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Cultural Values

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In February, FINRA released its first Targeted Exam Letter for 2016, entitled "Establishing, Communicating and Implementing Cultural Values."[1] FINRA introduced the focus on firm culture in the 2016 Regulatory and Examination Priorities Letter ("Priorities Letter").[2]

According to FINRA, a firm may have its own definition of firm culture. Alternatively, FINRA defines firm culture as the set of explicit and implicit norms, practices and expected behaviors that influence how employees make and carry out decisions in the course of conducting the firm's business.

In its Priorities Letter, FINRA provided five indicators of a firm's culture that it intends to assess. They are whether:

- Control functions are valued within the organization;
- Policy or control breaches are not tolerated;
- The organization proactively seeks to identify risk and compliance events;
- Supervisors are effective role models of firm culture; and
- Sub-cultures (e.g. at a branch office, a trading desk or an investment banking department) that may not confirm to overall corporate culture are identified and addressed.

Though it shifts to the term "cultural values" in the Targeted Exam Letter, the eight difficult questions posed by FINRA are intended to help it formalize its assessment of firm culture – presumably also based on what it also conveyed in the Priorities Letter. As difficult as the topic of cultural values is within a firm, it will be exponentially more difficult for FINRA to create an objective assessment model for thousands of firms of varying size and business models.

In the Targeted Exam Letter, FINRA's general introductory remarks about ethics and culture do not convey any specific regulatory foundation. FINRA does not cite Rule 2010 and the longstanding requirement for members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade, a rule mandated by the Exchange Act. It does not cite supervisory rules such as Rule 3110 or 3120. Rather, FINRA provides a short statement of the importance of ethical considerations and client interests and the cost of failure -- in terms of harm to investors, markets and the firms themselves.

FINRA reinforces the costs to firms by citing $300 billion in legal costs incurred by banks as a result of the cultural failures from the 2008 financial crisis. Indeed, following the financial crisis, some organizations undertook reviews of their business practices which resulted in enhanced policies and processes directed at better supporting ethical treatment of their customers.

The broader approach of larger organizations is adopted by FINRA in the Targeted Exam Letter. It does not cite explicit regulatory foundations and it clearly expands its focus beyond culture of compliance and tone from the top, demanding information from numerous parts of an organization.

For firms that did not review their business practices, firm culture, cultural values or ethics in the recent past, making immediate changes to respond to the Targeted Exam Letter is not feasible or advisable. Nonetheless, to prevent being caught flat footed in an examination, each firm should begin assessing its cultural values using the Priorities Letter and the Targeted Exam Letter as guidance, as vague as they are. Large bank affiliated brokerages, firms offering structured products, and firms with complex or conflicting business lines are particularly at risk of immediate scrutiny.

The starting point for each firm is to attempt to define or catalogue the firm culture or cultural values they have adopted, formally or informally. According to FINRA's definition, compliance and supervisory requirements are cultural values. They are the norms, practices and expected behaviors that guide and support compliance with applicable rules and regulations. Codes of Ethics are cultural values. Mission statements commonly go beyond

1. https://www.finra.org/industry/establishing-communicating-and-implementing-cultural-values
2. https://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf

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purpose and espouse values which fall within the meaning of cultural values. Statements of standards or practices often fall within the meaning of cultural values. Recruiting materials might convey cultural values to potential employees. Ultimately, after taking inventory and making a fuller assessment, a firm may determine to revise its cultural values.

Once a firm has compiled a starting inventory of values, it can begin to address the questions in the Targeted Exam Letter. The first question in the Targeted Exam Letter asks for a summary of key policies and processes by which the firm establishes cultural values, including whether it is a board level function or established by the corporate parent. It also asks for the steps taken in the past 24 months to promote, strengthen or change firm culture.

Information responsive to this question is that which shows the extent of the involvement of top level personnel and the robustness of the firm's policies. From its inventory of cultural values, a firm can review how they were formulated, who participated in their formulation and other elements of the process.

Because compliance and supervisory policies and procedures should be a primary set of documentation that establishes cultural values, firm leadership and supervisory personnel will want to review them with FINRA's new perspective in mind. Going forward, firms of any notable size or complexity should consider whether new or revamped committee structures will be useful to focusing leadership on the topic. While committee structures are necessary for large organizations and they add gravitas at small companies, any committee convened to address cultural values must be a strong working group.

FINRA's second question is closely related to the first question. It asks for a description of the processes employed by executive management, business unit leaders and control functions in establishing communicating and implementing cultural values. Recipients must include in their response how executive management addresses "tone from the top" and how the firm ensures its cultural values are adopted and applied by middle management. The second question moves beyond the formulation of firm culture and "values" to the process by which key personnel convey the values to other personnel.

Like the first question, this question appears to focus on larger firms. However, each firm, regardless of its size, is familiar with the concept of tone from the top. Accordingly, each firm should be able to explain how its cultural values are introduced to each level within the organization, how personnel are trained on the relevant topics, and how cultural values are reinforced.

In the second question, FINRA is looking not only at appropriate delegation, but also at whether there is monitoring of "middle management." Seeking information as to how the firm "ensures cultural values are adopted and applied by middle management," might presage a focused effort by FINRA to prevent executives and middle management from disavowing ethical lapses within their organization. Ethical lapses may not be rule violations, but FINRA's reference to the financial crisis in the introduction was useful in driving home the connection between ethical lapses and the collapse of business standards that lead to violations of law.

The third question asks if and how the firm assesses and measures the impact of cultural values and whether cultural values have made a difference in achieving desired behaviors, along with a request for documentation relating to assessments and measures. Recipients that are responding to the Targeted Exam Letter can only answer this question to the extent they assess and measure the impact of cultural values. Firms definitely should not create new assessments and measurements at this stage.

While larger firms are much more likely to have formalized assessments, it is difficult to understand what objective criteria FINRA is seeking outside the firm's compliance and supervisory procedures. Additional guidance is sorely needed. Controls relating to conflicts of interest and other areas dedicated to prioritizing customer interests might be relevant assessments of cultural values, but those assessments are not what FINRA is seeking when, as stated in the Priorities Letter, it wants to understand how cultural values support the control functions.

In the future, large and mid-sized firms likely will have an added task of determining which assessments and measurements are provided to upper level management as part of its review of firm culture, as contemplated by the first question.

The fourth question seeks a summary of the process used to identify breaches of cultural values, but admonishes the recipient to focus on the activities that are directly related to reinforcing the firm's culture. This question also is paradoxical. Outside the context of compliance and supervision, identifying breaches of cultural values is as amorphous a process as the term itself.

Key processes that may be responsive to this question are those that promote transparency and reporting, such as any processes by which personnel identify potential problems or insure there is no retaliation by supervisors or co-workers. A firm's size may make an anonymous reporting structure impractical, but it should consider how it is encouraging personnel to voice relevant concerns.

Related to the prior question, question five asks for a description of how the firm addresses breaches, including efforts to promptly address breaches of cultural values. It asks for the firm's escalation process "to surface and resolve" breaches. Most firms describe disciplinary actions that may be taken for breaches of policy. That potentiality may not be a sufficient response.

The process by which a firm assesses the impact of a breach, e.g., on the customer or the markets, should be documented and may mirror existing policies and procedures. Firms will have to evaluate whether there are, or should be, different processes for particular cultural values that have been breached. For example, keeping client information confidential is typically addressed by rule and compliance and supervisory procedures, and when client confidentially is incorporated into the firm's cultural values, there likely will be an existing process for addressing the breach. There may be some cultural values that go beyond existing rules and regulations, such as client service initiatives, and a firm may implement processes to support these elevated requirements.

It may be helpful to consider the extent to which elevated requirements or enhancements to a firm's cultural values can lead to new legal and compliance problems. Personnel charged with responding to FINRA, or beginning to address this topic in anticipation of examination questions, should be extremely attentive to additional risks FINRA is creating. Each enhancement to policies and procedures intended to address firm culture opens the door for a breach, and for FINRA to make additional findings of violations when the firm does not adhere to those policies and procedures. Firms should use this opportunity to address cultural values, business standards and ethics, but carefully weigh any proposed changes. For example, in many situations, monitoring of client activities is not legally required but, to enhance client communication and service, some firms might consider adopting a new process to monitor and report particular information to their clients. Whether enhanced monitoring and reporting is appropriate will vary by firm and situation, but once a firm has undertaken this new responsibility as part of a cultural values program, it has created a new firm requirement that can be breached.

A firm also should consider which breaches of cultural values are addressed, if at all, in performance reviews (see questions seven and eight).

Question six asks for policies and processes to identify and address subcultures within the firm that undermine cultural values articulated by the board and senior management. The Priorities Letter refers to sub-cultures at a branch office, trading desk or investment banking department. Without any specific criteria regarding sub-cultures, it is appropriate to presume that they include personnel that raise compliance flags, including those that require closer surveillance upon hiring.

While this question is open-ended, it is helpful to explore whether, and the extent to which, competing cultures detract from the firm's identified cultural values or create incentives to disregard them. Certain factors such as a new business line, increased risk within a business line, a higher risk customer base, non-conformance with certain requirements, high risk personnel or performance that varies from expectations (e.g., outsized profitability) could be incorporated into a risk assessment model that potentially identifies negative sub-cultures. Questioning whether a business line or group has reasonably attainable goals, the process that establishes the goals and the incentives the goals create, may be as helpful to other risk assessments as it is to identifying sub-cultures.

Question seven is the most potentially invasive of the questions, setting the stage for intrusive inquiries into discretionary and confidential firm information. It asks for the firm's compensation practices and how they reinforce the firm's cultural values. Initially, firms should be able to confirm that their compensation structures do not penalize personnel who report violations or reward personnel for achievements gained through rule violations or glaringly questionable behavior. Firms obviously should be sensitive to the occurrence, or even appearance, of rewarding unethical behavior since even the appearance of condoning bad actors is a huge disincentive to ethical conduct within an organization. Firms should explore whether their compensation practices emphasize longer-term goals and require accountability for failures to conform to specific business standards or cultural values.

The eighth and final question asks for a description of the cultural value criteria used to determine promotions, compensation or other rewards and the opportunities for promotion to managing director or equivalent level available to compliance, legal, risk and internal audit functions. This is similar to the prior question, but not so subtly suggests that personnel in so-called "cost centers" should have more advancement opportunities within the organization. While laudable, this last question also seeks extremely sensitive information. At minimum, a firm should consider whether it is allocating resources to personnel and business lines that are most closely conforming to, or enriching, the firm's cultural values and whether it provides sufficient visibility and support to the personnel performing the roles specified by FINRA in this question.

The questions and unlimited variety of potential responses suggest cultural values may turn out to be a quagmire for which FINRA is unable to craft an objective assessment. This will not preclude examiners from seeking information regarding cultural values or making subjective assessments that affect a firm's examination findings. Therefore, though difficult given the ambiguities surrounding the term and the limited guidance from FINRA, firms should begin evaluating whether their cultural values positively contribute to the five indicators announced in FINRA's Priorities Letter and the eight questions in the Targeted Exam Letter. ✦