

Conduct Risk Management and Ethical Culture

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SIFMA 2020 ANNUAL SEMINAR***I. Conduct Risk Management****A. The Definition of Conduct Risk (across firms and regulators)**

Conduct risk is generally defined as “the potential for behaviors or business practices that are illegal, unethical, or contrary to a firm’s stated beliefs, values, policies and procedures.”¹

- In other words, the risk of “[c]onduct that falls short of expected standards, including legal, professional and ethical standards.”²
- Analyses of cases of misconduct in the financial sector “suggest that misconduct is not just the product of a few individuals or bad processes, but is the result of wider organizational breakdowns. Often, large numbers of employees and managers were either complicit in improper conduct, encouraged it, or turned a blind eye to troubling behavior.”³
- Firms generally agree that there are three main components of conduct risk: (1) culture, ethics, integrity; (2) corporate governance, tone from the top; and (3) conflicts of interest.⁴

Organizational culture is viewed “a key driver of behavior and resultant misconduct risk.”⁵

- “[C]ulture is the set of attitudes, beliefs, practices, and values that mitigate or enhance misconduct risk.”⁶

* This outline was drafted by Michèle A. Coffey and Ariel Gursky of Morgan, Lewis & Bockius LLP. The outline does not represent the views of their law firm or the other panelists or their organizations. In addition to the sources noted in the outline, the authors drew upon the outlines prepared for the SIFMA C&L Annual Seminar 2019 entitled “Conduct and Ethical Culture Convergence: The Evolving Paradigm” and “What is Conduct Risk Data and How Do You Use it?”

¹ Stephanie Chaly et al., *Misconduct Risk, Culture, and Supervision*, FEDERAL RESERVE BANK OF N.Y., at 3 (Dec. 2017), <https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/2017-whitepaper.pdf>.

² See *Stocktake of Efforts to Strengthen Governance Frameworks to Mitigate Misconduct Risks*, FINANCIAL STABILITY BOARD, at 6 (May 23, 2017), <https://www.fsb.org/wp-content/uploads/WGGF-Phase-1-report-and-recommendations-for-Phase-2.pdf>.

³ Chaly et al., *supra* note 1, at 4.

⁴ See Stacey English et al., *Culture and Conduct Risk Report 2018: Benchmarking 5 Years of Implementation*, THOMSON REUTERS, at 5 (May 9, 2018), <https://legal.thomsonreuters.com/content/dam/ewp-m/documents/legal/en/pdf/reports/culture-and-conduct-risk-2018.pdf>.

⁵ Chaly et al., *supra* note 1, at 4.

⁶ *Id.*

- It is the “shared set of norms within a group that influences decision-making and is evidenced through behavior.”⁷
- In other words, firm culture is “the set of explicit and implicit norms, practices, and expected behaviors that influence how firm executives, supervisors and employees make and implement decisions in the course of conducting a firm’s business.”⁸
- “Every organization has a culture, and in some cases, the firm’s culture is in fact a collection of many sub-cultures.”⁹

Conduct failings have been widespread across several jurisdictions.

- Misconduct undermines trust in financial institutions and markets.¹⁰

Regulatory focus on conduct—and the culture in which it occurs—is expected to continue; financial institutions will continue to face pressure to be aware of and monitor for poor behavior.

B. Regulatory Landscape and Regulatory Expectations

Regulators around the world are focused on conduct risk and its intersection with firm culture. For example:

- U.S. Securities and Exchange Commission (“SEC”): In a 2018 speech, Chairman Clayton stated “We do not Expect Perfection; We do Expect Commitment and Action.” Recognizing that “human beings make mistakes and some break from cultural expectations and legal requirements,” he then noted “[w]hen this behavior occurs, key questions a firm should ask include whether the conduct represented a clear breach of the firm’s controls and culture as well as whether the firm’s remediation efforts, in addition to any controls enhancements, sent an appropriate and lasting cultural message.”¹¹
- Financial Industry Regulatory Organization (“FINRA”): There is no general FINRA ethics rule; FINRA often cites FINRA Rule 2010 (Standards of Commercial Honor and Principles) for ethical practices.¹²

⁷ *Id.* at 5.

⁸ *2016 Regulatory and Examination Priorities Letter*, FINRA (Jan. 5, 2016), <http://www.finra.org/industry/2016-regulatory-and-examination-priorities-letter>.

⁹ Jay Clayton, Chairman, U.S. Sec. & Exch. Comm’n, *Observations on Culture at Financial Institutions and the SEC*, (June 18, 2018), <https://www.sec.gov/news/speech/speech-clayton-061818>.

¹⁰ Chaly et al., *supra* note 1, at 3.

¹¹ Clayton, *supra* note 9.

¹² *2018 FINRA Annual Conference, Building and Maintaining an Ethical Culture*, FINRA, at 5 (May 23, 2018), https://www.finra.org/sites/default/files/2018_AC_Ethical_Culture.pdf.

- In 2016, FINRA sent firms a “Targeted Examination Letter on Establishing, Communicating and Implementing Cultural Values.”¹³ In that letter, FINRA stated: “Firm culture has a profound influence on how a broker-dealer conducts its business, including how it manages conflicts of interest. A culture that consistently places ethical considerations and client interests at the center of business decisions helps protect investors and the integrity of the markets. Conversely, failures in these areas can impose significant harm on investors and the markets as well as firms themselves.”¹⁴
- More recently, in 2018, a FINRA panel acknowledged that “ethical practices” can be hard to define but “we know it when we see it.”¹⁵ In that same presentation, the panel noted that “Legality is not always the best guide. Just because it is legal doesn’t mean it is ethical.”¹⁶
- In May 2019, the then Chief Risk Officer and Head of Strategy for FINRA argued that “It’s difficult to change the behavior of people who want to commit fraud or other investor harm . . . [b]ut firms can strengthen culture and improve conduct outcomes broadly by setting the right policies, aligning incentives and rewards, and leveraging technology and data analytics to monitor performance.”¹⁷
- U.S. Department of Justice (“DOJ”): The DOJ Criminal Division issued guidance to its prosecutors in April 2019 regarding the Evaluation of Corporate Compliance Programs.
 - Regarding the evaluation of policies and procedures, the guidance stated: “Any well-designed compliance program entails policies and procedures that give both content and effect to ethical norms and that address and aim to reduce risks identified by the company as part of its risk assessment process. As a threshold matter, prosecutors should examine whether the company has a code of conduct that sets forth, among other things, the company’s commitment to full compliance with relevant Federal laws that is accessible and applicable to all company employees. As a corollary, prosecutors should also assess whether the company has established policies and procedures that incorporate the culture of compliance into its day-to-day operations.”¹⁸

¹³ See *Targeted Examination Letter on Establishing, Communicating and Implementing Cultural Values*, FINRA (February 2016), <https://www.finra.org/rules-guidance/guidance/targeted-exam-letter/establishing-communicating-and-implementing-cultural-values>.

¹⁴ See *id.*

¹⁵ FINRA, *supra* note 12, at 5.

¹⁶ *Id.*

¹⁷ Frank Devlin, *Mitigating Conduct Risk to Preserve and Improve Reputation*, THE RMA JOURNAL (May 2019) http://rmajournal.org/rmajournal/may_2019/MobilePagedArticle.action?articleId=1483461#articleId1483461.

¹⁸ *Evaluation of Corporate Compliance Programs*, U.S. DEPARTMENT OF JUSTICE: CRIMINAL DIVISION, at 3-4 (April 2019), <https://www.justice.gov/criminal-fraud/page/file/937501/download>.

- Federal Reserve Bank of New York: “The impact of employee misconduct extends beyond the individual and can impact the firm as a whole, as well as the economy and financial markets more broadly. That is, misconduct risk has both prudential and financial stability implications.”¹⁹

C. Assessment, Identification and Measurement: A Practitioner’s Guide

1. Usefulness of Metrics

Conduct risk data can come from many areas of a firm. Examples of such data include:

- Trade data
- Performance analytics
- Electronic communications (including firm issued devices, policies around cell phones and non-approved business channels and social media)²⁰
- Employee-related information (personal transactions,²¹ outside business activities,²² access card logs, attendance, gifts, background and credit checks,²³ expense reports, etc.)
- Conduct risks that are indicative of propensity for misconduct (e.g. racial, gender, sexual harassment, use of inappropriate language, other violations of Code of Conduct)
- Firm Compliance Policies/Code of Conduct²⁴
- Customer complaint information
- The key to the usefulness of metrics is connecting the dots across a large organization.

This is true in both institutional and retail environments. In retail environments, there is greater focus on:

¹⁹ See Kevin J. Stiroh, *Misconduct Risk, Culture and Supervision; Remarks at the Culture Roundtable Session with Business Schools and Financial Services Industry*, FEDERAL RESERVE BANK OF N.Y. (December 7, 2017), <https://www.newyorkfed.org/newsevents/speeches/2017/sti171207>.

²⁰ See FINRA Regulatory Notice 07-59 (December 2007).

²¹ See FINRA Rule 3280.

²² See FINRA Rule 3270.

²³ See FINRA Regulatory Notice 15-05 (March 2015).

²⁴ See 17 CFR § 275.206(4)-7 (2003); FINRA Rule 3110.

- Information drawn from the book of business
- Client holdings
- Customer complaints²⁵
- Form U4 items²⁶
- Geographically-linked analytics

2. Behavioral Analytics

Risk management policies and procedures should incorporate analysis of conduct data and identified patterns and trends.

- Conduct risk data should be reviewed against other metrics and frameworks, including incentive compensation practices, where appropriate.
 - For certain businesses, there is a regulatory expectation that production and compensation incentives will align with the consumer interest.²⁷
- Regulators are using advanced analytics to assess risk. For example, FINRA is using analytics to identify registered representatives with potentially problematic regulatory histories,²⁸ and is devoting particular attention to firms' hiring and monitoring of high-risk brokers.²⁹

D. Misconduct and Recent Enforcement Actions

“Even a well-designed compliance program may be unsuccessful in practice if implementation is lax or ineffective. Prosecutors are instructed to probe specifically whether a compliance program is a ‘paper program’ or one ‘implemented, reviewed, and revised, as appropriate, in an effective manner.’ JM 9-28.800. In addition, prosecutors should determine ‘whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation’s compliance efforts.’ JM 9-28.800. Prosecutors should also determine ‘whether the corporation’s employees are

²⁵ FINRA Rule 4513; *see also* CFPB Examination Procedures, Compliance Management Review, CONSUMER FINANCIAL PROTECTION BUREAU, at 4-5 (August 2017), https://files.consumerfinance.gov/f/documents/201708_cfpb_compliance-management-review_supervision-and-examination-manual.pdf.

²⁶ *See* FINRA Rule 3110(e); Form U4, FINRA (May 2009), <https://www.finra.org/sites/default/files/form-u4.pdf>.

²⁷ CFPB Compliance Bulletin 2016-03, Detecting and Preventing Consumer Harm from Production Incentives, at 3 (Nov. 28, 2016).

²⁸ Richard G. Ketchum, *Remarks From the 2016 FINRA Annual Conference*, FINRA (May 23, 2016) <https://www.finra.org/media-center/speeches-testimony/remarks-2016-finra-annual-conference>.

²⁹ *See 2017 Annual Regulatory and Examination Priorities Letter*, FINRA, at 2 (January 2017) <http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf>.

adequately informed about the compliance program and are convinced of the corporation's commitment to it.' JM 9-28.800; see also JM 9-47.120(2)(c) (criteria for an effective compliance program include '[t]he company's culture of compliance, including awareness among employees that any criminal conduct, including the conduct underlying the investigation, will not be tolerated')."³⁰

- LIBOR and FX: collusion and coordinated trading;³¹ other manipulation; and abuse in customer relationships (e.g., unfairly profiting at the expense of the customer).³²
- Sales practices violations - unauthorized accounts:³³ misconduct included, among other things, opening accounts without customer authorization.
- Credit Card Add-On Actions:³⁴ Misconduct included, among other things, deceptively marketing add-on products and enrolling consumers without consent.

II. Ethical Culture: Culture Drives Conduct

"[C]ulture is collective."³⁵ It is critical that there is alignment between the board of directors, senior management, and middle and lower management on issues of conduct and culture as employees take cues from their direct managers even more than the tone at the top.³⁶

"[I]n an organization with a high level of cultural capital, misconduct risk is low and observed structures, processes, formal incentives and desired business outcomes are consistent with the firm's stated values and beliefs promoting ethical conduct. The unspoken patterns of behavior reinforce this alignment. Employees understand and internalize the expectations of the law and the meaning of regulatory rules or supervisory guidance, and do not need to be reminded by enforcement actions and large penalties that compliance is an important part of sustained success. Problems are escalated to business unit leaders and senior managers routinely, as employees feel empowered to raise their hand and believe that their efforts will result in meaningful responses. And, senior leaders advance through the organization because, in addition to strong financial performance, they model behaviors consistent with the firm's values."³⁷

³⁰ *Evaluation of Corporate Compliance Programs* *supra* note 18, at 9.

³¹ See Deutsche Bank AG, Federal Reserve No. 17-008 (April 20, 2017).

³² U.S. v. HSBC Holdings OLC, 1:18-cr-00030-NGG-1 (E.D.N.Y. filed Jan. 18, 2018).

³³ Wells Fargo Bank, N.A., 2016-CFPB-0015 (Sept. 8, 2016).

³⁴ See Capital One Bank, 2012-CFPB-0001 (July 18, 2012).

³⁵ Clayton, *supra* note 9.

³⁶ See Stiroh, *supra* note 19.

³⁷ Chaly et al., *supra* note 1, at 6.

A. Role of the Board of Directors

Board members play a critical role in a firm's governance structure and culture.

- “Beyond compliance structures, policies, and procedures, it is important for a company to create and foster a culture of ethics and compliance with the law. The effectiveness of a compliance program requires a high-level commitment by company leadership to implement a culture of compliance from the top.”³⁸
- “Firms and their boards of directors have primary responsibility to improve a firm's culture and reduce misconduct risk.”³⁹
- “The company's top leaders – the board of directors and executives – set the tone for the rest of the company. Prosecutors should examine the extent to which senior management have clearly articulated the company's ethical standards, conveyed and disseminated them in clear and unambiguous terms, and demonstrated rigorous adherence by example. Prosecutors should also examine how middle management, in turn, have reinforced those standards and encouraged employees to abide by them. *See* U.S.S.G. § 8B2.1(b)(2)(A)-(C) (the company's ‘*governing authority* shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight’ of it; ‘*high-level personnel* ... shall ensure that the organization has an effective compliance and ethics program’ (emphasis added)).”⁴⁰
- It is recommended that there is a specific board committee with oversight of conduct and culture.⁴¹

Behavioral indicators can help Boards understand their firms' cultures and identify potential trouble spot.

B. Senior Management/Middle Management

The performance management framework established by senior management influences conduct and culture.

- Some firms have established conduct committees and have established ethics directors and ethics divisions

³⁸ *Evaluation of Corporate Compliance Programs supra* note 18, at 9.

³⁹ Chaly et al., *supra* note 1, at 5.

⁴⁰ *Evaluation of Corporate Compliance Programs supra* note 18, at 9.

⁴¹ *See* GROUP OF THIRTY, BANKING CONDUCT AND CULTURE A PERMANENT MINDSET CHANGE, at 39-40 (November 2018), https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2018/december/Oliver_Wyman_G30_Report_on_Banking_Conduct_and_Culture.pdf.

1. Tone from the Top

“As a threshold matter, we would like to emphasize that compliance programs, chief compliance officers, and other compliance staff play critically important roles at firms. Indeed, culture and tone from the top are key. In the course of conducting thousands of examinations of many different types of firms, the hallmarks of effective compliance become apparent. One such hallmark includes compliance’s active engagement in most facets of firm operations and early involvement in important business developments, such as product innovation and new services. Another is a knowledgeable and empowered chief compliance officer with full responsibility, authority, and resources to develop and enforce policies and procedures of the firm. And perhaps most importantly, a commitment to compliance from C-level and similar executives to set a tone from the top that compliance is integral to the organization’s success and that there is tangible support for compliance at all levels of an organization.”⁴²

2. Tone from the Middle

“Culture plays a role in determining how much effort will be devoted to defeating regulations, rather than complying with them. In this way, culture is an important complement to rules and not a substitute. Part of the role of supervisors has always been to monitor the gaps in the rules and to ensure that firms are complying with relevant regulations, not compromising them.”⁴³

- Compliance and Risk departments play a critical a defensive role in establishing enterprise-wide risk limits and monitoring adherence to those limits, including identifying, measuring, and aggregating risks, and providing risk reports to the board and senior management.
- In addition to providing legal advice, the Legal Department may collaborate, on relevant aspects of data management, inquiries/investigations of potential misconduct incidents, and concerns with using and sharing data.

C. Echo from the Bottom

“There are many reasons why having a clear mission is beneficial to culture and improving culture. . . . It fills in the gaps. Organizations with the most comprehensive compliance programs and policies and procedures will inevitably encounter circumstances not contemplated by their policies and procedures. In those situations, what drives how people will act? The law and regulations? What if those also do not contemplate the situation? Or, more significantly, what if the law permits a range of

⁴² 2020 Examination Priorities; *Office of Compliance Inspections and Examinations*, SECURITIES AND EXCHANGE COMMISSION, at 1 (Jan. 7, 2020), <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf>.

⁴³ Chaly et al., *supra* note 1, at 12.

actions with some that, while legal, can cause significant harm. In these circumstances, those on the front lines, those making decisions, need a touchstone.”⁴⁴

D. Ethical Decision-Making Tools

“There are many familiar methods for communicating, monitoring and reinforcing cultural objectives — compliance programs, policies and procedures, training, personnel decisions (including evaluations and compensation), etc. . . . [A]ll of these methods are important and, in large financial organizations, essential. . . . [T]hese methods are enhanced by, and in fact, to be effective over the long term, require, a clear, candid, easily understandable articulation of the organization’s core mission.”⁴⁵

E. Measuring Culture

To determine the quality of the culture, firms can consider various methods by which to measure their culture.

- “[T]o effectively manage the business of your organization on a day-to-day basis and over the long term, management needs to know what the culture of the organization is today, including the key drivers of that culture. For example, a new strategic initiative is much more likely to be successful if it is designed and implemented in a manner that is consistent with, and, hopefully, leverages the firm’s culture.”⁴⁶
- “[O]ver time, whatever the cultural goals for your organization may be, the chances of achieving them go up dramatically if you understand where your culture stands relative to those goals. In driving organizational culture, it is difficult, if not impossible, to get from A to B unless you have a clear sense of what A is.”⁴⁷
- This is especially important because “if there is a disconnect between what management thinks the firm’s culture is today and what the regulator thinks the firm’s culture is today, agreeing on measures to enhance the culture will be difficult – very difficult. Said starkly, if the regulator is convinced a firm has a cultural problem and the firm continues to fight that conclusion, tension is likely to be high and progress — which involves fostering mutual regulator -firm respect and trust — will be slow and costly all around.”⁴⁸

⁴⁴ Clayton, *supra* note 9.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

1. Employee Surveys

The Thomson Reuters Culture and Conduct Risk Report for 2018 found that 51% of respondent firms relied on staff opinion survey results.⁴⁹

- The April 2019 DOJ guidance noted that “prosecutors should consider whether the company has engaged in meaningful efforts to review its compliance program and ensure that it is not stale. Some companies survey employees to gauge the compliance culture and evaluate the strength of controls . . . though the nature and frequency of evaluations may depend on the company’s size and complexity.”⁵⁰

2. Third Line – Audit Role

The April 2019 DOJ Guidance states: “Prosecutors should evaluate whether ‘internal audit functions [are] conducted at a level sufficient to ensure their independence and accuracy,’ as an indicator of whether compliance personnel are in fact empowered and positioned to ‘effectively detect and prevent misconduct.’ JM 9-28.800. Prosecutors should also evaluate ‘[t]he resources the company has dedicated to compliance,’ ‘[t]he quality and experience of the personnel involved in compliance, such that they can understand and identify the transactions and activities that pose a potential risk,’ and ‘[t]he authority and independence of the compliance function and the availability of compliance expertise to the board.’ JM 9-47.120(2)(c); *see also* JM 9-28.800 (instructing prosecutors to evaluate whether ‘the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization’s compliance with the law’); U.S.S.G. § 8B2.1(b)(2)(C) (those with ‘day-to-day operational responsibility’ shall have ‘adequate resources, appropriate authority and direct access to the governing authority or an appropriate subgroup of the governing authority’).”⁵¹

F. Escalation/Speak Up Culture

“Banks are also focused on creating environments of ‘psychological safety’ where employees can speak up, challenge groupthink, and escalate concerns.”⁵²

“[T]he ability and willingness of staff to voice ideas or concerns is rightly regarded as critical, both for employees and organisations.”⁵³ But a 2018 survey by the Banking

⁴⁹ See English et al., *supra* note 4, at 34.

⁵⁰ *Evaluation of Corporate Compliance Programs* *supra* note 18, at 14.

⁵¹ *Id.* at 10-11.

⁵² See GROUP OF THIRTY, *supra* note 41, at 43.

⁵³ Kate Coombs, *Speaking Up: Small Steps to Big Changes*, FIN. CONDUCT AUTH. (July 24, 2019), <https://www.fca.org.uk/insight/speaking-small-steps-big-changes>.

Standards Board (“BSB”) found that one quarter of employees who have concerns do not raise them.⁵⁴

In July 2019, the Financial Conduct Authority (“FCA”) identified four key questions that organizations should consider when developing a strategy for fostering a culture of “speaking up.”⁵⁵

- “What do your employees currently find it easy or difficult to speak up about?” Employees are more likely to raise organizational concerns organization (e.g., treatment of customers, policies, and market integrity) than personal concerns (e.g., sexual harassment, bullying, and discrimination). The FCA recommended that firms “foster positive team relations where employees feel that voicing personal concerns is not just individually acceptable, but a social norm.”⁵⁶
- “Who do you need to target to change the culture?” “Should the intervention target the speakers themselves or the listener?” The FCA notes that understanding the experiences of the employee population is essential in deciding where to focus a “speaking up” strategy.⁵⁷
- “How do you want your employees to be able to speak up?” Employees appear to think strategically in deciding who they speak to and how they speak to them. The FCA suggests that considering to whom and how employees are likely to speak up in a specific context is crucial in designing a “speaking up” intervention.⁵⁸
- “How will you know what you are doing is working?” A baseline measure in the target population prior to and post-intervention can prove to be a helpful method for measuring effectiveness. Firms can also create scales on which employees can estimate how often they spoke up in the previous calendar month.⁵⁹

“Financial services firms are focusing on ensuring the first line owns risk in their business line, strengthening second line challenge, and creating a ‘speak up’ culture. For example, management maps are being drawn up to articulate and communicate roles and responsibilities, and rotations between business and risk management are being implemented. Some firms also are rolling out new training to specific business units on risk and on how they (the business units) can effectively perform their function. In addition, employee issue escalation processes and customer complaints workflows—

⁵⁴ Coombs, *supra* note 53.

⁵⁵ *Id.*; see Currie et al., *UK Regulators Continue Focus on Cultural Accountability, Diversity in Financial Services Sector*, MORGAN LEWIS (July 26, 2019), <https://www.morganlewis.com/pubs/uk-regulators-continue-focus-on-cultural-accountability-diversity-in-financial-services-sector>.

⁵⁶ Coombs, *supra* note 53.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

particularly in relation to whistleblowing—are being reviewed and strengthened at many firms.”⁶⁰

- “Firms are rolling out programs which include comprehensive communication plans and evaluations of the role that culture plays with respect to risk, conduct and compliance. They also are developing purpose statements that emphasize support for customers or broader society, and are systematically assessing the role culture plays with respect to risk, conduct and compliance. Culture and conduct are also being embedded into risk management frameworks, placed as regular discussion topics on board agendas and incorporated into strategies, business models and governance arrangements.”⁶¹

Assessment considerations:

- Establishing alert thresholds
- Individual versus collective “bad act” identification
- Maintaining a conduct database to identify patterns of behavior/misconduct
- Running risk reports
- Conducting internal investigations, as needed
- Committees focused on conduct

Key facets of a conduct risk program:

- Whistleblower Hotline⁶²
- Anti-Retaliation Policies
- Organizational Justice (Consistency, Transparency, Fairness)⁶³

“[P]romoting individual accountability and positive firm culture is a complex and multifaceted issue. While employers, employees, and regulators continue to grapple with

⁶⁰ See DELOITTE, *Confronting Eight Drivers of Misconduct in Financial Services*, WALL ST. J. (July 11, 2017), <https://deloitte.wsj.com/riskandcompliance/2017/07/11/confronting-eight-drivers-of-misconduct-in-financial-services/>.

⁶¹ See DELOITTE, *supra* note 60.

⁶² See *Evaluation of Corporate Compliance Programs*, *supra* note 18, at 5-6.

⁶³ See Michael Silva & Azish Filabi, *Safeguarding Financial-Firm Cultures: Five Focus Factors for Directors*, REUTERS (Apr. 4, 2018), <https://www.reuters.com/article/bc-finreg-financial-firm-culture/commentary-safeguarding-financial-firm-cultures-five-focus-factors-for-directors-idUSKCN1HB2JQ>.

the shifting tide of regulatory best practices, the importance of continuity and consistency in creating real and lasting cultural change should not be underestimated.”⁶⁴

III. Legal Advice and Privilege Considerations

A. The Role of The Lawyer in Conduct Risk Management

Some commentators have observed that the role of in-house counsel has been diminished by the rise of the risk management function.⁶⁵ Among the factors potentially contributing to this diminution is the accepted framework for managing risk, which identified three lines of defense: (1) the front line business, which owns the risk; (2) the risk professionals who identify the risk for the front line and help to manage and control those risks; and (3) audit, which determines how well the framework is functioning. The second line risk function generally encompasses operational and compliance risk, apparently leaving legal risk outside of the framework. Yet operational risks often are broadly defined, and at least some definitions would include legal risk as a component of operational risk.⁶⁶ Similarly, definitions of compliance risk overlap substantially with definitions of legal risk. These broad and overlapping definitions might lead to the conclusion that the remit of the risk professionals who manage operational and compliance risk includes management of legal risk.

1. The Importance of Clear Lines of Responsibility for Legal Judgment

Legal judgment – the core of the legal function – is not limited to matters of legal risk. Legal judgment impacts many other categories of risk, including conduct risk. Because the distinction between legal risk and other types of risk, including compliance and operational risk, may be unclear, there may be conflicts or misunderstandings as to roles and responsibilities – which can have numerous implications, including decision-making and communications that are not informed by legal judgment and protected by attorney-client privilege.

2. The Role of the Lawyer in Reforming and Culture and Conduct

Comment [2] to Model Rule 2.1 of the Rules of Professional Responsibility acknowledges that “it is proper for a lawyer to refer to relevant moral and ethical considerations in giving advice,” because “moral and ethical considerations impinge

⁶⁴ Currie, *supra* note 55.

⁶⁵ Thomas C. Baxter, *The Rise of Risk Management in Financial Institutions and a Potential Unintended Consequence – the Diminution of the Legal Function*, BUS. LAW SECTION, AM. BAR ASS’N (APR. 2, 2019), <https://businesslawtoday.org/2019/04/rise-risk-management-financial-institutions-potential-unintended-consequence-diminution-legal-function/>.

⁶⁶ *Id.* (quoting BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR THE SOUND MANAGEMENT OF OPERATIONAL RISK, 3 n.5 (2011) (“Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.”)).

upon most legal questions and may decisively influence how the law will be applied.”⁶⁷

Thus, lawyers can provide important insight into an organization’s culture, based on the relationship of trust that the lawyer has built with his/her client over time. Indeed, “a lawyer who is both a partner and a guardian – an insider and an outsider – can greatly benefit a financial services firm.”⁶⁸

- Practice Tip: While reference to such non-legal considerations might be intrinsic to certain legal advice, the further a lawyer’s contribution strays from legal advice, the greater the potential that those contributions and communications will be privileged.

3. Role of the Lawyer in Risk Assessment

Risk assessments may reveal, among other categories of risk, legal risks within an organization. As a result, some organizations conduct risk assessments at the direction of counsel, and try to protect it from disclosure on the basis of attorney-client privilege. In addition to foundational challenges to a privilege assertion, a privilege assertion over a risk assessment poses another challenge: it may limit the organization’s ability to use the assessment to its advantage, unless the organization waives the privilege. Waiver, in turn, produces its own risks, including risk that the waiver extends beyond the assessment to include the broader subject matter of the entire risk assessment process, and communications related to it.

- Practice Tip: Consider conducting the assessment in a manner that the process and the outcome are privileged, but the risk assessment itself is not. Receive legal advice on this *before* commencing the risk assessment.

B. Privilege Implications When Lawyers Handle Culture and Conduct Data

1. The Dual Hats Worn by Many In-House Counsel

An attorney-client relationship arises when a person manifests an intent that the lawyer provide legal services and the lawyer consents to do so. Restatement (Third) of Governing Law § 14 (2000). Attorney client privilege attaches to (1) communications; (2) made in confidence; (3) by the client; (4) where legal advice of any kind is sought; (5) from a professional legal advisor in his or her capacity as such – unless the privilege is waived. The privilege does not attach when a lawyer renders business advice or other non-legal advice.

⁶⁷ MODEL RULES OF PROF’L RESPONSIBILITY r. 2.1 cmt. 2, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_2_1_advisor/comment_on_rule_2_1_advisor/.

⁶⁸ See Michael Held, Remarks at Yale Law School’s Chirelstein Colloquium: Reforming Culture and Conduct in the Financial Services Industry: How Can Lawyers Help? (Mar. 8, 2018), <https://www.newyorkfed.org/newsevents/speeches/2018/hel170308>.

The often mixed business/legal nature of an in-house counsel's responsibilities, and, often, the titles reflecting that mixture, provide fertile ground for challenges to the assertion of attorney-client privilege in the corporate setting.

2. Business versus Legal Advice

Unfortunately, there is no ready test for distinguishing between protected legal communications and unprotected business communications. However, most courts look to the primary purpose of the communication. See, e.g., *United States v. chevron*, 1996 U.S. Dist. LEXIS 4154 (N.D. Cal. March 13, 1996) (“A party seeking to withhold discovery based upon the attorney-client privilege must prove that all of the communications it seeks to protect were made ‘primarily for the purpose of generating legal advice.’”).

- Practice Tips:
 - Segregate business from legal advice. Where mixed, divide into separate documents or clearly labeled sections.
 - Create a record when giving legal advice. For example, ground all advice in legal matters and clearly indicate that the communication is primarily legal, e.g., with a disclosure/legend such as “You sought my legal advice regarding...”
 - Avoid blanket assertions of privilege, routine copying of legal counsel on non-legal communications.