COMPLIANCE CONFLICTS IN THE SELF REGULATION OF FINANCIAL SERVICES

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ABSTRACT

Compliance professionals in financial services must face personal risks when ensuring others follow the guidelines of the Securities and Exchange Commission and Financial Industry Regulatory Authorities. Ethics in this morally biased industry means effective self-regulation to police bad behaviours of employees. Those who understand the complexity of the financial markets are in the best position to prevent unethical behaviour. These individuals are typically portfolio managers, traders, market makers, financial advisers, or underwriters whose salaries outweigh the risk and compensation of the compliance officer. There have been numerous scandals within the financial services industry in the 21st century where officers of self-regulatory policies were at a disadvantage because of the actions of others. The Financial Industry Regulatory Authority continues to respond to these epic events through the issuance of additional broad based regulations (i.e. Dodd-Frank). The interpretation of these regulations is not without challenges. The increased regulation of FINRA over the past five years has resulted in more sanctions each year. Since increasing regulations have not minimized the incidences of bad behaviour then how are we to determine if self-regulation is an effective solution? Those who understand the complexity of the industry are also best to financially gain from the regulatory gaps within new legislation. Individuals who are best to stop bad behaviours make the choice to hire attorneys to fight violations or compliance officers that lack a full understanding of the firm's business activities. The increase of CCO liability has given concern for those who stand to lose their reputation based on the bad decisions of others. With a lack of understanding regarding the capability of the compliance role, external laws chase violations as new unethical behaviours are created. Although self-regulation is not without problems, the proposed individual paper will explore the insights into the compliance officer liability and discuss some of the challenges that these individuals face within a greed-based industry.

Key Words: financial services, compliance, FINRA, CCO, securities, regulations

COMPLIANCE CONFLICTS IN THE SELF-REGULATION OF FINANCIAL SERVICES

Acting under the direction of regulations set forth by the Financial Industry Regulatory Authority ("FINRA"), financial services firms must conduct business with the highest standards of commercial honour and principles of trade.[2] Peer review reports highlight the unethical behaviours of financial professionals who balance the pursuit of wealth with their fiduciary duties owed to clients; expected by supervisors; and enforced by regulatory authorities.[3] In an effort to protect investors from financial harm, congressional legislation created securities regulations and regulatory entities to mitigate unethical behaviours[4].

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[2] See, FINRA Rule 2010. Standards of Commercial Honor and Principles of Fair Trade

[3] See, R.B. Lamb, 'Ethics in financial services' (1999) 104(1) Business and Society Review 13; M.K. Lewis, 'New dogs, old tricks. Why do Ponzi schemes succeed?' (2012) 36(4) Accounting Forum 294; J.F. Madden, 'Performance-Support Bias and the Gender Pay Gap among Stockbrokers' (2012) 26(3) Gender and Society 488.

[4] See, Securities and Exchange Act 1933 and 1934

Negative behaviours that lead to unethical practices have the potential to damage a society's faith in a government system meant to protect investors.[5]

FINRA is an independent regulating authority for financial services firms that conduct business in America.[6] The Securities and Exchange Act of 1934 establishes the need for a self-regulatory organization for the broker-dealer industry; where FINRA plays an important role as the sole entity that meets this definition.[7] FINRA has the power to bring disciplinary actions against those firms that violate securities regulations. Disciplinary actions recommended by FINRA for the year 2012 entail the dissemination of fraudulent statements, borrowing money from customers, failing to detect prohibited trades, and sales practice abuses.[8] A review of FINRA annual reports from 2002 until 2012 indicates a steady increase in sanctions and fines for violation of securities laws by firms and individuals. The 2002 annual report shows 814 disciplinary actions charged out of 5,392 financial firms and 662,311 professionals.[9] In comparison, the 2012 report indicates 1,541 disciplinary actions charged out of 4,300 financial firms and 630,000 professionals.[10] The 2012 statistics represent an increase of sanctioned securities violations in an environment with less financial organizations and professionals.

SELF-REGULATORY CHALLENGES

If the interest of the industry is to improve the behavior of financial professionals, the statistics represent a problem. The increasing number of disciplinary actions over the years continue to grow, in spite of continuous policy making by regulators. From 2002 to 2012, FINRA proposed 1,269 regulations for industry comments; an average of 115 regulations per year.[11] Leaders within financial services comment on the growing challenges compliance presents in an increasingly regulatory framework.[12] Consequences for firms failing to abide by FINRA regulations result in disciplinary actions and reputational damages.[13] Society has an expectation that firms will comply.

The compilation of information contained in FINRA annual reports reflect that more firms and financial professionals are at the center of unethical activity. As financial professionals, compliance officers are not immune to this scrutiny. Pursuant to SEC Exchange Act Release No. 50, 347, 83 SEC Docket 2219 (Sept. 10, 2004), a firm must designate a Chief Compliance Officer (CCO) to adopt and implement policies and procedures to prevent securities violations.[14] These are individuals who bear the burden of securities compliance. Compliance leaders who can implement an effective organizational program to deter unethical behavior have the ability to maintain a culture of compliance. But, how simple is this when the choice to implement an internal compliance program is not that of the firm?[15]

Philosophical leadership theorists help to identify the profiles of CEOs and organizational structures that facilitate successful investment firms.[16] Successful outcome

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[5] G.R. Berry, 'Adding ethical consideration to the decision-making process: A leadership challenge' (2007) 1(1) Journal of Leadership Studies 45.
[6] Financial Industry Regulatory Authority (FINRA) (2013) <www.finra.org> accessed 15 December 2015
[7] B. Black, 'Punishing bad brokers: Self-regulation and FINRA Sanctions' (2013) 8 Brooklyn Journal of Corporate, Financial and Commercial Law 23
[8] FINRA, *January 2012 Disciplinary Actions* (FINRA 2012).
[9] NASD, *2002 Year in Review: Annual Report* (FINRA 2002)
[10] FINRA, *2012 Year in review and annual financial report* (FINRA 2012).
[11] FINRA, *FINRA Industry. Rule Filings* (FINRA) <http://www.finra.org/industry/rule-filings> accessed 01 December 2015).
[12] A.B. Scanlan and C. Purdon, 'Compliance program management for financial services institutions in today's environment' (2007) 62(2) The Business Lawyer 735.
[13] ibid.
[14] D.A. DeMott, 'The crucial but (potentially) precarious position of the chief compliance officer' (2013) 8 Brooklyn Journal of Corporate, Financial, and Commercial Law 56.
[15] ibid.
[16] See, Berry (n 5); D. Knights and H. Willmott, 'Conceptualizing leadership processes: A study of senior

means that these firms increase profits. Organizations do not run without the existence of people and systems. The internal regulation of organizations requires one individual to take responsibility and speak out against firm activities which present conflict with investor investing and regulation. Based on Bandura's general observations, people's values and significance will motivate certain aspects of their activity.[17] Those functions that bring less value will be ignored. The management of individuals motivated by maneuvering the complexities of the market to increase firm's profits and subsequently reaping potentially exponential profits would selectively consider attending to those policies that would prevent the desired outcome. This becomes the challenge of the CCO. The behaviors of men within an organization create the type of environment. Embracing these diverse behaviors among separate men is key for interaction to fulfill the universal goals.

Research Challenges

Based on a series of qualitative observations and interviews, the examination of the CCO can explore the projects, plans, and activities which orchestrates the administration of the compliance program. The study will attempt to understand the individual's "orient commonplace awareness" within the financial institution.[18] A phenomenological study of effective compliance leadership uncovers meaning behind the actions of the individual's responsibilities. In a phenomenological analysis, one should return to the philosophy of consciousness or cognitive life; shaped by perception and projected through moral situation.[19] The challenge in self-regulation stems from the intent or perceived notion that actions have little effect when people lack the capability for exercising good judgement based on their own motivation and behaviours.[20]

The interaction between leadership and organizations within the financial services industry are important insights to the practical implementation of regulatory requirements. The study intends to show similar characteristics related to these philosophies in the transcripts of compliance officers when participants respond to the research questionnaire. Open-ended questions will identify similarities in the experiences of the compliance leader.[21] Taking an exploratory approach assists with the identification of themes to enhance the effectiveness of compliance with regulatory requirements of FINRA.

The academic study will be an addition to scholarly examination of compliance personnel suggested in the work of DeMott[22] and Black[23]. The changing regulatory environment will continue to spur the need for the development of effective compliance programs and management.[24] Past experiences of compliance professionals will illustrate how practical procedures implemented intend to meet compliance with regulations. While a quantitative report would provide research relating to the probability of specific strategies, the type of study would not explain the reasoning behind compliance strategies that transform legislative policies into practical policing. If the intent is to implement an effective program of compliance, then a design used to affirm behavioral intentions is appropriate.

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managers in a financial services company' (1992) 29(6) Journal of Management Studies 761; Lamb (n 3); PricewaterhouseCoopers LLP, *Broker-dealer and investment adviser compliance programs: More similar than different (*FS Regulatory Brief, 2012)

[17] A. Bandura, 'Social cognitive theory of self-regulation' (1991) 50 Organizational Behavior and Human Decision Processes 248.

[18] N. Friesen, A. Feenberg and G. Smith, 'Phenomenology and surveillance studies: Returning to things themselves' (2009) 25 The Information Society 84, 85.

[19] ibid.

[20] A. Bandura and K.M. Simon, 'The role of proximal intentions in self-regulation of refractory behavior' (1977) 1 Cognitive Therapy and Research 177; Bandura (n 17).

[21] W. L. Neumann, *Social research methods: Qualitative and quantitative approaches* (7th edn, Allyn and Bacon 2011).

[22] DeMott (n 14)

[23] Black (n 7).

[24] Scanlon and Purdon (n 12).

Compliance Research

Research and white papers relating to compliance within the broker-dealer industry address the challenges that compliance professionals face implementing regulation.[25]. In Pershing's industry survey, the top five compliance challenges of broker-dealers include: sales practice monitoring, regulatory changes, suitability review, product education, and operational processes.[26] The Securities Industry and Financial Markets Association encourage relationships between compliance and executive leaders.[27] The perspective being that working together with executives, regulators, and compliance professionals creates an effective compliance program. Other studies in best practices toward meeting regulatory obligations include the use of comprehensive written policy and procedures; maintaining a compliance calendar; testing; and prompt remedial resolution.[28]

Academics argue that regulators are focused on the unfairness of market activity instead of the threats to direct investor harm.[29] Compliance knowledge must extend to market technology to provide guidance on the internal systems which process investment transactions. Based on the type of investment transactions, broker-dealers may require additional registration with other market exchanges. Multiple registrations with various exchanges can create instances where regulatory demands conflict.[30] The compliance professional creates a program that addresses each regulator that has jurisdiction over the activities of the firm.

Studies regarding effective compliance systems do not distinguish from the myriad of variable business models of financial services organizations.[31] In addition, studies do not focus on the compliance programs based on the specific organizational size of the firms. In 2012, the North American Securities Administrators Associations identified top compliance violations of broker-dealers that included; home offices, one-person branch offices, 2-5 agent branch offices, 5 plus more agents in the branch office, and non-branch offices.[32] The findings revealed the highest violation percentage recorded from one-person branch offices.

Aspects of Relational Compliance and Ethics

Enforcing ethical behaviour in daily activities requires an understanding of how leaders are able to engage followers.[33] A social science approach that analyzes collected transcript to develop a deeper understanding of "creating an atmosphere of compliance" provides an academic interpretation of the compliance process within the specified industry based on conflicting moral perceptions.

Leonard, Cronan, and Kreie affirmed behavioural intention as a result of attitudes and personal normative beliefs in a design to examine ethical models in qualitative study.[34] The research is important in the pursuit of truth in the management of compliance regulations.

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[25] Pershing, *Effective sales supervision and compliance* (White paper, Pershing 2012).

[26] ibid.

[27] Securities Industry and Financial Markets Association (SIFMA), *The evolving role of compliance* (White paper, 2013).

[28] F. Cooke, *Zero deficiencies: Closing the gap* (ACA Compliance Group Broker-Dealer Services, 2012).

[29] See, H. Chitimira, 'An analysis of the market abuse prohibition enforcement in the United States of America' (2014) 5(7) Mediterranean Journal of Social Sciences 188; L.L. Hanson, '"Gossip boys": Insider trading and regulatory ambiguity' (2013) 21(1) Journal of Financial Crime 29; K. Johnson, 'Governing financial markets: Regulating conflicts' (2013) 88(1) Washington Law Review 185; H. R. Stoll, 'Electronic trading in stock markets' (2006) 20(1) Journal of Economic Perspectives 153; M.H. West and M.K. Kerfoot, 'The impact of Dodd-Frank on derivatives' (2013) 18(2) Fordham Journal of Corporate and Financial Law 269.

[30] SIFMA (n 27).

[31] PricewaterhouseCooper (n 16); Cooke (n 28); SIFMA (n 27).

[32] NASAA, 'Broker-dealer coordinated examinations project' (Powerpoint by North American Securities Administrators Association, Inc. Annual Conference, San Diego, September 2012).

[33] A. Savage-Austin and A. Honeycutt, 'Servant leadership: A phenomenological study of practices, experiences, organizational effectiveness, and barriers' (2011) 9(1) Journal of Business and Economics Research 49.

[34] L.N. Leanard, T.P. Cronan and J. Kreie, 'What influences IT behavior intention-planned behavior, reasoned action, perceived importance, or individual characteristics' (2004) 42 Information and Management 143.

Kuhn discusses the scientific revolution that leads to new paradigms of practices.[35] An increase of negative behaviours in a framework designed to mitigate the problem does not resolve the problem. In other words, if the desire for x is to lower the incidences of disciplinary actions then any multiplier of x would lead to increased measures of negative behaviours. The rationale of identifying multipliers of negative behaviours within financial regulations could generate new revolutionary thoughts that require a new framework for industry policymakers. This research will open the door for further leadership studies in the area of compliance leadership in the financial services industry. At the end of this research, dialogue from compliance leaders who are on the obligatory side of industry regulations will add practical perspective on meeting regulations.

The ineluctable duty of the compliance leader fundamentally purports to aid in the number of disciplinary actions imposed. As the number of securities regulations put in place to prevent improper activity within the financial markets, so does the number of disciplinary actions. Capturing the essence of compliance professional does not irrevocably mean an immediate improvement in the scandals within the marketplace. A methodical approach to the observation of intent and actions is an unbiased approach for data collection. Although the data collected in this manner will remain un-prejudicial the feelings of the individuals will undoubtedly be reflected.

CONCLUSION

The results of this exploration will contribute to the academic literature on the ethics of financial leaders. Specifically, this research will help analyse the meaning of ethics based regulation for those with the task of compliance leadership. These experiences will demonstrate how compliance leaders are able to effectively implement securities regulations into practical procedures within an organizational. The researcher will explore how compliance leaders are influencing compliant behaviours and what methods avoid disciplinary actions by industry regulators.

Continuing an academic unbiased dialogue of positive factors for effective compliance is only one factor in improving our economic framework. In the quest for regulated securities markets, reports are mixed on the support for effective compliance professionals to efficient regulations. The mandated position of the CCO starts as a necessary need imposed by external forces. As a compensated employee of the firm, the CCO must weigh his own self-regulated moral value with that of an unseen imposer. In the self-regulatory industry of financial services, the CCO will be challenged with defining intention in the environment of lucrative opportunities, moral self-monitoring, and negative consequence.

[35] T. S. Kuhn, *The structure of scientific revolutions (*University of Chicago Press 2012).