawyers in a Post-Financial Crisis World*, 18 BROOK. L. SCH. LAW NOTES, Fall 2013, at 20, 21 (2013).

2. Aruna Viswanatha & Brett Wolf, *Wall Street's Hot Hire: Anti-Money Laundering Compliance Officers*, REUTERS FIN. REGULATORY FORUM (Oct. 14, 2013), http://blogs.reuters.com/financial-regulatory-forum/2013/10/14/wall-streets-hot-hire-anti-money-laundering-compliance-officers/.

3. *Id.*

4. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-2047, 116 Stat. 745 (2002).

5. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

6. Nick Allard, *Why Compliance Experts Are the New Key to Mega-Deals*, YAHOO! FINANCE (July 15, 2013, 3:19 PM), http://finance.yahoo.com/blogs/the-exchange/why-compliance-experts-key-mega-deals-191921713.html.

7. Lauren Tala LaCapra & David Henry, *JPMorgan to Spend $4 Billion on Compliance and Risk Controls*, REUTERS (Sept. 12, 2013, 10:09 PM), http://www.reuters.com/article/2013/09/13/us-usa-jpmorgan-risk-idUSBRE98C00720130913. The London Whale scandal occurred during April and May 2012, in which JPMorgan's Chief Investment Office booked outsized transactions involving credit default swaps that culminated in a large trading loss that led to a number of investigations to examine the firm's risk management system and internal controls.

During the same time period, HSBC also hired 3,000 compliance officers to bring its total compliance workforce to over 5,000 employees.[8]

There have been a multitude of challenges imposed on banking organizations since 2008. Some of these challenges have come in the form of new regulations, standards, and guidelines that need to be interpreted and monitored requiring firms to increase their compliance presence.[9] Furthermore, the task of compliance has become more complex for financial institutions that have a global presence and therefore implicates a plethora of conflicting local laws, supervisory authorities, and cultural differences.[10]

As the compliance function gains popularity with its rising importance in banking organizations, it is vital for leaders in the organization to fully understand the best way to position respective compliance departments to ensure they are effective and robust. Compliance is a relatively new industry[11] that has seen huge growth in the past few years after the financial crisis.[12] Unfortunately, there is no "one-size fits all" approach[13] that can be taken for compliance programs given that each organization must look to its overall risk profile to determine the approach that will best fit its needs. In order to create an effective and robust compliance program, leaders in the organization need to be aware of best practices and regulatory guidance to ensure that compliance risk is adequately mitigated. Part I of this Note will explore the history and background of compliance functions within large banking organizations, primarily focusing on the regulatory guidance that has been provided by the Board of Governors of the Federal Reserve as to how an independent compliance function should operate within large banking organizations. Part II provides an analysis of how the current incentive-based compensation arrangement for compliance staff and the reporting line structure for compliance departments may be construed as an inherent contradiction against the regulatory guidance provided for how an independent compliance department should function. Part III suggests alternative options to today's current compensation setup and reporting line structure, taking into consideration the guidance promulgated by the Federal Reserve, along with practical concerns that exist within large banking organizations.

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8. *HSBC to Bring in 3,000 Compliance Staff*, HR GRAPEVINE (Sept. 25, 2013), http://www.hrgrapevine.com/markets/hr/article/2013-09-25-hsbc-to-bring-in-3-000-compliance-staff.

9. McKinsey & Co., *Compliance and Control 2.0: Unlocking Potential Through Compliance and Quality-Control Activities*, MCKINSEY WORKING PAPERS ON RISK, June 2012, at 1.

10. *Id.*

11. Emmanuel Olaoye, *After SAC, Corporate Monitor Says What Makes Effective Compliance Programs*, REUTERS (Nov. 14, 2013), http://blog.thomsonreuters.com/index.php/interview-after-sac-corporate-monitor-says-what-makes-effective-compliance-programs/.

12. Viswanatha & Wolf, *supra* note 2.

13. Olaoye, *supra* note 11.

It is important to emphasize that this Note focuses on compliance functions within traditional banking organizations as opposed to compliance functions within the investment advisory or broker-dealer space of financial services firms. Compliance operates in different spheres utilizing the same fundamental skill set and focus on controls within both spaces; however, the varying set of rules and regulations that investment advisory and broker-dealer firms face call for a different setup and operation of the overall compliance landscape.[14] Banks are regulated under the authority of various banking regulators, primarily the Federal Reserve, along with the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation,[15] while securities regulators primarily include the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority, and the Commodity Futures Trading Commission.[16]

I. HISTORY AND BACKGROUND OF COMPLIANCE

A. DEVELOPMENT OF COMPLIANCE WITHIN LARGE BANKING ORGANIZATIONS

Compliance programs exist today as departments or units within banking organizations and have a wide range of roles and responsibilities, including monitoring trading activity, preventing conflicts of interest, and providing surveillance to prevent money laundering, among many other roles that ensure adherence with applicable laws, rules, and regulations.[17] Compliance officers work to identify risks and develop targeted trainings and policies, along with tailored monitoring programs to address potential risks and deter misconduct.[18] There are a variety of departments within the bank that compliance officers interact with on a day-to-day basis, including the business areas, legal department, internal audit department, and the

14. *See* James A. Fanto, *Advising Compliance in Financial Firms: A New Mission for the Legal Academy*, 8 BROOK. J. CORP. FIN. & COM. L. 1 (2013) (exploring the increasing importance of compliance within the legal academy, with a focus on compliance in the broker-dealer context). *See also* Barbara Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, 8 BROOK. J. CORP. FIN. & COM. L. 23 (2013) (discussing the regulatory landscape within the broker-dealer space).

15. Stephen D. Simpson, *The Banking System: Commercial Banking—How Banks Are Regulated*, INVESTOPEDIA, http://www.investopedia.com/university/banking-system/banking-system6.asp (last visited Dec. 12, 2013). The Federal Reserve mainly regulates state-chartered banks that are members of the Federal Reserve system, the OCC regulates national and federal savings bank associations, and the FDIC insures state-chartered banks that are not members of the Federal Reserve system.

16. *Other US Regulators: Regulatory Agencies*, FINRA, http://www.finra.org/industry/other-us-regulators (last visited Apr. 9, 2015).

17. *Compliance Department*, INVESTOPEDIA, http://www.investopedia.com/terms/c/compliancedepartment.asp (last visited Nov. 10, 2013).

18. Olaoye, *supra* note 11.

other risk management departments.[19] While many compliance officers have a legal background to assist in interpreting and applying the rules and regulations, others lacking the legal background have the depth of experience from working in the business area.[20]

Some firms have opted to place compliance within the overall risk management umbrella.[21] Risk Management (Risk) generally involves identifying, analyzing, and accepting or mitigating uncertainty of the overall market such that the business is aware of certain risk thresholds.[22] Traditional enterprise risk management has its foundations in capital management for credit, market, interest rate, and operational risk.[23]

Compliance's responsibilities are also distinct from the traditional risk management areas.[24] Because compliance departments are relatively new and have a constantly evolving set of responsibilities, some firms have, sometimes for lack of a better placement, inserted compliance within the overall enterprise-risk management umbrella even though it may not be the most appropriate place for the compliance function to sit in.[25] Therefore, the reporting structure and overall hierarchy where compliance may be found within the organization is not consistent across companies because there is often a lack of clarity as to who in the organization is responsible for compliance.[26] It is useful then to look to the history of compliance to determine the best approach for creating an effective compliance program.

There is no one point in time that can serve as the genesis for compliance departments within organizations; rather, we can look to various antecedents that prompted organizations to develop and invest in compliance.[27] Some trace the history of compliance back to the turn of the twentieth century when public safety agencies began to emerge spurred on by novels such as *The Jungle*,[28] which generated an increased friction and distrust between private businesses and customers.[29] As compliance may have had its roots formed earlier in the century, modern-day compliance organization began in 1977 with the requirements of the Foreign Corrupt

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19. *What Does a Compliance Officer Do?*, WISEGEEK, http://www.wisegeek.org/what-does-a-compliance-officer-do.htm (last visited Nov. 10, 2013).

20. *Id.*

21. Paul L. Lee, *Compliance: A New Paradigm*, 121 BANKING L.J. 867, 873 (2004).

22. *Risk Management*, INVESTOPEDIA, http://www.investopedia.com/terms/r/riskmanagement.asp (last visited Dec. 12, 2013).

23. Lee, *supra* note 21, at 872.

24. *Id.*

25. *Id.*

26. McKinsey & Co., *supra* note 9, at 3.

27. JEFFREY M. KAPLAN, SEMI-TOUGH: A SHORT HISTORY OF COMPLIANCE AND ETHICS PROGRAM LAW 1, 1–9 (2012).

28. *The Jungle* is a novel by muckraker Upton Sinclair, written in 1906, to expose horrid working conditions. UPTON SINCLAIR, THE JUNGLE (1906).

29. John MacKessy, *Knowledge of Good and Evil: A Brief History of Compliance*, FIN. PROF'LS' POST (May 26, 2010), http://post.nyssa.org/nyssa-news/2010/05/a-brief-history-of-compliance.html.

Practices Act (FCPA).[30] The FCPA was signed into law after an investigation by the SEC uncovered significant bribery activity within United States companies.[31] As a result, the FCPA ensured that many companies developed their own internal resources to "actively monitor" business activities to maintain compliance with the applicable rules and regulations.[32]

The most important development for compliance was the advent of the Federal Sentencing Guidelines for Organizations (FSGO) in 1991 by the United States Sentencing Commission.[33] The FSGO was groundbreaking—it provided the first significant incentive for organizations to create a formal compliance program.[34] The FSGO was geared to encourage deterrence and to ensure that companies would proactively take steps to prevent and detect violations.[35] Under the FSGO, organizations were provided with a sentence downgrade for a violation if they could demonstrate the existence of an "effective compliance program."[36] This led to the burgeoning of the compliance industry, as organizations developed entire departments to focus on compliance in hopes of qualifying for the sentence downgrade if the corporation were subject to an investigation and found in violation.[37]

Courts began to note the powerful effect of the FSGO within organizations. In 1996, the Court of Chancery of Delaware decided *In re Caremark International Inc. Derivative Litigation*, and noted the FSGO offered "powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts." [38] The *Caremark* court commented that officers and directors could possibly face liability if the organization did not have an effective compliance program in place.[39] *Caremark* specifically

30. Miriam Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 962 (2009).

31. MacKessy, *supra* note 29.

32. *Id.*

33. KAPLAN, *supra* note 27, at 1.

34. *Id.*

35. Diana Murphy, *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 703 (2002). *See* U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(b) (2001) (setting forth the sentencing guidelines for organizations). The FSGO set forth the following minimum criteria for a program to be deemed effective: 1) Compliance standards and procedures must be established to deter crime; 2) High-level personnel must be involved in oversight; 3) Substantial discretionary authority must be carefully delegated; 4) Compliance standards and procedures must be communicated to employees; 5) Steps must be taken to achieve compliance in establishment of monitoring and auditing systems and of reporting systems with protective safeguards; 6) Standards must be consistently enforced; 7) Any violations require appropriate responses, which may include modification of compliance standards and procedures and other preventive measures. *Id.*

36. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (2004).

37. Murphy, *supra* note 35, at 710.

38. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969 (Del. Ch. 1996).

39. Pamela H. Bucy & Anthony A. Joseph, *Conducting Business in the 21st Century: How to Avoid Organizational Suicide (Part 1)*, 70 ALA. L. 185, 186–187 (2009).

made mention of a 1963 Delaware Supreme Court case, *Graham v. Allis-Chalmers*, in which the Delaware Supreme Court held that absent cause for suspicion, the directors have no duty to install and operate a corporate system of espionage to find wrongdoing that they have no reason to think exists.[40] However, the *Caremark* court emphasized the directors "ought to have known" of the wrongdoing in *Graham*, as the directors are under a duty to bring the corporation into compliance with the law.[41] Therefore, *Caremark* adopts a narrow interpretation of *Graham* and rejects the supposition that there be a basis for suspicion to install an effective compliance program; rather, it is the duty of the officers and directors to proactively ensure compliance with the law.[42]

Due to the increasing pressure, corporate Boards of Directors (Boards) have become burdened with ensuring an adequate compliance program that meets, if not exceeds, the standards set by the FSGO.[43] Boards were faced with several issues when deciding how to effectively implement a compliance program that would serve the best interests of the company.[44] A significant issue became the possibility that negative information generated by the compliance program would ultimately be used against the corporation, either by the government or in civil suits.[45] Consequently, the more effective a compliance program, the more harm it could possibly inflict on the corporation when it became subject to litigation.[46] Others argued that compliance programs would only be implemented to serve as a window-dressing function and give the illusion of market legitimacy.[47]

Irrespective of how the company viewed the ultimate objective of its compliance program, it became clear that if organizations failed to implement a compliance program that effectively allowed for adequate self-policing, the FSGO would have failed in providing an adequate incentive for corporations to build an effective program that encouraged compliance with the applicable rules and regulations.[48] However, given that companies could take advantage of the sentence downgrade feature of the FSGO by evidencing a strong and effective compliance program,[49] many companies

40. *Caremark*, 698 A.2d at 969.
41. *Id.*
42. *Id.*
43. MacKessy, *supra* note 29.
44. *Id.*
45. Philip A. Wellner, *Effective Compliance Programs and Corporate Criminal Prosecutions*, 27 CARDOZO L. REV. 497, 510 (2005) (citing UNITED STATES SENTENCING COMMISSION, REPORT OF THE AD HOC ADVISORY GROUP ON THE ORGANIZATIONAL SENTENCING GUIDELINES 6 (2003)).
46. *Id.* at 511.
47. Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 495 (2003).
48. Wellner, *supra* note 45, at 520.
49. Michael Goldblatt, *Implementing Effective Compliance Programs*, 38 PRAC. LAW. 75, 77 (1992).

deemed it necessary to implement a robust compliance program that met the standard set forth by the FSGO. Additionally, prosecutors began to adopt a more stringent approach against corporate defendants on both a state and federal level, thereby highlighting the need for companies to have effective programs in place that could provide evidence of adequate self-policing.[50] Subsequently, compliance programs became more integrated with general risk management practices, specifically within large banking organizations.[51]

B. A SEPARATE CLASS OF RISK: COMPLIANCE RISK

In 2005, compliance risk became recognized as a distinct class of risk when the Basel Committee on Banking Supervision (Basel Committee) defined "compliance risk" as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities."[52] The Basel Committee went on to further outline ten principles that compliance functions within banking organizations should follow, covering aspects such as reporting lines to resourcing for compliance functions.[53] These ten principles became the benchmark for compliance functions within global banking organizations until October 2008 when the Board of Governors of the Federal Reserve released Supervisory Letter SR 08-8 (SR 08-8)[54] that provided guidance regarding the compliance function in banking organizations.

SR 08-8 is consistent with the Basel Committee guidance and endorses its principles[55]—both agree that banking organizations have faced continuing challenges with risk management, specifically compliance risk

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50. *Id.*

51. MacKessy, *supra* note 29.

52. BASEL COMM. ON BANKING SUPERVISION, COMPLIANCE AND THE COMPLIANCE FUNCTION IN BANKS 7 (2005). The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters and its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.

53. *Id.* at 9. The ten principles the Basel Committee on Banking Supervision outlined were: 1) Responsibilities of the Board of Directors for Compliance: Overseeing Management of Bank's Compliance Risk; 2) Responsibilities of Senior Management for Compliance: Effective Management; 3) Responsibilities of Senior Management for Compliance: Establishing and Communicating Compliance Policy; 4) Responsibilities of Senior Management for Compliance: Establishing a Permanent and Effective Compliance Function; 5) Compliance Function Principles: Independence; 6) Compliance Function Principles: Resources; 7) Compliance Function Responsibilities: Assist Senior Management in Managing Effecting the Compliance Risks faced by the Bank; 8) Relationship with Internal Audit; 9) Cross-Border Issues; 10) Outsourcing.

54. BD. OF GOVERNORS OF THE FED. RESERVE SYS., SR 08-8/CA 08-11: COMPLIANCE RISK MANAGEMENT PROGRAMS AND OVERSIGHT AT LARGE BANKING ORGANIZATIONS WITH COMPLEX COMPLIANCE PROFILES 2 (2008).

55. *Id.*

management.[56] SR 08-8 further clarifies, that for US banking organizations, there are certain points to focus on, including a firm-wide approach to compliance risk, independence of compliance staff, and responsibilities of Boards and senior management regarding compliance risk management and oversight.[57]

II. THE INHERENT CONTRADICTION OF AN INDEPENDENT COMPLIANCE FUNCTION

A. COMPENSATION CONCERNS

As compliance has grown into an area of high demand, compensation concerns have also accompanied this area of growth.[58] SR 08-8 provides that, "[c]ompensation and incentive programs should be carefully structured to avoid undermining the independence of compliance staff. Compliance staff should not be compensated on the basis of the financial performance of the business line. Such an arrangement creates an improper conflict of interest."[59] This very statement indicates a contradiction—how can compliance staff be compensated if not for the performance of the business line that contributes to the firm's bottom line?

Compensation in the financial services industry tends to be much more generous than other sectors of the economy[60] given that incentive compensation, in the form of annual bonuses, can often be double or triple an individual's base compensation.[61] In a recent survey of compensation for compliance staff conducted by the National Regulatory Services, 60% of the respondents to the survey said they participate in some form of incentive compensation program.[62] The data analyzed by the survey indicated incentive compensation is generally around 20% to 30% of base compensation, with some respondents indicating that they received incentive compensation equal to 100% of their base compensation.[63] This could come into conflict with SR 08-8; however, it would depend upon what the incentive compensation is tied to—whether it is tied to a more short-term indicator, such as the company's profitability for a given year or

56. *Id.*
57. *Id.*
58. Viswanatha & Wolf, *supra* note 2.
59. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 2.
60. Mark Kolakowski, *Compensation in Financial Services*, ABOUT.COM FINANCIAL CAREERS, http://financecareers.about.com/bio/Mark-Kolakowski-33968.htm (last visited Nov. 9, 2013).
61. NAT'L REGULATORY SERVS., NRS COMPLIANCE COMPENSATION STUDY 2011 4 (2011).
62. *Id.*
63. *Id.*

whether the incentive compensation is based on a more long-term indicator, such as shareholder value.[64]

Incentive compensation is usually viewed through a short-term or long-term lens.[65] If companies focus on too many short-term incentives, they run the risk of an improper increase in short-term risk taking.[66] As with prior financial crises, short-term bonuses can encourage individuals to maximize current profits at the expense of long-term shareholder value.[67] On the other hand, stock options provide the benefit of motivating employees to increase the value of the company's share price with the intent of focusing on a more long-term approach.[68]

Given that financial services employees may not bear the full cost of their failures because they are agents of the corporation, there is a significant incentive to take more risk than they otherwise would in the short-term approach.[69] A significant conflict of interest arises when a compliance officer approves a transaction that could well determine profitability for the company, ultimately affecting his incentive compensation. Therefore, issues arise when companies award compliance officers incentive compensation based on more risky strategies that could have an impact on the systematic risk to the company.[70]

Issues may also arise when compliance staff are provided with stock options. If compliance officers are provided with long-term stock option incentive plans, this compensation arrangement could thereby affect the "independence" that compliance is supposed to maintain; hence, some companies do not permit compliance staff to participate in stock option programs in order to maintain an appearance that compliance is completely independent.[71] Stock options also increase employees' incentive to take risk because they are looking to further increase the stock price to make their stock options more valuable.[72]

The incentives provided by compensation should not be considered independently, but rather holistically.[73] The Institute of International

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64. Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 233–34 (1999).

65. *Id.*

66. Greta E. Coward & Bart J. Briggs, *The Perfect Storm Swirling Around Executive Compensation and the Related Corporate Governance Changes*, 26 CORP. COUNS. Q., July 2010, at 1.

67. David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435, 440 (2010).

68. Stan Mack, *Why Do Companies Offer Stock Options?*, ZACKS, http://finance.zacks.com/companies-offer-stock-options-8473.html (last visited Nov. 9, 2013).

69. Martin N. Baily et al., *Regulation of Executive Compensation in Financial Services* (Council on Foreign Relations, Working Paper, 2010).

70. *Id.*

71. INDEP. DIRS. COUNCIL, BOARD OVERSIGHT OF FUND COMPLIANCE 21 (2009).

72. *See* Baily et al., *supra* note 69.

73. INST. OF INT'L FIN., COMPENSATION IN FINANCIAL SERVICES: INDUSTRY PROGRESS AND THE AGENDA FOR CHANGE 21 (2009). Front office staff refers to specific groups of employees

Finance (IIF) produced a paper in 2009 that discussed compensation in the overall risk management space of financial services firms and identified two main issues that arise—the disparity in the compensation levels between front office producers and risk management staff, along with the need to control risk with revenue generation when considering incentive compensation for risk management staff.[74]

With regard to the disparity in compensation levels between front office producers and risk management staff, the IIF commented that compensation structures should incorporate a review of pay differential between oversight functions and producers.[75] The disparity of pay is important to note given that a mid-level front office producer can take home approximately $300,000 per year, while the average total compensation for compliance staff (across junior and senior corporate titles) is $125,000.[76] It then becomes important to ensure that compensation for compliance staff is adequate, but does not have so much a disparity from other front office employees that it becomes an issue when determining total compensation.[77]

More importantly, the IIF recognizes the balance that needs to be struck between controlling risk and revenue generation.[78] Given that qualitative measures play a much more important part in risk management incentive compensation than quantitative measures, it is important to ensure that a conflict of interest does not arise that would wrongly incentivize risk management staff to increase risk solely for the purpose of revenue generation.[79] Given that incentive compensation is usually derived from quantitative measures to provide a concrete benchmark, the difficulty becomes in assessing what is the correct criteria to use in determining risk management incentive compensation. The IIF survey of respondents indicated that companies, in setting incentive compensation, have used a variety of qualitative and quantitative measures, including management discretion, qualitative assessment, firm profits, overall firm risk-adjusted profits, and overall firm revenues.[80]

Another complication involved in measuring compliance staff performance rests on which performance indicator is most effective.[81] The role of compliance, as other Risk functions in large banking organizations, tends to be a thankless task, "because compliance is one of those things that

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within financial services firms whose departments are considered "revenue generating" and are not designated as a cost center for the company.

74. *Id.* Note for the purposes of this study, risk management staff was inclusive of compliance risk staff.

75. *Id.*

76. NAT'L REGULATORY SERVS., *supra* note 61, at 4.

77. *See* INST. OF INT'L FIN., *supra* note 73, at 21.

78. *Id.* at 22.

79. *Id.*

80. *Id.*

81. *See supra* note 62 for list of indicators.

no one notices when it goes right, and [everyone] notices when it goes horribly wrong."[82] Others have indicated that companies do not take compliance seriously until there is some form of misconduct.[83] It becomes difficult then to pinpoint a correct indicator that will effectively measure compliance staff performance to ensure that performance is adequately assessed and is not reactive as the above quotes indicate.

SR 08-8 places the responsibility on the Board to ensure, "that senior management has established appropriate incentives to integrate compliance objectives into the management goals and compensation structure across the organization."[84] As demand for compliance professionals increases with the ever-increasing regulatory environment, large banking organizations have to ensure they are adequately compensating for the role while not creating perverse incentives.[85] Overall, the compensation concerns for compliance staff become a significant challenge in ensuring an independent compliance function within the guidelines provided by SR 08-8.

B. REPORTING LINE CONCERNS

One of the most important determinants of the compliance officer's empowerment in the organization lies with the compliance function's reporting line.[86] The compliance officer should be able to raise matters of concern without fear of reprisal or a conflict of interest.[87] If the compliance officer does not have the proper reporting structure, the overall compliance program is likely to be ineffective and could potentially fail.[88]

As outlined in SR 08-8, compliance independence is necessary in order to obtain objectivity and avoid conflicts of interest.[89] Likewise, it is also important to build a compliance program that cultivates a trustful corporate environment with appropriate incentives and rewards that are aligned with honesty and fair dealing.[90] SR 08-8 recognizes that compliance staff should

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82. Darcy Jacobsen, *Using Recognition to Build Compliance (And Avoid Risk)*, GLOBOFORCE (Apr. 16, 2013), http://www.globoforce.com/gfblog/2013/using-recognition-to-build-compliance-and-avoid-risk/.

83. Stuart Gittleman, *Compliance Staff Can Help Their Firms by Reflecting Regulators' Expectations, SEC Enforcer Says*, REUTERS FIN. REGULATORY FORUM (Oct. 16, 2013), http://blogs.reuters.com/financial-regulatory-forum/2013/10/16/compliance-staff-can-help-their-firms-by-reflecting-regulators-expectations-sec-enforcer-says/.

84. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 7.

85. Viswanatha & Wolf, *supra* note 2.

86. SCOTT A RONEY ET AL., ETHICS RESOURCE CTR., LEADING CORPORATE INTEGRITY: DEFINING THE ROLE OF THE CHIEF ETHICS AND COMPLIANCE OFFICER (CECO) 6 (2010).

87. *Id.*

88. DONNA BOEHME, FROM ENRON TO MADOFF: WHY MOST CORPORATE COMPLIANCE AND ETHICS PROGRAMS ARE POSITIONED FOR FAILURE 5, 1–7 (2009), *available at* http://www.compliancestrategists.org/wp-content/uploads/2012/09/March-5-2009-Boehme-PDF-Download.pdf.

89. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 2.

90. Johanna Pitcairn, *Corporate Compliance and Executive Compensation Since the AIG Scandal*, 82-DEC N.Y. St. B.J., Nov./Dec. 2010, at 35, 36.

work closely with business lines and emphasizes the need for strong working relationships in order to have an effective compliance function.[91]

In addition to banking regulators, securities regulators, such as the SEC, have also emphasized the need for an independent compliance program that has an appropriate amount of standing and authority to implement programs that objectively monitor and escalate issues.[92] As Carlo di Florio, the former Director for the Office of Compliance Inspections and Examinations, highlighted, all too often the mindset amongst senior management involves a "sweep it under the rug" mentality that begs the question as to how independent and challenging compliance functions truly are within these organizations.[93]

Maintaining an effective and independent compliance function is made more complicated through the perception of the role within the overall function because the role of the compliance officer was previously viewed as someone in lower-level management with little empowerment and mandate to fulfill his or her role.[94] Some have gone so far to comment that "compliance officers have become trendy in recent years . . . they act mainly as window dressing."[95] Some viewed compliance as an irritating cost center that impedes business development.[96] However, as time passed and more corporate blunders have been unveiled, companies have realized the importance of compliance functions and believe that compliance is an essential part of general business operations.[97] Therefore, a pre-requisite to building and developing a robust and independent compliance function is ensuring the individuals within the department are adequately empowered to receive the proper level of stature and respect within the organization.

Given that compliance functions have been increasing in size during the past decade, there has been considerable debate as to what the appropriate reporting line structure should look like.[98] Certain stakeholders in the debate—senior management, external boards, general counsel, and senior compliance officials—often do not agree on what is the appropriate reporting line structure.[99] There are a range of possibilities for possible compliance reporting lines, some being stand-alone (reporting directly to

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91. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 2.

92. Carlo V. di Florio, Dir., SEC Off. of Compliance Inspections & Examinations, Remarks at the Compliance Outreach Program (Jan. 31, 2012).

93. *Id.*

94. BOEHME, *supra* note 88, at 3.

95. Hannah Clark, *Chief Ethics Officers: Who Needs Them?*, FORBES (Oct. 23, 2006, 12:05 PM), http://www.forbes.com/2006/10/23/leadership-ethics-hp-lead-govern-cx_hc_1023ethics.html.

96. Robertson Park & Timothy P. Peterson, *Regulatory: Compliance Stakes Its Independence*, INSIDE COUNSEL (May 15, 2013), http://www.insidecounsel.com/2013/05/15/regulatory-compliance-stakes-its-independence.

97. *Id.*

98. *Id.*

99. *Id.*

the Board), others reporting to Risk, or to the general counsel.[100] Decisions about the reporting relationship are not taken lightly, as the reporting line structure can be a reflection of the organization's priorities and can also provide protection in the event of external scrutiny.[101] Of course, each compliance program is based on the unique need of the firm, as there is no cookie-cutter approach that companies can take to implement an effective compliance program.

1. Compliance as a Stand-Alone Department

Compliance as a stand-alone department allows for a completely independent function in which all compliance personnel provide support to each of the firm's business units, even if the firm's business operations are in different countries.[102] Some firms find this approach impractical given that it is undesirable to have one compliance function focus on sometimes conflicting legal requirements or expectations of different jurisdictions.[103] Having a stand-alone compliance function can also increase costs and potentially create new silos, creating inefficient working conditions.[104]

However, there are certain benefits to this approach as well. The stand-alone approach is one way to completely avoid a conflict of interest with the business, given that there would be completely separate reporting lines and no opportunity for the business to undermine decisions made by compliance.[105] As a stand-alone reporting area within the organization, it is less likely that compliance input will be interfered with when difficult decisions need to be made.[106]

Regulators often gain comfort when compliance is organized as a stand-alone reporting area, such that the absence of an intermediary provides unfettered access to the Board when escalation of issues is warranted.[107] The Board also gains comfort when compliance-related issues are brought directly to its attention in order to determine proper remedial action, given that the Board can be held liable based on a host of regulations, including Sarbanes-Oxley, Dodd-Frank, and the increased enforcement and prosecution of FCPA and anti-money laundering violations.[108]

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100. KPMG, THE FUTURE OF COMPLIANCE: COMPLIANCE FUNCTIONS AS STRATEGIC PARTNERS IN THE NEW REGULATORY WORLD 10 (2012).

101. RONEY, *supra* note 86, at 22.

102. SEC. INDUS. & FIN. MKTS. ASS'N, THE EVOLVING ROLE OF COMPLIANCE 18 (2013).

103. *Id.*

104. ECONOMIST INTELLIGENCE UNIT, ASCENDING THE MATURITY CURVE: EFFECTIVE MANAGEMENT OF ENTERPRISE RISK AND COMPLIANCE 13 (2011).

105. RONEY, *supra* note 86, at 23.

106. *Id.*

107. KPMG, *supra* note 100, at 10.

108. Park & Peterson, *supra* note 96.

As SR 08-8 indicates, compliance should have an "appropriately prominent status within the organization."[109] While SR 08-8 leaves open exactly how to go about achieving "prominent status" to the organization to decide based on its unique needs, the stand-alone option has become a solution that many companies have started to adopt to demonstrate clear mechanisms for independent and direct reporting to the Board.[110]

2. Compliance Reporting through Risk

Given that compliance was specifically named as a separate risk class by the Basel Committee in 2005, some firms have considered compliance risk as part of their general risk management practice.[111] In this scenario, compliance risk then becomes a subset of the enterprise-risk management program, in which there are established procedures for setting risk measurement, control mechanisms, and monitoring procedures.[112] A possible downside to the strategy of ingraining compliance within the already established Risk function is that an institution can take too narrow of an approach because it may not consider broader values than merely achieving reliability and conformity with existing laws and regulations.[113] An organization can be in technical compliance with the law through the enterprise-risk management practices, but it can still have exposure to reputational risk concerns if it does not abide by the spirit of the law through the lens of the compliance officer.[114]

SR 08-8 notes two main benefits of placing compliance within the Risk function—it benefits from an aggregate view of risk exposure and an integrated approach to managing those risks.[115] If implemented effectively, compliance would be constructed from within the enterprise and promoted as a core key value throughout the organization.[116] However, the Risk organization could be perceived differently if compliance was included within its overall umbrella, as Risk staff may find it difficult to achieve, "peer status with business line leaders and will likely not have the desired impact at the crucial moment when a contrarian voice is needed."[117]

Research recently conducted by the Economist Intelligence Unit set out to analyze how senior executives in various companies assess their risk

109. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 7.
110. KPMG, *supra* note 100, at 10.
111. Lee, *supra* note 21, at 872.
112. *Id.*
113. *Id.*
114. *Id.* at 873.
115. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 3.
116. Lee, *supra* note 21, at 873.
117. PROTIVITI, EFFECTIVE POSITIONING OF THE RISK MANAGEMENT ORGANIZATION: ENABLING THE CHIEF RISK OFFICER'S SUCCESS 9 (2013).

mitigation capabilities against how the company is performing.[118] The results showed three observations—that companies may be underestimating the extent of risk and compliance failures in their organization, risk and compliance management processes may appear to work well until something goes wrong, and companies may not be learning the broader lessons from risk failures.[119] One could interpret these results to indicate the overall Risk function within banking organizations may not be working as well in practice as it may be in theory.

Organizations would need to consider these ideas when thinking about integrating the compliance function into the existing Risk function, such that the organization can best align with SR 08-8 in order to "benefit from an aggregate view of the organization's compliance risk exposure."[120]

3. Compliance Reporting through General Counsel

While SR 08-8 does not directly address compliance reporting through the general counsel, some firms place the compliance function within the legal department, which has often drawn stark criticism from compliance professionals.[121] However, more recently, many have come to recognize the distinct mandates between the general counsel and compliance, along with the inherent conflicts that may arise.[122] Most notably, the general counsel could be put in a compromising situation if she has to fulfill the responsibility of defending a corporate action that could appear questionable from a compliance perspective.[123]

Generally, both compliance and the general counsel are tasked with ensuring the organization complies with the relevant laws, regulations, rules, and standards.[124] Their roles diverge in how they achieve their respective objectives and impact the organization.[125] The general counsel is usually perceived as the "legal defender" of the company tasked with avoiding or limiting legal risks, while compliance is mandated to prevent and detect misconduct.[126] The difference has been succinctly stated as,

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118. ECONOMIST INTELLIGENCE UNIT, *supra* note 104. Companies that participated in this survey included compliance risk within the overall risk management umbrella for this comparative study.

119. *Id.*

120. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 3.

121. *Compliance Professionals Overwhelmingly Reject General Counsel Reporting Structure*, SOC'Y OF CORP. COMPLIANCE & ETHICS (Mar. 11, 2013, 1:13 PM), http://www.corporatecompliance.org/Resources/View/ArticleId/918/Compliance-professionals-overwhelmingly-reject-general-counsel-reporting-structure.aspx.

122. *Id.*

123. James F. Kelley, *The Role of the General Counsel*, 46 EMORY L.J. 1197, 1199 (1997).

124. José A. Tabuena, *The Chief Compliance Officer vs the General Counsel: Friend or Foe?*, SOC'Y OF CORP. COMPLIANCE & ETHICS, Dec. 2006, at 5–6.

125. *Id.* at 6.

126. Michael W. Peregrine & Joshua T. Buchman, *Managing the General Counsel/Compliance Officer Relationship*, AHLA CONNECTION, Oct. 2011, at 35.

"lawyers (general counsel) tell you whether you *can* do something, and compliance tells you whether you *should*."[127] While these tasks are complementary in the sense that they are both protecting the interests of the firm, they are substantively different duties and objectives.[128]

There are others who believe that there is no inherent contradiction here—instead, these individuals argue that the role of the general counsel is not only to address the question of "what is technically legal" but also to raise and analyze the question of "what is right."[129] Consequently, it is argued that the general counsel will adopt a "what-is-right" attitude given this attitude is central to the role of the modern, broad-gauged general counsel.[130] Others point to the fact that the general counsel and compliance each have a unique position in the company giving access to sensitive information. The general counsel's unique position in a corporation may allow her to have access to privileged information that may require uncomfortable choices as opposed to an independent third-party view that compliance could take.[131] Whether or not an organization prefers to adopt the general counsel reporting structure for compliance, it is important to emphasize the need for strong controls to maintain adequate checks and balances to ensure that conflicts are being properly mitigated.[132]

III. CONSIDERATIONS FOR COMPLIANCE FUNCTIONS WITHIN LARGE BANKING ORGANIZATIONS

There are certain aspects of compliance functions that can be enhanced to ensure a more effective and robust compliance program, specifically: a) an enhanced process for incentive-based compensation for compliance staff; b) the optimal reporting structure for compliance; and c) compliance representation on firm committees.

A. ENHANCED PROCESS FOR INCENTIVE-BASED COMPENSATION FOR COMPLIANCE STAFF

As explored in Part II, there are various challenges that arise when incentive compensation is factored into compliance staff pay. If compliance staff salaries are based on the company's performance, compliance staff—

127. Roy Snell, *Who Reports to Whom?*, CORP. SEC'Y (Feb. 1, 2000) (emphasis added), http://www.corporatesecretary.com/articles/regulation-and-legal/11218/who-reports-whom/.

128. Tabuena, *supra* note 124, at 6.

129. Ben W. Heineman, Jr., *Don't Divorce the GC and Compliance Officer*, HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 26, 2011, 9:53 AM), http://blogs.law.harvard.edu/corpgov/2010/12/26/don%E2%80%99t-divorce-the-gc-and-compliance-officer/.

130. *Id.*

131. Deborah A. DeMott, *The Discrete Roles of General Counsel*, 74 FORDHAM L. REV. 955, 966 (2005).

132. Peregrine & Buchman, *supra* note 126, at 36 (citing OIG 1998 Guidance, 63 Fed. Reg. 8987, 8993 (Feb. 23, 1998)).

as is true of other financial services professionals—will want to maximize their potential paychecks,[133] while the company will want to ensure that there are adequate checks and balances on the amount of risk the firm is being allowed to take. How can an organization ensure they are compensating compliance staff enough, but not too much? One solution is to completely eliminate incentive-based compensation to eradicate the existence of a potential conflict of interest. Another less extreme idea would be to have incentive-based compensation tied to a performance indicator that is separate and apart from the firm's performance.

Incentive-based compensation becomes a vicious cycle where, "employees focus on doing what they need to do to gain rewards—and that just feeds their self-interest even more . . . people chase the money 'often at the expense' of doing other things that would help the organization."[134] Companies run the risk of employees expecting the "contingent reward," and eventually employees see the payment less like a bonus and more like the status quo.[135] All too often, if individuals do not feel they are being compensated well enough, they play "musical chairs," where some companies lure talent away from other companies, often luring employees away with the promise of a 20% increase in salary.[136] Organizations must align this thinking with the guidance provided in SR 08-8, which states that, "compensation and incentive programs should be carefully structured to avoid undermining the independence of compliance staff."[137]

Regulators have commented that flawed incentive compensation practices in the financial industry have previously rewarded employees for increasing the organization's revenue or short-term profit without a sufficient recognition of the risks involved.[138] Therefore, a company could create a compensation system that relies solely on a guaranteed base salary that does away with risky incentive-based rewards.[139] However, this will likely not work because the industry will find a way around it. Organizations would simply take the amount of the incentive-based portion of pay and increase the individual's base salary to compensate for the lack

133. Viswanatha & Wolf, *supra* note 2.

134. Kevin Gray, *How NOT to Do Incentive Pay*, CBS NEWS (Sept. 21, 2009, 3:00 AM), http://www.cbsnews.com/8301-505125_162-51344828/how-not-to-do-incentive-pay/.

135. Donald Delves, *Is Incentive Compensation a True Motivator?*, FORBES (Feb. 16, 2011, 1:03 PM), http://www.forbes.com/sites/donalddelves/2011/02/16/is-incentive-compensation-a-true-motivator/.

136. Viswanatha & Wolf, *supra* note 2.

137. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 6.

138. Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. 36396 (June 25, 2010).

139. Craig D. Miller & John J. Heber, *Eliminate All Incentive Compensation*, AM. BANKER (Apr. 26, 2012, 8:30 AM), http://www.americanbanker.com/bankthink/eliminate-all-incentive-compensation-executive-pay-1048746-1.html?CMP=OTC-RSS.

of incentive-based compensation.[140] This could cause a host of issues, including a lack of motivation for the employee, inflated pay, and continuous turnover by employees looking to increase their salaries by constantly switching firms.[141] Overall, the idea of eliminating incentive-based compensation would seem to be the simplest and easiest mechanism to comply with SR 08-8 and ensure a completely independent compliance function; but, the approach would not work in a practical setting where many of the individuals in the financial services industry are by their very nature motivated by incentive-based compensation.

Another option, in the spirit of SR 08-8, is to align a form of incentive-based compensation with a qualitative performance indicator that parallels SR 08-8's view of how compliance should operate. SR 08-8 provides that "quantitative limits reflecting the Board's risk appetite can be established for market and credit risk [and] compliance risk does not lend itself to similar processes."[142] Given that SR 08-8 acknowledges that quantitative limits do not exist to determine risk appetite or other indicators for compliance risk, the qualitative indicators referenced by the IIF can provide guidance to determine risk management incentive-based compensation.[143]

The IIF included five indicators in its 2009 risk-management compensation survey, including management discretion, qualitative assessment, firm profits, overall firm risk-adjusted profits, and overall firm revenues.[144] In order to ensure that compliance stays within the boundaries set by the guidance of SR 08-8, the IIF factors that could possibly create an improper conflict of interest or undermine the independence of compliance staff should be rejected. The criteria pertaining to firm revenues or profits should be rejected given that, according to SR 08-8, "[c]ompliance staff should not be tied to the financial performance of the business line."[145] Therefore, these three IIF criteria—firm profits, overall firm risk-adjusted profits, and overall firm revenues—can be rejected as a viable option for how to determine compliance incentive-based compensation.

The remaining two factors provided by the IIF are management discretion and qualitative assessment. Management discretion, in which the entire decision-making process is left to the employee's manager, could indicate charges of bias or favoritism and could possibly leave employees

140. Viswanatha & Wolf, *supra* note 2. Competing institutions lure talent away from other companies with the promise of higher salaries, sometimes 20% larger than what the candidate is currently making. The 20% increase is often in the form of a base salary increase.

141. *Id.*

142. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 1.

143. *See* INST. OF INT'L FIN., *supra* note 73, at 21.

144. *Id.* at 22.

145. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 6.

feeling undervalued.[146] However, others argue that management discretion allows managers to properly groom their best performers.[147]

After conducting a horizontal review across the banking industry, the Board of Governors of the Federal Reserve released its own report on incentive compensation practices in 2011.[148] There were two challenges noted when considering judgment and discretion in the context of incentive compensation arrangements: "1) ensuring that decisions based on judgment are made consistently…and 2) risk adjustments may only be one of many inputs into decision-making about incentive compensation awards."[149] Therefore, management discretion would be a poor performance indicator to determine incentive-based compensation because it could undermine consistency and effectiveness across the organization.

The final factor provided by the IIF is qualitative assessment. Qualitative assessment could possibly be seen as similar to management discretion given the potential for lack of consistency in the judgment-making process. However, "to promote consistency and effectiveness of the impact of judgment on balanced risk-taking incentives…firms are expected to have robust policies and procedures to guide the consistent use of judgment."[150] If organizations could evidence the consistency of qualitative assessment being used across compliance groups, they would be following the guidance set forth in SR 08-8 by carefully structuring incentive programs to avoid undermining the independence of compliance staff.[151] Qualitative assessment allows for a combination of the advantages of management discretion, coupled with the benefits of taking firm performance into consideration. As SR 08-8 notes, the financial performance of the business line should not factor into compliance incentive-based compensation; therefore, the qualitative assessment performance indicator can allow for a more holistic approach.

Qualitative assessment indicators could include a variety of performance driven-metrics along with measures to determine whether an employee would be eligible for certain incentive-based payouts.[152] A performance indicator that creates targets and constructive assessments for the employee will be beneficial because an employee who is not satisfied

146. Mark A. Newman, *Positive Reinforcement Through Incentives*, REMODELING MAGAZINE (May 22, 2012), http://www.remodeling.hw.net/bonus-systems-and-incentives/positive-reinforcement-through-incentives.aspx.

147. *Id.*

148. BD. OF GOVERNORS OF THE FED. RESERVE SYS., INCENTIVE COMPENSATION PRACTICES: A REPORT ON THE HORIZONTAL REVIEW OF PRACTICES AT LARGE BANKING ORGANIZATIONS 19 (2011).

149. *Id.*

150. *Id.*

151. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 6.

152. Newman, *supra* note 146.

with his pay will be incentivized to do better work in the year ahead to boost his performance.[153]

Qualitative assessment can take different forms through the performance review process. The overall qualitative assessment can include various factors of the employee's performance, including accomplishments, strengths, opportunities for improvement, and how well the employee exhibits the company's values.[154] However, considerations also need to be made for certain situations involving staff shortages or other situations that lead to a reduction in employees' productivity.[155] A qualitative assessment will need to consider both the employee-specific review in tandem with any special circumstances for the corporation.

Performance can have different definitions for different groups within the organization.[156] For the compliance department, performance should be measured by its independence and ultimate risk control for the firm.[157] Therefore, it is important to ensure the incentive-based compensation is adopted successfully to reward behavior that is positive for the company.[158] As presented, incentive-based compensation would be appropriate if adequately measured using a qualitative assessment approach.

B. OPTIMAL REPORTING STRUCTURE FOR COMPLIANCE

SR 08-8 does not prescribe a particular organizational structure for compliance; however, SR 08-8 provides guidance to indicate that conflicts of interest should be minimized when organizations decide to have compliance report through the business line in some capacity.[159]

Considering the three options for reporting line structures presented in Part II, the optimal structure would be one that takes ideas from each of the three options to maximize independence while minimizing conflict of interest. It is vital to view any approach from both a theoretical and practical perspective to ensure that the approach meets the criteria of both the regulatory guidance provided and the actual market environment.

Given that SR 08-8 and regulators have put their trust in compliance as a control function, it is important to underscore the independence aspect of compliance.[160] SR 08-8 expressly states, "a particular challenge for many

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153. *Id.*

154. *Performance: Appraisal: Qualitative Evaluation Form*, SOC'Y FOR HUM. RESOURCE MGMT. (Aug. 21, 2014), http://www.shrm.org/templatestools/samples/hrforms/articles/pages/cms_002013.aspx.

155. Ciaran John, *How Can HR Departments Use Quantitative & Qualitative Data?*, DEMAND MEDIA, http://smallbusiness.chron.com/can-hr-departments-use-quantitative-qualitative-data-39617.html (last visited Mar. 2, 2015).

156. Gray, *supra* note 134.

157. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 6.

158. Gray, *supra* note 134.

159. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 5.

160. Luis A. Aguilar, Comm'r, SEC, Remarks at the Regulatory Compliance Association, Regulation, Operations & Compliance (ROC) 2013 (Apr. 18, 2013).

organizations is attaining an appropriate level of independence with respect to compliance staff."[161] Therefore, the optimal structure to address this issue is the stand-alone reporting line structure, which provides the highest level of independence of the three reporting line structures examined.[162]

Even though the stand-alone reporting line has the primary advantage of independence, it does have the potential to create silos and become impractical for conflicting regulatory requirements across jurisdictions that could add inefficiency and increased costs.[163] However, rather than viewing these two ideas as roadblocks to an effective and independent compliance function, this approach can be lauded for its potential safeguards.

Dr. John Kotter, a well-known speaker on the topics of leadership and change, describes an innovative idea to address inefficiency amid constant turbulence and disruption in the modern corporation.[164] Dr. Kotter describes developing a "second operating system . . . that uses an agile, network-like structure and a very different set of processes [to] complement rather than overburden the traditional hierarchy."[165] Dr. Kotter goes on to describe this solution as having roots in familiar structures to ensure that organizations pay attention to strategy and create opportunities while ensuring an effective, yet nimble organization.[166]

Dr. Kotter's idea of a "second operating system" is how compliance can, and should, operate in large banking organizations—compliance needs to use a different set of processes to be independent enough, while also using a network structure that does not slow the organization down. Compliance can then assess the business and react with agility while working in tandem with the business lines. The "second operating system" thinking also complies with SR 08-8's guidance for compliance monitoring and testing, in which "robust compliance monitoring and testing play a key role in identifying weaknesses."[167] Most importantly, this approach primarily retains the independence of compliance as an advisory function to abide by the statement, "compliance tells you whether you should [do something]."[168]

Dr. Kotter uses the idea of the "second operating system" mainly to present a way to effect change in organizations that feel threatened by competitors.[169] Dr. Kotter argues that by adopting a second system that keeps the original system in check, it brings about innovation and speed that

161. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 5.
162. *See supra* Part II.
163. ECONOMIST INTELLIGENCE UNIT, *supra* note 104.
164. John P. Kotter, *Accelerate!*, HARV. BUS. REV., Nov. 2012, at 45.
165. *Id.*
166. *Id.*
167. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 6.
168. Snell, *supra* note 127.
169. Kotter, *supra* note 164, at 45.

allow the organization to adapt.[170] If compliance were to operate as an effective "second operating system," there would be potential for compliance to not only become the safeguard function of the company, but also to push the company forward to develop strategies and solutions that it may not have previously explored.

It is important then to understand the proposed challenges posed by the other reporting line structures. SR 08-8 suggests there are a different set of risks presented by compliance risk compared to general risk management practices, as it provides that, "the management and oversight of compliance risk presents certain challenges . . . [C]ompliance risk does not lend itself to similar processes for establishing and allocating overall risk tolerance."[171] If compliance risk does not lend itself to the similar processes that have been established within the enterprise-risk management framework, it could be a challenge to provide adequate oversight of nonconforming standards. Additionally, many of the benefits that have been put forth for the Risk reporting line structure would be diminished by the fact that compliance would require a separate set of standards to effectively monitor compliance risk because compliance risk involves a different set of monitoring than established risk management practices.[172] Therefore, compliance would not be an effective function for the company if it would have to operate within the Risk reporting line structure.

The inherent conflict of interest presented in the general counsel reporting line structure is fraught with potential issues that conflict with SR 08-8 guidance as well. SR 08-8 explicitly provides that compliance independence is meant to "avoid conflicts of interest."[173] As many have noted, the compliance function is at odds with the function of being a legal advisor or advocate for the company.[174] Compliance is intended to make a company more accountable to its constituents and the outside world.[175] How can compliance achieve this objective if there is the possibility that the general counsel may quash a compliance issue because general counsel does not perceive of it as an adequate "legal" risk? There needs to be delineation between the two roles to ensure an adequate level of independence and stature for compliance.[176]

Therefore, the stand-alone reporting structure would ensure the optimal level of independence to allow compliance to function as an effective function and within the guidelines provided by SR 08-8.

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170. *Id.*
171. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 1.
172. *Id.* at 6.
173. *Id.* at 5.
174. Tanina Rostain, *General Counsel in the Age of Compliance: Preliminary Findings and New Research Questions*, 21 GEO. J. LEGAL ETHICS 465, 483 (2008).
175. *Id.*
176. *Id.*

C. COMPLIANCE REPRESENTATION ON FIRM COMMITTEES

If organizations adopt the stand-alone reporting line structure, one way to ensure the compliance function does not operate in a silo is to mandate its active participation and representation on various firm governance committees.[177] If an organization can clearly evidence that compliance remains an active independent stakeholder across various risk committees, there is a higher likelihood that a culture of compliance will pervade throughout the organization.[178] SR 08-8 addresses compliance participation in firm committees but does not precisely suggest how an organization should ensure a reliable governance structure that will empower and ensure an independent compliance function.[179] Therefore, compliance needs to have its own standing committee reporting to the Board and be an active participant on various business-line committees across the organization.

A compliance committee should operate to amalgamate information seen across the organization, with powers to inform, advise, and propose ideas to the Board.[180] The charter of the committee should take into consideration factors such as how the company should address overall risk management, how the compliance program should be designed and operate, and what steps the Board and the company should take to communicate and build a corporate culture of ethics.[181] Operating in such a fashion will not only reinforce the independent, third-party perspective that compliance should foster, but will also meet the needs of SR 08-8 as "compliance risk underscore[s] the need for a firm-wide approach to compliance risk management and oversight."[182]

The role of compliance has been described as taking the lead in "identifying and managing the significant regulatory compliance risks to which the business is exposed."[183] In order to achieve this objective, compliance stakeholders must be involved with the various firm committees in order to provide them with the appropriate business updates and strategies to assess the potential compliance risks.[184] Compliance involvement in firm committees is beneficial because it encourages management to seek compliance's input on business decisions, while

177. KPMG, *supra* note 100, at 10.

178. *Id.* at 11.

179. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 5.

180. *Corporate Governance Audit and Compliance Committee*, IBERDROLA USA, http://www.iberdrolausa.com/CorporateGovernance/BoardofDirectors/AuditandComplianceCommittee.html (last visited Nov. 10, 2013).

181. Michael Volkov, *The Importance of a Board Compliance Committee*, CORRUPTION, CRIME & COMPLIANCE (Apr. 15, 2013), http://corruptioncrimecompliance.com/2013/04/the-importance-of-a-board-compliance-committee/.

182. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 1.

183. KPMG, *supra* note 100, at 13.

184. *Id.* at 10.

allowing compliance to have direct access to real-time information.[185] Furthermore, this approach will emphasize the firm's culture of compliance such that it can partner with the business as a trusted advisor,[186] and thus it ties back to SR 08-8's comment that "compliance functions are generally more effective when strong working relationships between compliance and business line staff exist."[187]

Mandating compliance participation on firm committees and the creation of a compliance committee will address the potential challenges that are raised with the stand-alone reporting structure. Compliance will operate in less of a silo because compliance staff will have access to information that is current and direct from the business. There will be stronger working relationships forged with the business lines because compliance will play a more active and constructive role in its decision-making process. More importantly, compliance will still maintain its complete independence given that it would not fall into the same reporting structure of the business or any other firm function. By having a direct reporting line to the Board, compliance will be able to make decisions through an independent, third-party lens, thereby satisfying the SR 08-8 requirement for independence.[188] Compliance risks across the organization can be synthesized through the compliance committee, thereby satisfying the SR 08-8 requirement to ensure a firm-wide approach to risk monitoring.[189]

CONCLUSION

Given the recent burgeoning of the compliance industry and the ever-changing regulatory environment, regulators, companies, and individuals need to constantly react to the ongoing change. What will remain constant is the need for compliance to remain an effective and independent function within organizations.

The regulatory guidance provided by SR 08-8 provides organizations with a blueprint to create a best-in-class compliance program; however, because there is no "one-size-fits-all"[190] approach to compliance, organizations should adopt the best practices that will enable their compliance program to function as an independent and effective area of the organization in today's ever-changing regulatory world. It is vital for organizations not only to obtain the best resources to fit into the compliance department, but also to shape the compliance function as effectively as possible to stay ahead of regulatory issues that may arise. As explored

185. SEC. INDUS. & FIN. MKTS. ASS'N, *supra* note 102, at 7.
186. *Id.*
187. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 54, at 5.
188. *Id.*
189. *Id.* at 1.
190. Olaoye, *supra* note 11.

through this Note, organizations should implement an effective qualitative assessment performance indicator in order to consistently and effectively structure incentive-based compensation in alignment with SR 08-8. Additionally, organizations should adopt a stand-alone reporting line structure for compliance that reports directly to the Board. Finally, compliance should be involved as an active member on various senior-level firm committees, along with establishing an independent compliance committee dedicated to discussing compliance risks within the organization. Implementing these recommendations should enable the organization to develop a best-in-class compliance program to not only manage through the current regulatory environment but also to navigate through future regulatory changes.

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