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Incentivizing Good Compliance

By Lori A. Richards

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The Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations conducts compliance examinations of securities firms for compliance with the law. An important function of examinations is to identify weaknesses in compliance programs and other internal controls that could allow fraud and other types of violations to occur down the road.

As Director of the SEC's examination program, as you might expect, my perspective on regulation and compliance is an acutely practical one. I have seen every day the way that firms go about implementing the law. I have seen what works and what does not work in practice. So, it's this quite functional, non-theoretical perspective that forms my views.

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I come to this conclusion after witnessing compliance breakdowns and failures of various types. For example, revelations in the media of Jerome Kerviel's alleged unauthorized trading at Societe Generale[1]; the fraud allegedly orchestrated by the former Chairman and CEO of Refco, Inc. in which he allegedly concealed trading losses and operating expenses during the company's initial public offering (IPO)[2]; charges in a settled action that Fidelity Investments allowed its traders to accept lavish gifts from brokers courting its trading business[3]; allegations in the SEC complaint that Bear Stearns' hedge fund managers fraudulently mislead investors about the funds' holdings [4]; charges in a settled action that E*Trade failed to have an adequate anti-money laundering compliance program[5]; and many, many more.

While these incidents may be devastating for the companies, investors, and employees involved, they also provide value in the work of compliance professionals. In any good organization, when things go wrong at the firm or at another firm in the industry, people dissect those incidents, asking "How was this possible?" "What could have prevented it?" "How might we have detected early signs of it sooner?" In this way, compliance failures often lead to stronger preventative controls at other firms in the industry. This is "incident-driven" learning.

An incident-driven case in point is the Frank Gruttadauria matter. Remember him? He was the securities broker in Ohio who diverted his customers' account statements to his own post office box and sent his customers inflated account balances on fake account statements, thereby perpetuating a massive fraud.[6] Ultimately, an understanding of the methodologies he used to perpetrate his fraud led to a widespread appreciation of the value of protections for customer changes of address, wire transfers, and account statements, and improvements in controls in the securities industry. It's a perfect example of how a compliance breakdown

can lead to strengthened compliance controls at other organizations.

We should not underestimate the value of this kind of incident-driven learning. It is important and it can lead to significant improvements in prevention and detection techniques in the particular areas that gave rise to the incident. But, although we learn from failures, it seems to me that organizations could benefit by focusing greater attention on how to better incentivize strong compliance by employees more broadly. This could serve to better prevent the next compliance breakdown.

Why does compliance happen?

Stepping back a bit, before thinking about how to incentivize compliance, I think we first need to identify reasons why non-compliance occurs, and, on the flip side of that question, why compliance occurs. I posit that there are many different reasons why people don't comply with an obligation. For example, they may not be aware of an obligation, they may perceive that they will obtain a benefit by not complying, they may think that they are unable to comply, or they may simply disagree with the obligation.

If that's why non-compliance occurs, why does compliance occur? I think that compliance "happens" when three things occur:

- First, when person understands what his or her obligation is;
- Second, when he/she is able to comply with the obligation; and
- Third, when he/she is willing to comply with the obligation.

Simply put, he knows what he has to do, he wants to do it, and he can do it. Let me describe each of these components briefly.

The first requirement for compliance is that a person must understand the obligation. This is obvious to you, I'm sure, but I'm amazed at the number of times that SEC examiners find deficient practices and the persons responsible claim they did not understand either that they had an obligation or its precise nature. We often find that firms are not aware of compliance obligations with respect to new rules. It sometimes takes time for people to learn about and understand their obligation. This is why effective education and training are so important. For example, at the SEC, we've included new rules in our CCOutreach programs, which are designed to help chief compliance officers (CCOs) learn techniques and strategies to strengthen their own firms' compliance programs. We also created a "plain English" summary of key provisions of the Investment Advisers Act and e-mailed it to some 10,000 advisory firms. In addition, we seek to provide clear explanations of the law and new rules whenever possible.

The second requirement for compliance is that the person must be able to discharge the compliance obligations. Compliance obligations must not be unattainable. At the Commission, the SEC engages in a notice-and-comment process before implementing new rules, which provides the Commission with input about (among other things) the feasibility of the proposed rule in practice.

It is the third requirement for compliance—a person's willingness to comply—that is perhaps the most complicated, because it is inherently human and relies on an individual's own behavioral characteristics. For example, some people will be willing to comply, because they place intrinsic value on doing what's right. As well, people's willingness to comply will be greater if they perceive that there is significant downside in not complying. This is why both regulators and compliance personnel spend so much time warning people about the harm that will befall them (e.g., losing their job, their reputation, or their freedom) if they don't comply. This is deterrence—the "stick"—and it's a powerful motivator and indispensable in the toolkit of any compliance professional.

In addition to imposing deterrence for non-compliance, I think that people will also be more willing to comply when they perceive that there are positive benefits in doing so. Human beings are purposeful, and will behave in certain ways if they perceive they will be rewarded for doing so. This is where we get to incentives—the "carrot"—the positive reward for undertaking the behavior we seek. I think that there has been limited focus on incentives in compliance.

Incentives and behavior

In the business world, firms provide incentives to their employees to draw performance, to achieve results, or to meet other expectations of the organization. Most commonly, and perhaps most powerfully, incentives

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are financial: salary and bonuses. Incentives also take other forms, including trips, titles, and other softer, rewards. Incentives are provided to individual employees and also to groups of employees within divisions or units. Most commonly, incentives are provided to encourage production: production of sales, production of profit, and production of accounts.

Academic literature is filled with studies of how incentives work. There is ample evidence, too, that incentives can yield unintended results. In his book called *The Cheating Culture: Why More Americans Are Doing Wrong to Get Ahead*, the author David Callahan writes that rampant cheating in American society is due, in part, to incentive structures that unintentionally reward deception and cheating.[7] Callahan provides multiple recent examples of this phenomenon:

- In the 1990s, when a company instituted a production quota for its car repair staff, mechanics began performing unnecessary and costly maintenance.
- In the legal profession, pressed to bill as many hours as possible, ambitious young lawyers overcharge clients.
- In the medical profession, to ensure that insurers won't deny coverage to the patient, doctors exaggerate the symptoms of their patients.

In the corporate world, incentives can also yield unintended results. Incentive compensation plans were often cited as one cause of the financial frauds at Enron and Worldcom. Compensation incentives encouraged employees to achieve results at whatever cost.[8] More recently, stock option compensation plans were gamed by some corporate executives.

In recent years, public policy has recognized the connection between incentives and behavior. Drawing the connection between compensation and compliance, one of the provisions of the Sarbanes Oxley Act, passed by Congress in response to corporate fraud, requires the CEO and CFO to reimburse the company for their bonus or incentive-based compensation if the company must restate its financial statements due to any material noncompliance with financial reporting requirements as a result of misconduct (Section 304).

And, following the Sarbanes-Oxley Act, the Federal Sentencing Guidelines were amended to place a greater focus on prevention of violations and conformity with ethical standards, and they made high-level personnel more responsible for implementing and overseeing a compliance program. Added to the Guidelines for an effective compliance and ethics program was a requirement that

> [t]he organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through … appropriate incentives to perform in accordance with the compliance and ethics program …

Also added was a requirement that organizations take appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.[9]

Incentives in the securities industry

With respect to securities firms and investment advisers who are registered with the SEC, there are many examples of incentive-based compensation systems. The most common compensation system, historically, has been the commission-based sales compensation paid to registered representatives for selling a security. This compensation structure incentivizes sales, but its exclusive focus on sales may encourage sales that are inappropriate for the customer. For example, in order to generate a commission, a registered representative may sell securities that are unsuitable for the customer, or buy and sell securities excessively (known as "churning"). And, when sales commissions are higher for the sales of certain products, such as variable annuities, a registered representative can be tempted to recommend them over other products that may be more suitable for the customer.

Some investment advisers are compensated based on the performance of their accounts. This structure aligns the performance-interests of the client and the adviser. It can, however, incentivize risk-taking beyond that which is appropriate for the customer or investor and beyond disclosures in order to pull in higher returns. Performance-based compensation could also incentivize the overvaluation of client portfolios in order to generate a higher performance-based fee.

It seems to me that one way to reduce the unintended incentives that can arise in an incentive compensation system is to ensure that the compensation system incentivizes production, but in a manner that is consistent with the law, the firm's code of ethics, and the internal compliance and risk culture of the firm. If the firm's compensation incentives include only hard production numbers (e.g., how many accounts did you open, how much profit did you generate, how many deals did you ink), the firm may encourage employees do so at any cost, and at cost to the firm, to its reputation, and to its customers and clients. We all know the adage "You get what you pay for," but it is perhaps more true that "You don't get what you don't pay for."

The performance that most firms want includes adherence to the firm's own policies and procedures with respect to internal controls and compliance, and it includes adherence to high ethical standards. As a starting point, the firm's compliance and internal controls infrastructure should be strong enough to underpin these incentives. This means that the firm should compensate its compliance staff adequately and ensure that they have sufficient resources to do the job. The responsibility to ensure a strong culture of compliance and a compliant organization, however, rests with managers and leaders of the firm.

Given that firm leaders and managers have this responsibility, why not incentivize it to happen, right along with incentivizing production? Here are some ways that I think securities firms might better incentivize their employees to comply with the firm's risk and compliance controls:

- **Be clear about expectations.** Managers and employees should be aware that compliance with the firm's internal risk management and compliance policies is expected, and performance expectations should be explicit on this point.
- **Reward managers who achieve compliance.** Managers could be compensated in part based on their branch's or unit's compliance activities (results of surveillance reviews, internal reviews, customer satisfaction levels). Positive results get higher compensation.
- **Reward managers who cultivate a culture of compliance.** Many organizations are measuring their employees' attitudes towards ethics and compliance by the use of surveys. Some firms then tie a component of their senior managers' compensation to the attitudes expressed by their unit's employees. Positive results get higher compensation.
- **Make strong compliance an advertised goal.** In industrial plants, firms advertise the number of days with a "clean" safety record to remind employees about the importance of safety on the job. Other organizations could take a lesson and publicize the number of days without a customer complaint, arbitration, or aggrieved customer.
- **Reward employees for considering compliance issues.** Employees could be incentivized to approach compliance staff early on with questions about compliance — well before the deal, or the product or the transaction is launched.
- **Consider new incentives.** Although sales incentives may be a part of the fabric of the securities business, wouldn't a reward based on the satisfaction levels of the clients of the registered representative or advisory representative be more meaningful? Satisfaction could be measured by, for example, whether the investor:
  - believes that the financial adviser understands the investor's needs, objectives, and risk tolerance;
  - is responsive;
  - effectively invests their funds;
  - adequately discloses risks and costs; and
  - provides understandable explanations about investment options.

Wouldn't that type of reward incentivize the kind of long-term relationships that firms so want to develop?

Incentives impact risk

Because incentives drive behavior, an organization's risk-assessment process could take into account the incentives that exist that encourage and reward compliance, and could identify areas and employees who do not operate with these incentives. Firms could include the latter as areas that may present higher risk and may warrant closer review. In addition, when organizations conduct special reviews or inquiries of compliance breakdowns, they could include an evaluation of the role that incentives played.

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I'm certain that there are other ways too that organizations could better incentivize strong compliance. I hope that organizations will take time to consider how they might better incentivize strong compliance, to help encourage the firm's employees to operate in accordance with the law, the firm's code of ethics, and its internal compliance and risk controls. I hope that there will be constructive thinking about how firms might better incentivize strong compliance practices right from the start. ✦

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Notes

1 Nicola Clark and David Jolly: "French Bank Says Rogue Trader Lost $7 Billion." New York Times, January 25, 2008.

2 *SEC v. Phillip R. Bennett*, 08 CV 1631 (GEL) (S.D.N.Y. filed February 19, 2008) http://www.sec.gov/litigation/litreleases/2008/lr20460.htm

3 http://www.sec.gov/news/press/2008/2008-32.htm

4 *SEC v. Ralph R. Cioffi and Matthew M. Tannin*, Civil Action No. 08 2457 (FB) (E.D.N.Y. June 19, 2008) http://www.sec.gov/litigation/litreleases/2008/lr20625.htm

5 http://www.sec.gov/news/press/2008/2008-156.htm

6 *SEC v. Frank D. Gruttadauria, et. al*, Civil Action No. 1:02CV324 (filed February 21, 2002) http://www.sec.gov/litigation/litreleases/lr17369.htm; http://www.sec.gov/litigation/litreleases/lr18678.htm; http://www.sec.gov/litigation/admin/34-49760.htm.

7 David Callahan: *The Cheating Culture: Why More Americans Are Doing Wrong to Get Ahead*. Harcourt, 2004

8 Malcolm S. Salter: "Skilling's Appeal and Enron's Legacy," BusinessWeek, August 21, 2008.

9 Federal Sentencing Guidelines, Chapter 8, §8B2.1 "Effective Compliance and Ethics Program." Available at http://www.ussc.gov/guidelin.htm.

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