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This Article argues that the compliance officer should play a major role in the ongoing reform of broker-dealers and other financial firms. This role is facilitated by the fact that 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 and then revising detailed compliance procedures and policies, 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 at times ignore it altogether because they understand that the rules are different from, and secondary to, the actual securities business. Moreover, the external approach "crowds out" another model that is necessary to achieve the most effective compliance: Ideal broker-dealer 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

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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 a compliance officer, rather than being only a transcriber of rules and monitor of their enforcement, would be an educator about policies, standards, and the appropriate firm and industry culture, as well as an advisor and counselor concerning how they should inform daily employee decisions.

INTRODUCTION

A key participant in the reform of broker-dealers and other financial firms in response to the financial crisis of 2007–2008 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 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, or legal. 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 and 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.

This Article argues that the compliance officer should play a major role in the ongoing reform of broker-dealers and other financial firms. This role is facilitated by the fact that compliance is now well established and accepted in financial firms and compliance officers are close to decision making at all levels of a firm. In the interest of keeping the discussion manageable, this Article focuses on compliance only in financial firms regulated by the SEC as broker-dealers under the Exchange Act and by FINRA, which is the SRO for these firms.[3] The contention of this Article is that the role of compliance must be rethought and reoriented if it is to contribute

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. *See* 15 U.S.C. § 78c(a)(26) (2012).

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 (2012). On the movement of lawyers and others between financial regulators and the financial industry, see Michael Smallberg, *Dangerous Liaisons: Revolving Door at SEC Creates Risk of Regulatory Capture*, PROJECT ON GOVERNMENT OVERSIGHT 2 (Feb. 11, 2013) http://www.pogo.org/our-work/reports/2013/dangerous-liaisons-revolving-door-at-sec.html ("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*, 2013 U. ILL. L. REV. 507 (2013) (questioning the criticism of this phenomenon).

3. *See* 15 U.S.C. § 78o (2012). 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)(4), 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, particularly registered investment advisers and swap dealers, for, as discussed below, broker-dealer compliance has been in existence for a long time and thus has served as a model for compliance in these other financial firms.

fully to the reform. Compliance officers now help ensure that 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 them and monitoring compliance with them.[4] 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 reduced.[5] Indeed, in a theoretical sense, the most effective disciplinary system would be to have compliance officers everywhere, scrutinizing and reviewing every client interaction and 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 enforced by compliance officers reinforces the distinction between the business of the firm, on the one hand, and law and regulation on the other. Under the external model of compliance, the securities business is the world of profit-making through talent, discretion, and effort, whereas compliance is viewed by brokers as restricting 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 managerial position.[6] 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 whether employees fulfill the obligations imposed by securities laws and regulations as well as SRO rules, and

4. *See infra* Part I.B.

5. *See* Gary R. Weaver & Linda Klebe Treviño, *Compliance and Values Oriented Ethics Programs: Influences on Employees' Attitudes and Behavior*, 9 BUS. ETHICS Q. 315, 329 (1999) (discussing the benefits of a compliance program).

6. *See infra* text accompanying notes 46–47 (discussing FINRA Rule 3013).

they investigate and report violations of these rules and laws, which can lead to criminal or civil enforcement by the Justice Department ("DOJ"), the SEC, and FINRA.[7] 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 ideal broker-dealer 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, regulations, and 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 following compliance procedures because other concerns influence their decision making.[8] 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, as well as an advisor and counselor concerning how rules can be applied in daily employee decisions in the firm.

This reorientation of broker-dealer 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.[9] The financial system appears to work best when entrepreneurs and financial institutions, such as broker-dealers, compete with their

7. *See infra* Part II.A.

8. *See* MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 69–70 (2011) (discussing "ethical" fading, where ethical dimensions of a decision "fade" at the time of decision making); Ann E. Tenbrunsel & Kristen Smith-Crowe, *Ethical Decision Making: Where We've Been and Where We're Going*, 2 ACAD. MGT. ANNALS 545, 561 (2008) (discussing literature on the subject of ethical fading).

9. *See* ROBERT J. SHILLER, THE NEW FINANCIAL ORDER: RISK IN THE 21ST CENTURY 99–104 (2003) (discussing beneficial financial innovations).

various products and services, with the inevitable successes and failures that come with our economic system. In the last thirty years, however, certain financial firms, generally the financial conglomerates that included the largest broker-dealers, upended this system by externalizing and socializing the risks of their failure.[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.[11] In the worst financial crisis in modern memory, many of the largest financial firms failed or had to be rescued by the government; indeed, the financial system nearly collapsed.[12] This crisis 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 blamed financial firms for, their difficult situation.[14]

10. The "classic" work setting forth this perspective is SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 189–222 (2010). *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).

11. For one narrative of how the growth in subprime lending and its toxic securities gradually spread throughout the financial system, see THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS OF THE UNITED STATES 3–24 (2011).

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. 2010). 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—AND THEMSELVES (2009).

13. *See, e.g.*, Viral V. Acharya et al., *A Bird's-Eye View: The Financial Crisis of 2007–2009: Causes and Remedies*, *in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 1, 10–11 (Viral V. Acharya & Matthew Richardson, eds. 2009).

14. For a view on the origins of social disparities that appeared in the financial crisis, written in the middle of the crisis, see generally CHARLES R. MORRIS, THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH 137–58 (2008). The "Occupy Wall Street" movement comes to mind, with its protest against the "1%," which owns most of the assets and receives most of the income in the United States. *See* OCCUPY WALL STREET, http://occupywallst.org (last visited Mar. 5, 2013); *see also* Josh Bivens & Lawrence Mishel, *The Pay of Corporate Executives and Financial Professionals as Evidence of Rents in Top 1 Percent Incomes*, 27 J. ECON. PERSP. 57, 65–66 (Summer 2013) (discussing "rent shifting," i.e., overcompensation, as an explanation for the growth of income in the financial sector).

In reaction, Congress produced the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") and regulators issued voluminous regulations based on it.[15] Not surprisingly, the creation of new financial regulators,[16] or new offices within existing ones,[17] accompanied this growth in law and regulation. SROs, particularly FINRA, enhanced their own regulatory and enforcement capabilities as well.[18] This legal and regulatory activity resulted in an enormous amount of new regulation being placed on financial firms, including broker-dealers. Critics of Dodd-Frank contended that legislators, regulators, and SROs had imposed excessive regulatory, and thus compliance, burdens upon the firms that would hurt firms' flexibility and competitiveness.[19]

Highly visible, well-functioning compliance, which helps firm employees make decisions animated by legal policies and professional and ethical standards, could save broker-dealers from this cycle of

15. *See* Pub. L. No. 111-203, 124 Stat. 1376 (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, through means such as 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.

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* Dodd-Frank Act tit I §§ 111, 112, codified at 12 U.S.C. §§ 5321–22. The Bureau of Consumer Financial Protection was also 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* Dodd-Frank Act tit X §§ 1011, 1021, codified at 12 U.S.C. §§ 5491, 5511.

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* *Economic & Risk Analysis*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/divisions/riskfin.shtml (last modified Mar. 13, 2014).

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).

19. *See, e.g.*, REPUBLICAN STAFF OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES, FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 88–90 (July 2014). By contrast, one could contend that, given their misconduct, broker-dealers and other financial firms need more, not less, regulation.

crisis followed by increased regulatory burdens. It could convince legislators, regulators, and, most important of all, the public that broker-dealers contribute an important social role (i.e., capital raising) and are not in business only for their employees' self-interest. Firms would thus need fewer express rules of conduct.[20] 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 public confidence in the financial markets and, perhaps, the reemergence of the kinds of risks and crises that threaten the entire financial system.[21]

This Article proceeds as follows. Part I provides a brief history of compliance in broker-dealers and its amplified importance over recent years as laws and regulations affecting these firms have increased. Part I then discusses the role and functions of the typical compliance department in a broker-dealer, generally as the producer, administrator, and enforcer of firm rules reflecting this ever-growing number of laws, regulations, and professional standards.

Part II 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. Part II relies on insights about the origin and purpose of this disciplinary approach, particularly those by the French

20. Other reforms, such as a change in business school education, would be useful, but they are outside the scope of this Article. *See, e.g.*, Robert A. Giacalone & Mark D. Promislo, *Broken When Entering: The Stigmatization of Goodness and Business Ethics Education*, 12 ACAD. MGT. LEARNING & EDUC. 86 (2013) (explaining how, before they enter business schools, many business students have been taught to belittle ethics and to espouse materialistic values).

21. 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).

philosopher Michel Foucault, who saw it as a technique of social control that emerged during the Enlightenment and that was applied first in the prisons and then in major social activities. It acknowledges that this approach contributes to compliance, as it constrains employees to act in accordance with the law and checks their misconduct through its monitoring.

Part II 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 compliance 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 securities business, the external approach inevitably makes brokers think of compliance as secondary in importance to 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 approach, because individuals meeting external compliance requirements may feel no need to understand and to be motivated by the legal policies and ethical standards underlying the requirements. Part II 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 II 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 suggests that the external compliance model has serious limitations. Yet reforms following the crisis have reinforced the external approach and even expanded its mission 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 the increase in compliance burdens on broker-dealers may undermine the flexibility and capacity for innovation that is the hallmark of a beneficial finance.

Part III 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 the social purposes of their activities. This approach finds support in current social psychological and organizational research on ethical and pro-social decision making.[22] Part III 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 the SEC would resist this change, as it differs from their established approach and 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 commenters to identify potential problems with the approach. 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 IV concludes.

I. THE FOUNDATIONS AND PRESENT CONFIGURATION OF COMPLIANCE

A. The Statutory and Regulatory Basis for Compliance in Broker-Dealers

The current state of compliance in broker-dealers is, to a great extent, a product of a broker-dealer's legal responsibility for its personnel that is imposed under the Exchange Act and the common

22. *See infra* Part III.A.

law.[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 securities laws or their regulations by the broker-dealer itself or by any person associated with such broker-dealer.[24] 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 even the revocation of its registration, which would mean that the broker-dealer could no longer engage in the brokerage business. In addition to this statute, the SEC, as enforcer of the federal securities laws, also used the common law doctrine of respondeat superior to make a firm responsible for the acts of its employees engaged in the securities business.[25] 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

23. The focus here is on the industry-specific origins of compliance within broker-dealers. These compliance systems have been influenced and shaped by factors leading to compliance in business (particularly publicly traded) firms. General business compliance is the subject of a rich scholarly literature. *See generally* Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 958–75 (2009) and accompanying notes (discussing origins of corporate compliance and referencing much of the significant contributions to this literature); Michele DeStefano, *Creating a Culture of Compliance: Why Departmentalization May Not Be the Answer*, 10 HASTINGS BUS. L. J. 71, 88–103 (2014).

24. *See* 15 U.S.C. § 78o(b)(4)(D) (2012). "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) (2012). 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).

regulations entails so that compliance and the accompanying supervision can be properly accomplished. The compliance function or department of a broker-dealer accomplishes this task.

Section 15(b)(4)(D) proved to be an inadequate provision for the SEC to enforce 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 fail to prevent the violations. The Securities Acts Amendments of 1964 remedied these problems by adding sections 15(b)(4)(E) and 15(b)(6), which made supervisory liability explicit in the Exchange Act and which thus gave a major impetus to compliance.[26] Under section 15(b)(4)(E), a broker-dealer is subject to sanctions if, among other things, it or an associated person willfully "failed reasonably to supervise, with a view to preventing" such violation, another person who committed the violation.[27] This amendment makes the broker-dealer explicitly liable for its own and its associated persons' failure to supervise. Furthermore, section 15(b)(6) provides that an associated person who, among other things, commits a supervisory violation is also liable and subject to SEC discipline.[28] Under this latter provision, 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 reinforce the need for a firm function (i.e., compliance) that would assist individual supervisors, who have personal supervisory liability, in fulfilling their supervisory obligations. Moreover, these provisions, which add to the enforcement authority of the SEC, have shaped the orientation of compliance so that, as discussed below, it becomes a subject of SEC and FINRA enforcement.

Section 15(b)(4)(E) provides both the firm and, through section 15(b)(6), firm supervisors with defenses to an SEC 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,

26. Pub. L. 88-467, 78 Stat. 565, 571–72 (1964) (15 U.S.C. §§ 78o(b)(5)(E), (b)(7) (1964)). These provisions are now codified at 15 U.S.C. §§ 78o(b)(4)(E), (b)(6).

27. 15 U.S.C. § 78o(b)(4)(E).

28. 15 U.S.C. § 78o(b)(6) (2012). This section imposes the supervisory obligation through a cross-reference to section 78(b)(4)(E) (2012).

insofar as practicable," any securities law violations by the supervised person;[29] and, second, if the supervisor has "reasonably discharged" her or his duties under the procedures and system "without reasonable cause to believe" that these "procedures and system were not being complied with."[30] This foregoing language means that, to offer the 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 just "window dressing."[31]

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 compliance department or group 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 is satisfied: that the procedures and the system are being followed. They would accomplish this task through their monitoring for legal compliance and following up on any problem or potential problem (known in the trade as a "red flag")[32] that surfaces in a firm, which could suggest a legal violation and thus potentially a

29. 15 U.S.C. § 78o(b)(4)(E)(i) (2012).

30. 15 U.S.C. § 78o(b)(4)(E)(ii) (2012).

31. *See id.*; *see also* RALPH C. FERRARA ET AL., STOCKBROKER SUPERVISION: MANAGING STOCKBROKERS AND SURVIVING SANCTIONS 15 (1989) (discussing, in general terms, the elements of the statutory defense from the SEC's perspective); John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 COLUM. BUS. L. REV. 165, 174–77 (discussing origins of the statutory defense).

32. A "red flag" is an unusual event or practice that could be a sign of a securities violation and, therefore, one that must be monitored or investigated. *See, e.g.*, FINRA, Regulatory Notice 08-18, Unauthorized Proprietary Trading (2008) (identifying "red flags" for improper conduct by proprietary traders in firms); *In re* Gutfreund et al., Exchange Act Release No. 31554, 52 SEC Docket 2849, 1992 WL 362753 at *12 (Dec. 3, 1992) ("red flags" are "'suggestions' of irregularity"). So ingrained is this notion in brokerage culture that parties engaging in inappropriate conduct and attempting to avoid detection themselves sometimes 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.'").

supervisory one. In sum, a firm has 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 is critical since, under sections 15(b)(4)(E) and 15(b)(6), the firm and its supervisors face explicit supervisory liability.

The SEC has 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 opinions issued in administrative proceedings against broker-dealers.[33] In certain significant 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.[34] As a 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 has been to require that a broker-dealer have a compliance department and adequate staff whose size would be proportional to the size of the firm and the growth and complexity of the firm's activities.[35] In this way, compliance officers would be able to oversee each part of the firm's business. Moreover, the SEC demands that compliance officers have autonomy within the firm; officers would have their own reporting structure and lines of authority apart from those of the firm's business. They also need the power to report their concerns about problems in transactions and new business development to senior

33. 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 (2012). On the rules governing the proceedings, see 17 C.F.R. §§ 201.200–490 (2013).

34. *See, e.g.*, *In re* Prudential-Bache Sec., Inc., Exchange Act Release No. 22755, 1986 WL 626342 (Jan. 2, 1986) (discussing problems with respect to the powers of the compliance department). 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.*, *In re* Prudential Sec., Inc., Exchange Act Release No. 33082, 1993 WL 430273 (Oct. 21, 1993) (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. 63829 (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).

35. 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. 33082, *supra* note 34, at *27.

firm decision makers and to have firm supervisors explicitly address these concerns.[36]

36. *See* Prudential-Bache Sec., Inc., Exchange Act Release No. 22755, *supra* note 34 (faulting firm for failing to follow directions of compliance as to dismissal of rogue brokers). *See also* FERRARA ET AL., *supra* note 31, at 19–27 (citing SEC decisions on this subject). 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 In re* Huff, Exchange Act Release No. 29017, 1991 WL 296561, at *9 (Mar. 28, 1991). In a seminal SEC decision on this subject, Gutfreund et al., *supra* note 32, 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 (emphasis added). 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 nor do they tell others what to do or make disciplinary decisions when a violation is found—those actions 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 foreground mainly because of a case involving a disciplinary action against a general counsel who was also the CCO of a broker-dealer. *See In re* 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 manipulator. Urban urged that the broker be dismissed, but he was overruled by the head of retail sales who agreed to supervise the broker 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 a 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 Urban was in fact a supervisor, but that he had fulfilled his supervisory responsibilities. At the urging of its 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

Similarly, SRO supervisory requirements significantly spur the growth of compliance in firms. The Exchange Act requires SROs to enforce compliance with federal securities laws and regulations, as well as compliance with their own rules, by their members and to have rules designed to "prevent fraudulent and manipulative acts and practices, [and] to promote just and equitable principles of trade."[37] To achieve these purposes, the NYSE and the NASD (FINRA's predecessor), as well as other SROs, historically 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.[38]

Over the years, the SRO requirements for supervisory systems have become extremely detailed and specify how a broker-dealer is to conduct supervision, as opposed to providing a defense to supervisory liability, as is the case with section 15(b)(4)(E) of the Exchange Act. FINRA requires each of its members to have "a system to supervise the activities of each registered representative, registered principal,[39] and other associated person that is reasonably

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and its board of directors. *See In re* 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 id.* 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). The SEC staff recently asserted that the administrative law judge's decision is "of no effect," in light of the dismissal of the action. *See* SEC Division of Trading & Markets, Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act 4 (Sept. 30, 2013), *available at* http:www.sec.gov divisions/ marketreg/faq-cco-supervision-093013.htm.

37. *See* 15 U.S.C. §§ 78o-3(b)(2), (6) (2012) (for securities associations); 15 U.S.C. §§ 78f(b)(1), (5) (2012) (for exchanges). The SEC reviews the rules in connection with the registration of an association or an exchange, as well as ongoing proposed rule changes or ones initiated by the SEC. *See* 15 U.S.C. § 78s(a)–(c).

38. The then NASD required in Article III section 27 of its Rules of Fair Practice that its members have 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, at 1389–94 (for a summary of these rules).

39. "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* FINRA, *Registration of Principals-1021*, NASD

designed to achieve compliance" with securities laws and regulations and FINRA rules.[40] 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 correspondence with the public of registered representatives relating to their securities business, and to investigate the character and qualifications of any associated person.[41] 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. Compliance officers are needed to help the firm and its supervisors administer the required supervisory system.

Moreover, since FINRA rules govern each securities business activity and generally dictate how it is to be conducted in accordance with the applicable law and regulation, nearly every FINRA rule has supervisory and, therefore, compliance implications.[42] Each year

RULES, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4254 &element_id=3579&highlight=registration#r4254 (last visited Aug. 24, 2014) (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.

40. *See* FINRA, *Supervision-3010*, NASD RULES, http://finra.complinet.com /en/display/display_main.html?rbid=2403&element_id=3717 (last visited Aug. 24, 2014) (Rule 3010(a)). FINRA proposed to create a new FINRA Rule 3110 to replace NASD Rule 3010 (as well as a new FINRA Rule 3120 to replace NASD Rule 3012 discussed below). *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). After amending its proposal in response to industry and other comments, FINRA received the SEC's approval on its new rules. *See* Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of a Proposed Rule Change To Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, as Modified by Amendment No. 1, Exchange Act Release No. 71,179, 78 Fed. Reg. 79,542 (Dec. 30, 2013). FINRA has determined that this rule change will take effect on December 1, 2014. *See* FINRA, Consolidated Supervision Rules, Regulatory Notice 14-10 (Mar. 2014). Since the new supervisory rules maintain the general content and overall orientation of the current rules, which are discussed below, the Article will focus on the FINRA rules currently in force.

41. *See* FINRA, *supra* note 40, at §§ 3010(a)–(e).

42. 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)

there are new FINRA rules or the existing rules are modified in response to the development of new businesses and products in broker-dealers or to the imposition of new legal obligations imposed upon these firms. These changes reinforce the need for a broker-dealer to have a compliance division or group that can keep track of all of the legal and regulatory duties of the firm and associated persons and that can help the firm's employees satisfy their obligations, and the firm's supervisors their supervisory duties through guidance, monitoring, and follow-up.

Specific SRO supervisory rules promulgated in reaction to scandals in the brokerage industry gave an additional impetus to the growth of compliance. In 2004, the SROs issued two compliance-related rules after a notable failure of supervision in several broker-dealers where, undetected, a single broker misappropriated over $100 million in customer money over fifteen years.[43] One of these rules was (to use the FINRA example) NASD Rule 3012, which 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 identify the need for additional WSPs.[44] 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

(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 id.* at 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 fulfilled these requirements for a given recommendation.

43. *See* Securities and Exchange Comm'n, Self-regulatory Organizations; Order Approving Proposed Rule Change and Amendments No. 1 and 2 by National Association of Securities Dealers, Inc. Relating to Internal Controls and Supervisory Control Amendments and Notice of Filing and Order Granting Accelerating Approval of Amendment No. 3, Exchange Act Release No. 49,883, 83 S.E.C. Docket 192, 2004 WL 1574002, at 1* (June 17, 2004) (recounting the case of Gruttadauria, the rogue broker).

44. *See* FINRA, *Supervisory Control System-3012*, NASD RULES, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3722 (NASD Rule 3012(a)(1)). FINRA is replacing NASD Rule 3012 by FINRA Rule 3120; *see also supra* note 39.

their findings.[45] This kind of supervisory control system and related testing procedure increased the demand for compliance specialists who understood supervisory and compliance systems, weaknesses in those systems, and industry developments with respect to their improvement. Even more specifically promoting compliance was the second rule, FINRA Rule 3130 (formerly NASD Rule 3013), which requires a firm to appoint at least one chief compliance officer ("CCO").[46] 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. The CEO must also certify that he or she has had "one or more meetings" with the CCO in the preceding 12 months to discuss the processes.[47] 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 ensure that compliance has become a specialized occupation within financial firms. Compliance duties initially were often done by firm supervisors with the help of in-house lawyers and outside counsel.[48] 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

45. *See* NASD Rule 3012(a)(1), *supra* note 44.

46. *See* FINRA, *Annual Certification of Compliance and Supervisory Processes-3130*, FINRA RULES, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6286 (FINRA Rule 3130(a)). *See also* 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.").

47. *See* FINRA Rule 3130(b), *supra* note 46. The Rule provides a "model" certification for the CEO. *See id.* at Rule 3130(c).

48. *See generally* SECS. INDUS. ASS'N: COMPLIANCE & LEGAL DIV., 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, but every firm must have a chief compliance officer who is responsible for compliance.

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.[49] They thus had to create and then 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 as well as ensure that their firm and its employees operated in accordance with the law and regulation and that their firm's supervisors satisfied their supervisory obligations. This meant that, as mentioned above and discussed further below, compliance officers would produce and implement the WSPs dictating how an activity should be conducted and supervised and would then monitor the firm to see that the WSPs were followed.

Because FINRA rules mandate that 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.[50] Larger

49. *See* SEC. INDUS. AND FIN. MKTS. ASS'N, WHITE PAPER: THE EVOLVING ROLE OF COMPLIANCE, at 18 (Mar. 2013) (discussing the various compliance models). An early writer on broker-dealer compliance observed that it took shape as a specialized activity in the early 1960s. *See* O. Ray Vass, *The Compliance Officer in Today's Regulatory Environment*, in CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 3 (PLI Corporate Law and Practice Course Handbook Ser. No. B4-6806 3).

50. There is different data on the number of broker-dealers. According to FINRA statistics, which are the most recent, as of July 2014, there are 4137 member firms with 162,634 branch offices and 634,506 registered representatives. *See* FINRA STATISTICS & DATA, http://www.finra.org/Newsroom/Statistics/ (last visited Sept. 9, 2014). As of the end of 2012, the SEC put the number of broker-dealers at 4761. *See* SELECT SEC AND MARKET DATA FISCAL 2013, at 21. As of the end of 2011, SIFMA put the number at 4527. *See* SEC. INDUS. AND FIN. MKTS. ASS'N, 2012 FACT BOOK 25 (2012). The firms fall into four rough categories: (i) the approximately 200 large firms, which historically were members of the New York Stock Exchange, which have most of the customer assets and most of the industry's revenue and which are often in large financial groups; *see id.* at 28–34 (reporting data on former NYSE firms), (ii) mid-sized, full-line firms, which are generally regional; (iii) discount brokerage firms; and (iv) smaller firms, sometimes operating with only few brokers or "registered representatives." *See* SEC. INDUS. AND FIN. MKTS. ASS'N, FACT BOOK 2009, at 43 (2009) (discussing the kinds of broker-dealers). More recent data on firm size is not readily available. SIFMA also provides a "heat map" of the location of broker-dealers in the United States, which shows that they are concentrated in urban areas, with a significant percentage in the New York City area. *See* SEC. INDUS. AND FIN. MKTS. ASS'N, BrokerDealer Heatmap, Table 1.1 (updated as of Aug. 6, 2014), ***available at*** http://www.sifma.org/research/statistics.aspx. Approximately a third of employees in the securities industry works in the tri-state area of Connecticut, New Jersey, and New York. *See U.S. Industry Employment*, SEC. INDUS. AND FIN. MKTS. ASS'N (as of Sept. 5, 2014), ***available at*** http://www.sifma.org/research/statistics.aspx. Like all financial firms, broker-dealers have consolidated in the past years, most recently due to the upheaval occasioned by the financial crisis. The number of broker-dealers has been gradually declining since the middle of the 1990s. *See* SIFMA,

firms are likely to have more compliance officers because their businesses are diverse and complex and because they thus need a more developed compliance function.[51] Compliance officers work in all kinds of structures, depending upon the size and businesses of a firm.[52] In large broker-dealers, compliance officers would generally be in a separate department or division under the CCO and thus in a separate reporting line. They might all be grouped in one central location or work in the business groups or branch offices that they advise and monitor.[53] In other words, like employees in other control functions, such as internal auditors, compliance officers have their own reporting structure, even if they work closely with business groups when developing compliance procedures for business activities. As a result of this distinction from business and of their control function, the compensation for full-time compliance officers, unlike that for most brokers and bankers, is not based on their business productivity and only indirectly determined upon the profitability of their branch or business line.[54]

Heatmap, Table Broker-Dealer Creation and Termination By Year. For example, from 2008 to July 2014, the number has declined from 4895 to 4137. *See* FINRA STATISTICS, http://www.finra.org/Newsroom/Statistics/. The consolidation is due to numerous causes, including the search for economies of scale, which has affected the entire financial industry, and technological innovations, which allow investors to trade themselves without the aid of a broker. *See generally* 1 NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION 1-10 to 1-26, 1-39 to 1-43 (4th ed. 2007 & Supp. 2013) (discussing the reasons for the industry's transformation).

51. For a description of compliance at Goldman Sachs, see http://www.goldman sachs.com/careers/why-goldman-sachs/our-divisions/global-compliance/index.html (last visited Jan. 8, 2014). Admittedly, many of those who have the position of compliance officer or CCO in smaller firms have other jobs and do not devote themselves fulltime to compliance. *See* NAT'L REGULATORY SERVS., COMPLIANCE COMPENSATION STUDY 5 (2011) (reporting that even CCOs in major firms spend only half of their time on compliance).

52. *See generally* SIFMA, *The Evolving Role of Compliance*, *supra* note 49, at 17–18 (discussing the various compliance structures used).

53. *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.

54. *See generally* INST. FOR INT'L FIN. & 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. There is not extensive information available about compliance compensation. *See generally* NAT'L REGULATORY SERV., *supra* note 51, at 5 (providing general survey data on compliance compensation); SOCIETY OF CORPORATE COMPLIANCE AND ETHICS, 2012 CROSS INDUSTRY CHIEF COMPLIANCE OFFICERS SALARY SURVEY 19 (2012) (indicating average compensation for CCOs in financial services to be approximately $165,000); *see also* BUREAU OF LABOR STATISTICS, OCCUPATIONAL EMPLOYMENT STATISTICS, OCCUPATIONAL

As compliance has become a specialized role, it has taken on the expected features of a professional undertaking, which reinforces its specialization.[55] Traditionally, 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."[56] Indeed, law schools are beginning to train students for compliance positions as a result of their perception that opportunities exist for students to become compliance officers in this difficult employment environment.[57] There are, moreover, compliance consultants often drawn from the ranks of former regulators who train compliance officers who, in turn, provide on-the-job advice about how to best perform their work and who even do certain compliance duties for a firm when they can be outsourced.[58] Additionally, societies of compliance professionals

EMPLOYMENT AND WAGES MAY 2013, 13-1041 COMPLIANCE OFFICERS (reporting the mean annual wage of compliance officers in other financial services as $90,800), *available at* http://www.bls.gov/oes/current/oes131041.htm. Other data shows that it is less than compensation for bankers and brokers, but that the gap has diminished as compensation for compliance officers has increased. *See* 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* NAT'L REGULATORY SERVS., *supra* note 51, at 2 (noting that compensation for compliance professionals has stagnated since 2008, despite new regulatory demands).

55. 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).

56. One example is the annual FINRA Institute at Wharton, which trains and certifies compliance professionals in the Certified Regulatory and Compliance Professional ("CRCP") Program. *See Certified Regulatory and Compliance Professional Program,* FINRA.ORG, http://www.finra.org/Industry/Education/UniversityPrograms/FINRAInstitute (last visited Sept. 22, 2014). The author of this Article has been a regular faculty member in this program, teaching, among other things, the subjects of supervision and suitability. The National Society of Compliance Professionals also operates a certification program, the Certified Securities Compliance Professional Program. *See Certified Securities Compliance Professional,* CSCP.ORG, http://www.cscp.org (last visited Sept. 22, 2014).

57. The Regulatory Compliance Association offers online education in asset management compliance in conjunction with law schools. *See Overview of Law & Masters Concentration,* https://www.rcaonline.org/law-masters-degree/law-students (last visited Sept. 22, 2014).

58. There are large numbers of these consultant groups. Representative of them are Ascendant Compliance Management, ASCENDANT COMPLIANCE MANAGEMENT, http://www.ascendantcompliance.com, (last visited Nov. 15, 2014), and Frontline Compliance, LLC, FRONTLINE COMPLIANCE, http://www.frontlinecompliance.com, (last

provide resources and discuss new issues and challenges.[59] Professional journals are also devoted to this activity.[60] Regulators have encouraged this professionalization of compliance.[61] Therefore, compliance officers can justly feel that the importance of their task has been recognized by senior management in their firms and by regulators, and that they have "arrived."

B. The Basic Tasks of Compliance Officers

As discussed above, compliance is closely associated with, and essentially makes possible, broker-dealer supervision 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, SRO rules, and industry standards. Compliance officers perform this basic compliance function by providing advice on a daily basis as to compliance requirements for individual business activities.[62] To accomplish this task, compliance officers must have a good understanding of WSPs and be familiar enough with business employees' activities to produce and update WSPs according to FINRA mandates.[63] The WSPs dictate how employees should conduct a particular business activity so as to comply with laws and regulations and how the activity should be supervised and monitored. The WSPs 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,

visited Nov. 15, 2014).

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

60. 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 this journal.

61. For example, in conjunction with FINRA, the SEC holds compliance outreach meetings where commissioners and staff meet with compliance officers and other control professionals of broker-dealers. *See 2014 Regional Compliance Outreach Program for Broker-Dealers*, SEC. & EXCH. COMM'N, *available at* http://www.sec.gov/info/complianceoutreach-bd.htm (last visited Sept. 22, 2014).

62. *See* SIFMA, *White Paper*, *supra* note 49, at 3. *See also* Vass, *supra* note 49, at 5 (referring to compliance, not pejoratively, as a "dumping ground").

63. *See* SIFMA, *White Paper*, *supra* note 49, at 4.

compliance officer, and/or another person should do in response to those problems.[64]

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 revealed by the firm's experience, by the testing mandated by NASD Rule 3012, or as a result of issues in WSPs raised by FINRA or regulators in an examination of a firm or because of industry-wide matters.[65] Implementation means that a

64. Take, for example, a broker recommending an investment to a client, which raises, among other things, "suitability" issues (i.e., the broker's duty) when recommending an investment or a strategy to a client to ensure that it is appropriate or "suitable" for the client. *See supra* note 42. The WSPs would specify what the basic suitability obligation of a broker is with reference to the law and to FINRA rules, 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), and direct the broker to record any resulting transaction as a recommended transaction as well as the information reflecting that he or she satisfied the suitability obligation. In addition, the WSPs should explain how a broker's supervisor reviews the transaction so as to ensure that the broker met his or her suitability obligation. Moreover, the WSPs should set forth additional monitoring by compliance officers and the procedures for brokers, supervisors, and compliance officers to follow if a client complains about a transaction or if any other "red flag" about lack of appropriateness of the product for the client appears. FINRA gives guidance on how a firm should design its compliance procedures with respect to the suitability obligation. *See* 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); FINRA, *Know Your Customer and Suitability*, *supra* note 42 (discussing a firm's policies on documenting its compliance with the suitability rule).

65. *See* SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 48, 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 49, 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, OFFICE OF 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 were revealed through SEC examinations).

compliance officer ensures that employees are following the WSPs. This task includes the distribution of the WSPs as well as any supplementary documentation, such as required reports or forms mandated by the WSPs, throughout the firm to its departments and branches and the training of brokers and supervisors in the WSPs.[66] Compliance officers then check on whether in fact the procedures are being followed, often through the production and review of reports on transactions.[67] Today, compliance monitoring is aided by technology, which has greatly automated the reporting and review process.[68]

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 to fraud.[69] They often identify problems because, as noted above, they review transaction records and communications and through this review, they signal matters warranting further

66. *See* SIFMA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 48, at 4.

67. *See id.* at 4–5. This is often referred to as compliance's "control," as opposed to its "advisory" function. *See* SIFMA, *The Evolving Role of Compliance*, *supra* note 49, 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.

68. 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. 669 (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 the WSPs, and that the broker had received appropriate training in the product. *See* SIFMA, *The Evolving Role of Compliance*, *supra* note 49, at 24 (discussing monitoring required by the new suitability rule).

69. *See* SIFMA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 48, at 5; SIFMA, *The Evolving Role of Compliance*, *supra* note 49, 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 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 a registered sales assistant in a branch office set up phony accounts and used them to siphon off customer funds; the scheme was not discovered even though the compliance department at the main office identified that the accounts often had phony addresses and used names of persons who were deceased).

investigation. Compliance officers also detect problems through the routine internal inspections of offices and branches that are part of the supervisory system.[70] In these inspections, officers check on compliance with regulations by personnel in the office or branch.[71] 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.[72]

This role of identifying potential violations of the federal securities laws, 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.[73] 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.[74] 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

70. *See* FINRA, *supra* note 40, at NASD Rule 3010(c). *See also* SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 48, at 5; SIFMA, *The Evolving Role of Compliance*, *supra* note 49, at 24–25.

71. Both the SEC and FINRA emphasize the importance of internal inspections, particularly of branch offices. *See* SEC, OFFICE OF 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).

72. *See also* SIFMA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 48, at 6; SIFMA, *The Evolving Role of Compliance*, *supra* note 49, at 26. A broker-dealer is subject to examination both by the SEC and FINRA, on a regular basis, as well as "for cause" (i.e., as a result of a complaint) or because of an overall investigation into brokerage practices. For a general discussion of this subject, see 1 POSER & FANTO, *supra* note 50, at 7-52 to 7-71.

73. *See supra* note 36.

74. *See id.*

action suggested by compliance), while not taking part in the disciplinary and supervisory decisions.[75]

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.[76] In addition, every broker must certify annually that he or she is in compliance with applicable laws and regulations.[77] 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.[78] Because compliance officers monitor legal and regulatory developments for WSP purposes, they are able to provide brokers with legal and regulatory updates. They are also likely to be involved in workforce training when new products or new business lines are being introduced, thus requiring education for brokers about how to sell the products or to do the new business in compliance with the law.[79] Education has 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.[80]

In sum, the overall picture of a compliance officer that emerges from the above review is that of a position that is intertwined with

75. *See* SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 48, 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).

76. For a discussion of the continuing education obligations of broker-dealers and their registered representatives, see generally 1 POSER & FANTO, *supra* note 50, 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.

77. *See supra* note 40, at NASD Rule 3010(a)(7).

78. *See* SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 48, at 4.

79. *See id.* at 7.

80. *See id.*; SIFMA, *The Evolving Role of Compliance*, *supra* note 49, 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* SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 48, at 5–6; SIFMA, *The Evolving Role of Compliance*, *supra* note 49, at 24–26. These functions are too numerous to discuss here.

every securities business of the firm and with each employee. As a central task, compliance officers must establish, test, and revise WSPs as well as educate brokers concerning them, monitor compliance with them, and identify and report on WSP problems. 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 and 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.

II. THE 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.[81] He employed 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.[82]

Foucault discussed how reformers of this period believed that prisoners could be controlled and, in some cases, rehabilitated through a discipline that contrasted with the brutal medieval punishment that 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" to become a productive person who could return to society.[83]

81. *See* MICHEL FOUCAULT, SURVEILLER ET PUNIR: NAISSANCE DE LA PRISON 80 (1975).

82. *See id.* at 201–13.

83. *See id.* at 126–32.

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 social goals, would exert over those in need of direction.[84] As he explained, the use of this power migrated out of the prison into other social activities when its proponents realized its value.[85] 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.[86] The use of the new discipline also transformed education when educational reformers employed it to train and to form children and young adults, both physically and mentally, for the labor that was needed in society.[87]

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 new techniques of control were employed in major productive social activities. Typical brokers, like Foucault's prisoners, are the "subjects" of the supervisory system and thus of compliance, and have their actions and words dictated by compliance procedures and monitored by compliance officers. As noted above, WSPs specify how brokers must conduct themselves, and even what they should say, with respect to a given securities activity.[88] Their actions and communications are both recorded and reviewed, sometimes in real time, by their immediate supervisors and also by compliance officers. From Foucault's perspective, therefore, compliance procedures "form" brokers by controlling their conduct and by subjecting them to scrutiny—in sum, brokers are surrounded by a web of control and surveillance. As broker-dealers have come to use technology in this monitoring, moreover, the scrutiny to which brokers are subject has become real-time.

This use of Foucault's insight concerning soft power in the broker-dealer context is not intended to ignore the obvious. The

84. *See id.* at 133–34.
85. *See id.* at 139–40.
86. *See, e.g.*, *id.* at 146–47.
87. *See, e.g.*, *id.* at 148–49.
88. *See supra* text accompanying notes 63–64.

current all-encompassing discipline and monitoring of broker-dealer employees by compliance officers owe much to the enhanced oversight of employee activities that has always typified financial firms. Since brokers, like bankers, insurance brokers, and commodity firm employees deal with cash and personal property that can be easily stolen or misused, they are subject to particular scrutiny.[89] 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, such as broker-dealers.[90] Investors 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.[91] 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 brokers 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 (albeit a vivid one), with other scholars and historians calling attention to hierarchical techniques and other features of production that came into widespread existence with industrialization in the modern era.[92]

89. 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. *See* JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 2–3 (12th ed. 2012) (discussing basic consumer protection rationale for securities regulation).

91. From the Foucault perspective, this important social activity, public investment, is exactly where the disciplinary power would be used.

92. *See, e.g.*, DAVID S. LANDES, THE WEALTH AND POVERTY OF NATIONS: WHY SOME ARE SO RICH AND SOME SO POOR 204–10 (1998) (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

Foucault suggested, however, that this all-pervasive discipline and surveillance were unlikely ever to be fully achieved in any given domain, even in prison. 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.[93] Social psychologists and organizational scholars offer related criticisms about the effectiveness of this "top-down," panoptical approach. They acknowledge that 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.[94] However, they 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.[95]

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, all employees in a broker-dealer today understand that they are 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-identities and self-definitions, which are centered on their productive securities activities and the business groups where they conduct these activities.[96] After all, broker-dealers are profit-making firms in the

knowledge-based fields, like computer engineering. *See, e.g.*, GIDEON KUNDA, ENGINEERING CULTURE (rev. ed. 2006).

93. *See* FOUCAULT, *supra* note 81, at 35, 315 (suggesting the resistance to the all-encompassing disciplinary power).

94. *See* Weaver & Treviño, *supra* note 5, at 329–30.

95. *See id.* at 323 (stating the drawbacks of a rules- or compliance-oriented approach, as opposed to one linked with values).

96. *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.

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[97] inevitably reinforces in the employees' minds the distinction between the securities business and the compliance function as well as the distinction between those who work in both sectors. Additionally, brokers know that compliance officers report problems to their supervisors and to senior management and understand that compliance officers are the "eyes 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.[98]

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 persuade compliance officials to ignore their transgressions, especially when the brokers are acting in accordance with their self-identity, which is formed by the attitudes of their business group and peers.[99] Since the WSPs embody the policies of

ALEXANDER HASLAM, PSYCHOLOGY IN ORGANIZATIONS: THE SOCIAL IDENTITY APPROACH 30 (2d ed. 2004) ("[A]s 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."). Anecdotally, this appears to reflect accounts of working in the securities industry, even for those who thought that they would never fit into its culture. *See, e.g.*, JONATHAN A. KNEE, THE ACCIDENTAL INVESTMENT BANKER: INSIDE THE DECADE THAT TRANSFORMED WALL STREET (2006).

97. *See generally* SECURITIES INDUSTRY ASS'N, THE COSTS OF COMPLIANCE IN THE U.S. SECURITIES INDUSTRY: SURVEY REPORT 5 (2006) (finding, based on a survey, compliance costs averaging 13% of net revenue (revenue less interest expenses) per firm).

98. 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 minor or serious violations, since FINRA acts as 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, and from practice to industry bars. *See generally* POSER & FANTO, *supra* note 50, at 14-1 to 14-60.

99. FINRA and SEC disciplinary actions bear witness that this kind of cooptation occurs when brokers enlist compliance officers in their wrongdoing. *See, e.g.*, Melhado, Flynn & Associates, Inc., Exchange Act Release No. 64468, 101 SEC DOCKET 181 (May 11, 2011) (recounting a settlement involving a compliance director who assisted the scheme of the CEO

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, become separated from brokers' main activities and, indeed, their 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.[100] This fading can in fact 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.[101] In addition and more subtly, by following the letter of the WSP routines, brokers

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. MGMT. 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).

100. *See* BAZERMAN & TENBRUNSEL, *supra* note 8, at 69–70; Tenbrunsel & Smith-Crowe, *supra* note 8, at 561 (discussing the phenomenon of fading).

101. That is, if legal and regulatory policies and professional and ethical standards do not come to the forefront in decision making, then 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 division or team all working for their collective self-interest, it is likely that self-interest will be the primary motivation for brokers. For a personal account of the loss of the client focus in favor of the self-interest of bankers, see KNEE, *supra* note 96, at 222–30. 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 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.").

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.[102]

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 exhort firms and brokers to espouse a "culture of compliance," which, as discussed below, should properly refer to a different kind of compliance approach—one that will be characterized as an internal, rather than an external, model of compliance.[103] After all, a basic FINRA professional standard is echoed in Rule 2010, which refers to conducting business with "high standards of commercial honor and just and equitable principles of trade."[104] Yet, despite the references to the culture of compliance, the panopticon approach remains the main one 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 2007–2008 financial crisis was, among other things, the result of a failure of compliance in broker-dealers.[105] Legal, regulatory, and ethical policies were pushed into the background, or

102. *See* Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1(2005) (discussing, among other things, the "liberating" effects of disclosure).

103. *See, e.g.*, SIFMA, *The Evolving Role of Compliance*, *supra* note 49, at 27 (citing calls for a "culture of compliance" by various SEC officials).

104. *See* FINRA Rule 2010.

105. Now, several years after the onset of the crisis, there have been countless studies about the crisis and continuing analysis about its causes. *See, e.g.*, THE PANIC OF 2008, *supra* note 12 (collection of essays on the topic); RESTORING FINANCIAL STABILITY, *supra* note 13 (same). Some blame the crisis on the flow of easy capital into the United States 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).

faded, in broker decision making while other human motivations, chiefly self-interest, crowded them out.[106] 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.[107] They also created the variations of these securities, including the collateralized debt obligations, which were securities on pools of other mortgage-backed securities, and the synthetic instruments that mirrored their performance.[108] As is now well known, the firms also made markets on these various instruments and designed specialized investments in them for sophisticated parties.[109] 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.[110] Broker-dealers marketing the securities had an obligation to provide adequate disclosure of the risks associated with those securities.[111] However, in many cases, firms did not properly value the assets or adequately disclose those risks.[112] Moreover, brokers were supposed to understand the products because without this understanding, they could not legally sell them

106. 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. MGMT. ANNALS 279, 295, 301 (2011). This 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*, 125 ORG'L BEHAV & HUM. DECISION PROCESSES 39, 43 (2014) (reciting results of experiments showing that triggering a calculative mindset produces more self-interested conduct at the expense of social and ethical values).

107. *See* THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 11, at 68–72.

108. *See id.* at 127–34.

109. 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 banks 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).

110. *See* THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 11, at xxii.

111. *See* SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, *supra* note 109, at 322–24 (summarizing these obligations).

112. *See id.* at 318–20 (summarizing these and other failings).

to any customer.[113] 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.[114] 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.[115] Since compliance's mission was to ensure that all these activities were done in accordance with the law, regulations, and professional standards, these illegalities and other problems represent a wholesale compliance failure.

Despite this failure, the existing external compliance model has since been reinforced and extended. The maintenance of the compliance status quo is not surprising because in the immediate response to the financial crisis, legislators, regulators, SROs, and financial firms followed the understandable strategy of trying to fill evident gaps in regulation and self-regulation of the financial sector that the crisis had exposed.[116] For example, the issuance of asset-backed securities and the conduct of the investment banks involved in this process are now regulated in more detail. Banks are required to avoid conflicts of interest in the sales of these securities and to enhance disclosure of any conflicts.[117] All of this lawmaking, with its accompanying growth in SEC regulations and FINRA rules, resulted

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113. *See supra* note 42 (summarizing suitability obligations).

114. *See, e.g.*, Cody, Exchange Act Release No. 64565 (2011) (recounting facts of FINRA disciplinary action, upheld by the SEC, where a broker sold mortgage-backed securities to retail customers with practically no understanding of the products).

115. This would include, for example, taking advantage of a client while not literally violating a regulation. *See, e.g.*, SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, *supra* note 109, at 425–30 (discussing Goldman Sachs's manipulation of prices of collateralized debt swaps that adversely affected counterparties).

116. The major response is obviously Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1375, 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); and 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).

117. This is in Subtitle D of Title IX of Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1890–98. The SEC promulgated rules relating to the issuance of asset-backed securities. *See* Regulation AB, 17 C.F.R. §§ 229.1100–1123 (2013).

in more work for compliance officers because they have to translate the rules and regulations into WSPs with accompanying monitoring, reporting, and inspections.[118] 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 their major participants.[119] Swap dealers are now regulated in a manner that, understandably enough, parallels, and is modeled on, that of broker-dealers.[120] As a result of these regulations, a swap dealer must have a supervisory and record-keeping structure, which naturally demands a compliance function.[121]

In addition, regulators and SROs enhanced their oversight of financial firms and their enforcement after the recent financial crisis, which increased the workload of compliance officers. This increased oversight comes in response to criticism that the regulators themselves failed to detect and to punish the abuses that were at the origin of the financial crisis.[122] 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.[123]

118. Compliance officers, like anybody else, have finite time and resources. The more time they need to write new WSPs, the less time they have for other activities. *See* Vass, *supra* note 49, at 10.

119. This is in Title VII of Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1658-1802. 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.

120. *See* POSER & FANTO, *supra* note 50, at 5-40 to 5-44.

121. Indeed, the 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. *See* 15 U.S.C. § 78o–78k.

122. *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 11, at xviii (faulting financial regulators with not having prevented the crisis).

123. 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. *See* SEC OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME—PUBLIC VERSION (Rep. No. OIG-509, Aug. 31, 2009). The SEC's enhancement of examinations was mandated by Congress in Dodd-Frank section 929U, Pub. L. No. 111-203, 124 Stat. 1867, which, among other things, added a new Section 4(h) to the Exchange Act. *See* 15 U.S.C. § 78d(h) (2012). This provision required specialized examiners for the SEC's Division of Trading and Markets, which oversees broker-dealers. *Id.* On the SEC's risk-based examination system, see U.S. SEC. & EXCH. COMM'N, FISCAL YEAR

The SEC formed prosecutorial groups that target particular kinds of financial institutions and specific abuses.[124] All of this examination and enforcement activity demands the attention of compliance officers, who generally function as the "point person" for the firm in regulatory examinations and assist legal officers in responding to enforcement inquiries.[125] Moreover, the aggressive attitude of the SEC and FINRA examiners and enforcement personnel reinforces the link between compliance officers and regulators, which, as noted above, further separates compliance officers from the securities business in the eyes of brokers.[126]

This reaffirmation and extension of the external model of compliance are a lost opportunity to think critically about the current orientation of compliance and may have adverse consequences for finance and the economy. The financial crisis revealed the dangers emanating from large financial conglomerates involved in, among other things, capital market activities, particularly the economic downturn and political instability that flow from the collapse or near collapse of these institutions.[127] Compliance, of

2012 AGENCY FINANCIAL REPORT 3 (2013). On FINRA's enhancement to its own examinations in reaction to the scandal, see SPECIAL REVIEW COMM., REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES 6–8 (Sept. 2009).

124. *See, e.g.*, Robert S. Khuzami, Director of SEC Div. of Enforcement, Speech (Jan. 13, 2010) (transcript available at http://www.sec.gov/news/speech/2010/spch011310rsk.htm) (introducing the directors of the five new National Specialized Units: Asset Management, Market Abuse, Structured and New Products, Foreign Corrupt Practices Act, and Municipal Securities and Public Pension).

125. *See supra* text accompanying note 72.

126. 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* 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.

127. 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, *supra* note 10, 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

course, cannot change financial firms in general and broker-dealers in particular, but it could play a critical role in reducing the instability and other externalities arising from financial firms. This may be because no other party can fulfill compliance's particular role. After a crisis, legislators, regulators, and SROs often show a renewed zeal for law creation and enforcement, but their efforts eventually wane. Legislators become distracted by other, more immediate concerns. Regulators, like the SEC, have limited resources in this time of scarcity and their budgets are not growing and are unlikely to grow.[128] Despite reforms, regulators cannot realistically be counted on to identify significant problems in broker-dealers ahead of time, 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 do not work in the firms on a day-to-day basis.[129]

Compliance officers, by contrast, are omnipresent in the broker-dealers and are specifically charged with legal, professional, and ethical compliance. Most importantly, they actually see what is occurring in the firms. These compliance officers are thus particularly well situated to alert supervisors and senior executives to growing problems, such as the subprime loans and their securitization, that may eventually infiltrate the financial industry and gradually grow into a systemic problem.[130] Because compliance officers are involved

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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 could contribute to 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. *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). They influence 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).

128. For a description of the SEC's lack of adequate financial resources for its mission in recent years, see U.S. SEC. & EXCH. COMM'N, STRATEGIC PLAN: FISCAL YEARS 2010–2015, at 6–7 (2010).

129. *See* FINRA, Compliance Exams, *available at* http://www.finra.org/Industry/Compliance/ComplianceExams/ (discussing FINRA's routine compliance examinations).

130. 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.

with compliance and assisting in the supervision of every broker and securities activity in a broker-dealer, they are perfectly positioned to identify problems before the problems transform 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 the industry could survive the regulatory response to another major crisis in its present form. That is, the laws, regulations, and standards affecting broker-dealers have become so numerous that it takes considerable time, effort, and cost for a firm, even with the help of compliance officers, to ensure that they are followed. These regulatory requirements lead to the elimination of smaller broker-dealers that cannot afford the regulatory burdens and inhibit firms from entering into new activities. The vibrancy, flexibility, and competitiveness of the financial industry are thus adversely affected. Highly visible, well-functioning compliance officers, who help firm employees make decisions animated by legal policies and professional and ethical standards, could help prevent the recurrence of this cycle of crisis and regulation. Their activity could convince legislators, regulators, and, most important of all, the public that financial firms are dedicated to the valuable social mission that finance fulfills and are not simply in business for their own self-interest and are thus not in need of still more detailed rules of conduct. However, for compliance to help firms stay true to their social purpose, reduce their risks, and thus remain viable requires that its current external orientation be supplemented.

III. THE REFORM OF COMPLIANCE

A. 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. As explained earlier, the external approach is necessary to prevent and detect major legal and ethical violations and is mandated by law and regulation.[131] Yet compliance cannot rely only upon this approach,

131. Psychologists explain the importance and effectiveness of external oversight on

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.[132] Rather, compliance must develop and promote another existing approach: internal compliance.

The basic purpose of internal compliance is what the term implies: to have brokers comply because of internal motivations rather than only because of pressures from external rules and from monitoring by compliance officers.[133] Naturally, brokers "internalize" the laws, regulations, and professional 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.[134] 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.[135] That is, the goals, policies, and standards come to mind in decision making because they are part of brokers' self-identity, and thus they contend with, and even suppress, other motivations such as the self-interest that may characterize brokers' business identity and that of their business group.[136] This internal

compliance. *See supra* note 94.

132. 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 one suspects that human ingenuity can find a way to game it.

133. *See* Weaver & Treviño, *supra* note 5, at 320 (noting how a values-based compliance orientation is part of an employee's identity).

134. *See id.* at 323 (discussing how an external compliance orientation affects an employee's internal calculations about how to conduct himself or herself).

135. *See id.* 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).

136. *See* BAZERMAN & TENBRUNSEL, *supra* note 8, at 153–54 (discussing the power of

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 monitors, to the extent it can, the exercise of discretion while the internal approach will use discretion to foster compliance.

Once again, to use an example from suitability, in recommending securities or strategies to a customer, a broker is mandated to find those "suitable" to the customer in light of his or her investment holdings and goals, time horizon for investing, liquidity needs, risk tolerance, etc.[137] In making the recommendation, the broker has considerable discretion among the possible products and strategies. It is certainly conceivable that a "suitable" product might favor the broker or his or her firm in some way, such as by an enhanced commission or because of its sponsorship by an affiliated firm.[138] A supervisor's review and compliance monitoring (or customer complaints) will likely identify only clear suitability violations and will thus have little effect upon the broker's discretion. By contrast, internal compliance would be designed to promote customer service and benefit as the animating goals, policies, or standards for the broker's decision making in this context. With such an orientation, the broker would be inclined to use discretion in the client's favor, i.e., in this case, to recommend a suitable, but low-cost product. An even broader principle applicable in these circumstances would be fostering customer trust, and therefore involvement, in the financial industry and the securities markets, which ultimately allows for an efficient use of capital in society. The purpose of internal compliance is, therefore, to have the brokers, on their own, live up to FINRA's

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 AM. PSYCHOLOGIST 462, 468–69 (1999).

137. *See supra* notes 42, 64 and accompanying text.

138. Under the suitability rule, a broker does not have to recommend a product that is the lowest in terms of commissions and fees; he or she must recommend one that, on the basis of all the factors involved, is suitable to the client. A broker would violate the suitability obligation, however, if, all things being equal, he or she recommended a product specifically to maximize his or her own profit. *See* FINRA, REG. NOTICE NO. 12-25, SUITABILITY: ADDITIONAL GUIDANCE ON FINRA'S NEW SUITABILITY RULE, at 4 (2012).

"high standards of commercial honor and just and equitable principles of trade."[139]

The internal approach is already part of compliance, which is why it 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."[140] These words must refer to a way of thinking about or a perspective on compliance that reflects internalized attitudes in firm employees. In other words, in a firm with a "good" culture, compliance officers say that they can generally trust the brokers and supervisors to make legal and ethical decisions and thus 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 and to enforce compliance among one another.[141] Compliance officers are called in only if there are new issues or problems, the compliance issue is not obvious and brokers need to discuss it with a compliance specialist, or 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 brokers' minds when they are making business and client decisions—in other words, to ensure

139. *See* FINRA Rule 2010, *supra* note 104. The examples of a broker's ability to exercise discretion in everyday tasks, despite detailed FINRA rules, are numerous (e.g., how and where to execute orders, conducting sales seminars). Of course, there are examples where rules leave the broker little room for discretion. *See, e.g.*, NASD Rule 3040, [2009–2014 Transfer Binder] FINRA Manual (Wolters Kluwer) 17353 (2014) (a broker cannot engage in a private securities transaction without first having provided written notice to his or her firm).

140. *See supra* note 103 and accompanying text; *see also* SIFMA, *The Evolving Role of Compliance*, *supra* note 49, 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."); TAMAR FRANKEL, LEGAL DUTIES OF FIDUCIARIES 312 (2012) (discussing the importance of leaders in the culture of legal compliance).

141. *See generally* Jennifer J. 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 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.

that the goals and policies do not "fade" in a given decision.[142] This purpose changes the nature of the compliance officer's role from being only a monitor of employee performance of WSPs to being an advocate and educator for the policies and standards behind them. The compliance officer 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.[143] 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, 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 important in reducing illegal and unethical conduct and organizational conflict in firms.[144]

142. The view of human decision making offered and 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 8 (on ethical fading); *see also* Kish-Gephart et al., *supra* note 141, 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); Mark N. Bing et al., *An Experimental Investigation of an Interactive Model of Academic Cheating Among Business School Students*, 11 ACAD. MGMT. 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—where "ethical blindness" means that a person adopts a rigid perspective, often as a result of complex causes, including organizational and institutional structures, 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.

143. A compliance officer can elucidate 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 ACAD. 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.

144. 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).

The internal approach faces daunting challenges in 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 professional 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 single-minded pursuit of profit.[145] To accomplish this task, compliance must use the guidance of psychologists, social psychologists, organizational theorists, and even neuroscientists about how best to encourage the creation of this identity and 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.[146] The learning of these scholars 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 the empirically established methods and techniques needed to achieve that goal.[147] Shifting the

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. MGMT. 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 leader. 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 Practices*, 56 ACAD. MGMT. 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, it is locally and "through discussions, negotiations, and ongoing network reconfigurations that values practices are performed").

145. *See supra* note 136.

146. *See, e.g.*, BAZERMAN & TENBRUNSEL, *supra* note 8, 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?*, 38 DEL. J. CORP. L. 191 (2013).

147. 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, *supra* note 20, at 94–95. For a recent example of this propensity, see Christopher M. Matthews, *Ex-SAC Portfolio Manager Martoma Was Expelled from Harvard Law School*, WALL ST. J. (Jan. 9, 2014 7:16 PM), http://online.wsj.com/news/articles/SB10001424052702304347904579310882291980594 (manager who was

emphasis from external to internal compliance will not happen overnight, and compliance officers have to recognize and maintain the psychological effectiveness of 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.[148] In sum, the challenge of

criminally prosecuted for insider trading had earlier doctored his law school transcript). 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 8, at 156–57. Even automatic, rather than deliberative, processes could be used by compliance officers 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*, 57 ACAD. MGM,T. J. 723 (2014). 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.

148. The reference here is to, among other things, emerging research that the conduct of 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*, 365 PHIL. TRANSACTIONS ROYAL SOC'Y B 331, 337–39 (2010) (discussing the influence of such hormones and ways to guard against their negative effects); *see also* JOHN COATES, THE HOUR BETWEEN DOG AND WOLF: RISK TAKING, GUT FEELINGS, AND THE BIOLOGY OF BOOM AND BUST (2012) (discussing biological basis for risk-taking in securities trading). 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 A. Shepherd et al., *"I Care About Nature, but . . .": Disengaging Values in Assessing Opportunities That Cause Harm*, 56 ACAD. MGMT. J. 1251 (2013) (finding, in a study of entrepreneurs, 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). For a discussion of 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, *supra* note 5, at 327–30 (finding that a compliance-based approach—what

compliance is to achieve a reorientation towards an internal system while maintaining an external system 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 because this approach has characterized FINRA's dealings with broker-dealers for a long time. To take one example, FINRA's examiners demand, as evidence of a broker-dealer's supervision of a given business activity, written proof of a firm's WSPs, the firm's records of compliance with the WSPs, and a chart of the hierarchy of supervisors.[149] By contrast, if an examiner were to evaluate whether a firm had an adequate internal compliance and customer-centric culture in place, he or she would have to spend considerable time in the firm to see how supervision and compliance operated in practice.[150] In addition, management of FINRA's member firms also benefits 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 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, as discussed above. By contrast, internal compliance in a firm will require significant commitment from and involvement by top management, as the psychological literature suggests.

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 the authors to believe that a compliance-based approach is effective only when coupled with a meaningful values-based approach).

149. On SEC and FINRA examinations, see generally Matthew C. Dwyer, *Preparing for Broker-Dealer Examinations*, 5 PRAC. COMPLIANCE & RISK MGMT. FOR SEC. INDUSTRY 21 (May–June 2012), *available at http://www.mcd-consulting.com/attachments/File/Dwyer_PCRM_05-12.pdf*.

150. 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.

A challenge to the reemphasis on internal compliance is, therefore, convincing FINRA and its member firms to go along with, and to assist in, this reform. This Article argues to FINRA, as well as to its member firms, that the reform will promote the professional standards and culture that FINRA and its members have always espoused and that are central to the concept of self-regulation.[151] The reform will also make compliance more effective and will not result in abandoning the external supervisory system, but will supplement it.[152] Another argument will likely appeal also to FINRA's membership, and possibly to FINRA itself: that the turn to internal compliance will eventually reduce the regulatory burden on broker-dealers as there will be less need for new FINRA rules, WSPs, and the accompanying FINRA oversight.[153]

Moreover, FINRA is unlikely to reorient the current compliance approach on its own, especially since it is subject to SEC oversight as an SRO.[154] 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 adopts 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.[155] It is true that the duty of supervision, as well as the defense to a failure to supervise, which is the foundation upon which external supervision and compliance have been built, is driven by avoidance of SEC prosecution and thus reinforces external compliance.[156] However, the defense is arguably

151. *See* FINRA Rule 2010, *supra* note 104 (referring to "standards of commercial honor and . . . principles of trade").

152. 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.

153. Professors Birdthistle and Henderson have argued that FINRA has evolved from an SRO into a quasi-governmental agency and thus has an institutional interest in maintaining the current emphasis upon rules and external compliance, which reinforces one reason for its existence. *See* William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 41–44 (2013) (discussing the "public choice" explanation for why FINRA likes the current situation).

154. *See supra* notes 1–2.

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

156. *See supra* text accompanying notes 26–36.

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 internal compliance as one component.

The challenge will be convincing the SEC to allow FINRA to promote the reemphasis on internal compliance. It is one thing for the SEC to publicize the culture of compliance, as it does today, when it can rely upon FINRA to impose a heavily rule-based external compliance approach on 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 the perception that it is too soft on the securities industry by approving a FINRA reorientation toward internal compliance and by allowing FINRA to emphasize rules and external compliance. The SEC would fear the occurrence of a situation like those in the past[157] where investors were harmed by conduct not explicitly forbidden or addressed by specific rules. Critics would accuse the SEC of having forgotten these past failings of self-regulation and of being too accommodating to broker-dealers and to the securities industry.[158]

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 the dilution of FINRA's current emphasis upon the external compliance approach, especially since the SEC occupies a difficult political position—it is short on resources, but then blamed for scandals in the securities markets.[159] Moreover, the SEC could contend that it has now struck the right balance between internal and external compliance by promoting the culture of compliance itself while leaving to FINRA the imposition of detailed 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 the SEC needs to alter the orientation if compliance is to succeed in its mission. The important question then becomes what will convince

157. *See supra* note 43 (discussing the 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).

158. *See generally* POSER & FANTO, *supra* note 50, § 1.01 n.3 (listing these failures).

159. *See* STRATEGIC PLAN: FISCAL YEARS 2010–2015, *supra* note 128 (discussing the SEC's budgetary constraints). On being blamed for scandals, see *supra* note 123 (discussing the blame placed on the SEC for Madoff's Ponzi scheme).

the SEC to take the initial steps, apart from persuading it of the theoretical merits of the internal approach in producing compliant conduct.[160] 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—otherwise, this approach would have little or no value. This decrease could be measured by the number of SEC and FINRA disciplinary actions aimed at individuals as well as meritorious customer complaints and arbitration actions.[161] 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 proof of causation because, as mentioned above, the internal approach is not meant to replace the external approach but rather to supplement it. Thus, any decrease in legal, rule, and standard violations could be due to the enhanced effectiveness of the external system as well as

160. If the SEC were to emphasize the internal approach, that 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 a seemingly unending number of costly new regulations and rules as well as the resultant need for new WSPs. This cost issue has been particularly highlighted by court cases striking down SEC rules because the SEC has done an inadequate economic analysis of the associated costs. *See, e.g.*, Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (striking down an 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 the promotion of internal compliance would be meaningful, as opposed to the SEC's current lip service to the culture of compliance, would be if, as the internal approach takes hold in firms, the SEC and FINRA would not increase, and might actually decrease, the number of rules affecting broker-dealers.

161. FINRA provides basic annual data on investor complaints and disciplinary actions that FINRA enforcement has brought. *See FINRA Statistics & Data*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/Newsroom/Statistics/ (last updated Aug. 19, 2014); *see also Dispute Resolution Statistics*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/ (last updated Sept. 16, 2014). The SEC provides annual data on enforcement actions in an annual report. *See, e.g.*, *Select SEC and Market Data: Fiscal 2012*, SEC.GOV, http://www.sec.gov/about/secstats2012.pdf (last visited Sept. 22, 2014).

renewed FINRA and SEC enforcement or threat of enforcement or it could be the result of applying the internal approach or some combination of the two. 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, without further exploration, 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 professional standards are inadequate, but where the rules and standards are ignored or gamed throughout an organization or a significant part of it.[162] These situations are also most damaging to the securities industry because they generally reveal abuses of numerous customers as employees and even supervisors put their own self-interest over customer interests. As noted earlier, the external approach is not effective in addressing this phenomenon because monitoring cannot be omnipresent and because external monitoring by compliance officers is generally gamed or simply ignored where there is a weak culture, widespread acceptance of illegal and questionable conduct, and/or the participation or willful blindness of supervisors.

Perhaps the SEC and FINRA could be persuaded to promote the internal approach through a pilot program. One could argue to them that there will be a way to measure the program's 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. That is, the prohibited behavior would not involve legal, rule, or professional-standard violations by a few individuals or in a small broker-dealer, even if the violations were serious in nature. It would also include instances where the misconduct appeared in a

162. Institutionalized misconduct clearly appeared in many of the firms involved in the packaging and selling of mortgage-backed securities. *See supra* text accompanying notes 105–115.

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 throughout an entire firm or in a significant part of it.[163] The cases would 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. FINRA also 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 website.[164] 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.[165] The proposal would recommend that the SEC and FINRA evaluate the success of the internal approach over at least ten years in its pilot program. The data in the initial years of

163. A recent example, although an investment adviser and 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* Steven A. Cohen, Investment Advisers Act Release No. 3634 (July 19, 2013), *available at* http://www.sec.gov. FINRA is clearly interested in cases of organizational corruption. *See, e.g.*, 2014 Exam Priorities Overview Letter of Daniel M. Sibears, Executive Vice President, Member Regulation Programs 3 (Jan. 2, 2014), *available at* http://www.finra.org/web/groups/industry /@ip/@reg/@guide/ documents/industry/p419710.pdf (discussing FINRA's plan to track brokers who formerly worked at severely disciplined firms because they may be bringing illegal and unethical practices to their new firms).

164. FINRA's disciplinary actions are available at *FINRA Disciplinary Actions Online Database*, FIN. INDUSTRY REG. AUTHORITY, 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 website database. The SEC's litigation part of its website, *Litigation*, U.S. SEC. & EXCHANGE COMMISSION, 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. FINRA also provides access to arbitration awards. But these would be less helpful since arbitrators typically do not write opinions or provide a justification for their decisions. *See FINRA Arbitration Awards Online Database*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/ArbitrationandMediation/FormsTools/p018127.

165. That is, the number of broker-dealer firms has been steadily declining, while the number of brokers or other representatives has stabilized and even recently increased. *See FINRA Statistics & Data*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/Newsroom/Statistics/.

the program will not reflect the success (or lack thereof) of the internal approach; institutional misconduct does not happen overnight and the internal approach needs several years to take hold in 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.[166] 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, for example every five years, to measure the progress of the adoption of the internal approach in firms. Firms would need to be careful to break down this data in accordance with firm size because smaller firms will likely find the adoption of the internal approach more challenging. Smaller firms are in a more precarious economic position and the temptation to push aside legal and professional standards for profits will be greater in them. Similar surveys should also be done with brokerage clients, both retail and institutional.[167] 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 measuring the value of the internal compliance approach may persuade the SEC and FINRA to promote internal compliance, at least in a pilot program and then ultimately to adopt internal compliance 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 steadily

166. *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*, 83 J. BUS. ETHICS 133 (2008) (discussing research methods for identifying organizational corruption, including surveying employees about the organizational norms and scope for misconduct in their firms).

167. The SEC has commissioned similar 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) (investigating, among other things, how well investors understood the duties of their financial advisors).

reinforcing the external approach. It is time then to turn to a discussion of how they can specifically promote internal compliance.

2. Initial steps by the SEC and FINRA to promote internal compliance

The question arises whether the SEC should adopt the reorientation toward internal compliance through an official notice and comment procedure.[168] Since, as noted above, the reorientation is only a reordering of existing compliance approaches, the SEC is arguably not doing anything fundamentally new here, which is what happens when it decides to give special examination or enforcement attention to a particular problem or area of financial activity. It is thus within the SEC's authority to engage in this reorientation as a policy matter, which would not demand any notice and comment.[169] However, it may be advisable for the SEC to accomplish this reorientation through a notice and comment procedure in order to effectively implement the reorientation itself and to deal with any opposition to it. This procedure would have the SEC highlight internal compliance in a policy statement,[170] explain its orientation, and suggest the ways in which it could be accomplished in a firm. This procedure 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 internal compliance could involve new costs to broker-dealers as compliance officers spend more time on advising employees or designing ways of triggering lawful and professional conduct, the SEC might discuss the costs in terms of the benefits of having more compliant firms, as measured in the ways discussed above.[171]

168. 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.

169. The SEC could contend that it is interpreting the statutory defense to supervisory liability, see text accompanying notes 29–30, by requiring the promotion of internal compliance as part of the defense. It is not clear that the SEC need even go so far since it is really taking a policy position on effective compliance.

170. Here the SEC would be clarifying its position on compliance. In the alternative, it could issue a "concept release" as a prelude to doing actual rulemaking on internal compliance.

171. 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. *See* 5 U.S.C. § 603. On the other hand, insofar as the SEC is making a policy pronouncement encouraging, but not mandating, broker-dealers to adopt internal compliance, it would avoid the difficult cost/benefit analysis and controversy that comes with it today.

Another possible, and perhaps even preferable, approach would be to have FINRA, rather than the SEC, propose the compliance reorientation through a new rule or an amendment to an existing rule.[172] This approach 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.[173] 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.[174] The proposed supplementary material about internal compliance could read as follows:

> .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, as well as ethics, in their decision making and thus in orienting their conduct in addition to their compliance with federal laws and regulations and FINRA rules. For this purpose, compliance officers would be expected to assist associated persons to make decisions and otherwise to conduct themselves in accordance with these goals, 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.

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

172. Alternatively, FINRA, rather than the SEC, could issue a policy statement promoting internal compliance.

173. *See supra* notes 46–47.

174. *See* FINRA Rule 3130.03, .05, .06.

a regulatory notice.[175] Second, before approving FINRA's rule change, the SEC would put the supplementary material out for further comment.[176] In the SEC's request for comment, as well as in its eventual approval of the rule change, 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 other 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 website while FINRA examiners would make it an examination priority.[177] 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.[178] Furthermore, behind every FINRA rule, and thus its requirement for specific WSPs, are the goals, policies, and standards that the rule is intended to promote. Indeed, FINRA officials often refer to the policies in their speeches, and FINRA regulatory notices similarly highlight the policies.[179] Therefore, whenever it issues a notice, FINRA should ensure that

175. Occasionally, FINRA will issue several regulatory notices as to a particular proposal if the initial one receives significant comments and if, as a result, FINRA must reissue it to take into account changes suggested by commentators.

176. 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 proposed new supplementary material would not be a "stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule." *See* 15 U.S.C. § 78s(b)(3)(A) (governing rules that take effect immediately upon filing).

177. For example, each year FINRA sets forth its examination priorities for the upcoming examinations. *See, e.g.*, 2014 Exam Priorities Overview Letter of Daniel M. Sibears, Executive Vice President, Member Regulation Programs (Jan. 2, 2014), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf.

178. For example, FINRA and the SEC issued a joint guidance on effective practices for broker-dealers' internal inspections of branches. *See, e.g.*, FINRA, REG. NOTICE NO. 11-54, *Branch Office inspections* (Nov. 2011) (attaching a copy of the joint FINRA-SEC risk alert on the topic).

179. 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*, *supra* note 42, 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.").

the policies do not recede into the background when the notice turns to a description of the rules and the ways in which compliance with and supervision of the rules 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-up 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 make suggestions as to how this might be accomplished.[180] 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.[181]

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.[182] 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 DOJ.[183] 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 a charge of supervisory liability for the violation.[184] In addition, FINRA and SEC enforcement officials, as well as federal prosecutors, take a more accommodating position towards a firm

180. 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.

181. 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 of them. *See* SEC OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, EXAMINATION PRIORITIES FOR 2013 (Feb. 21, 2013).

182. *See supra* text accompanying notes 69–72.

183. *See supra* text accompanying notes 74–75.

184. *See supra* text accompanying notes 30–31. 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.

with respect to its own liability when it reports violations and assists in the investigations of them.[185] 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 do not require a whistleblower to report a potential violation internally. Furthermore, a firm wants to avoid a situation where an employee or someone else, rather than the firm itself, reports such a violation to regulators or prosecutors.[186]

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 other scholars have analyzed well, that function is undermined by employees' perception that a compliance officer's goal is to protect supervisors and the firm by providing information about them to supervisors and ultimately to regulators and prosecutors.[187] Fearing that any information shared with compliance officers will be reported "up the chain," employees will be less open and more reluctant to consult with them. Indeed,

185. This generally means that the prosecutor or the enforcement official does not prosecute the firm or defers prosecution of it because of the firm's cooperation in investigating the misconduct by its employees. *See generally* SEC DIV. 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 (giving credit arises from cooperation, which means, among other things, disclosure of the relevant fact and taking of remedial action); FINRA, REG. NOTICE NO. 08-70, FINRA INVESTIGATION: FINRA PROVIDES GUIDANCE REGARDING CREDIT FOR EXTRAORDINARY COOPERATION (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).

186. 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 in Rule 21F, 17 C.F.R. §§ 240.21F-1 to 21F-17.

187. *See generally* John Hasnas, *Managing the Risks of Legal Compliance: Conflicting Demands of Law and Ethics*, 39 LOY. U. CHI. L. J. 507, 517 (2008) (noting conflicts between command and control and self-regulatory approach). *See also* SIFMA, *supra* note 49, at 30 (cautioning regulators against "deputizing" compliance officers as their agents); Vass, *supra* note 49, 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.").

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.[188] In sum, the reporting and potential enforcement roles of the compliance officer thus reinforce his or her position as part of external compliance.[189]

There is no question that the SEC and FINRA (as well as the DOJ) will always expect broker-dealers, their employees, and, by extension, compliance officers to report serious violations of the law. Therefore, just as a firm must maintain its external compliance for psychological deterrence, it must have compliance officers report these violations to supervisors and to FINRA and the SEC where necessary. But to promote the reorientation toward internal compliance, the SEC and FINRA could emphasize that generally discipline is the responsibility of supervisors in the firm rather than of compliance officers. 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.[190] 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

188. *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).

189. The issue of reporting to authorities raises an issue beyond the scope of this article—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. This has been ably dealt with by other scholars. For an early and valuable work on this subject, which is timely today, see ROBERTA KARMEL, REGULATION BY PROSECUTION (1981). Concerns about deterring 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).

190. *See supra* note 36. The SEC's Division of Trading and Markets recently issued a *Frequently Asked Questions About Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act*, U.S. SEC. EXCHANGE COMMISSION, *available at* http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm. The SEC staff echoed its position that compliance and legal personnel are not per se supervisors, but that this status "depends on whether, under the facts and circumstances of a particular case, that person has the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue." *Id.* Importantly, the staff did suggest that a compliance officer does not become a supervisor when exercising his or her advisory role.

another firm control function, such as the legal department.[191] 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 enforcement 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 is to take into consideration a firm's internal compliance when they are considering whether to bring, or are 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.[192] 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 the firm's 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.[193]

191. Firms themselves must try to separate these roles clearly, which can be challenging since some compliance personnel also function as legal officers. *See* SIFMA, *The Evolving Role of Compliance*, *supra* note 49, at 8–9.

192. *See supra* note 185.

193. 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 33–36.

IV. 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 these firms and, ultimately, to create more investor confidence in broker-dealers and in the financial system. Part I 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, regulations, and industry standards. It then reviewed the current state of compliance and the typical tasks of compliance officers, who produce detailed WSPs, monitor firm employees for compliance with them, and report any violations within the supervisory structure of the firm.

Part II 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 the targeted individuals. The Part then 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 model of compliance, particularly in financial services like brokerage, since financial professionals like brokers 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 result compliance systems intend to produce. In addition, external compliance 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, the SEC, and FINRA are reinforcing and extending the model of external compliance, which imposes heavy regulatory burdens upon broker-dealers that adversely affect their vibrancy, flexibility, and competitiveness.

Part III 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 even 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 the SEC would resist this change, which is contrary to their established approach and which risks making them seem soft towards the securities industry.

Part III 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 as a result of internal compliance. The Part also recommended that FINRA and the SEC 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 discussed the possibility that the SEC could promote internal compliance through a policy statement and particularly 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 supplemented with an internal one. Under the external approach, WSPs will be piled upon other WSPs until they risk being followed in a routine way and occasionally disregarded or gamed. 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 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.