Bank Culture and the Official Sector: A Spectrum of Options

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Culture is a topic of growing interest in financial services. The purpose of this Article is to explain why we—two lawyers at a central bank—have paid attention. We also hope to prompt conversations with academics, regulators, and bankers about how culture contributes to decisions and behaviors in the financial services industry.

Culture, ethics, and behavior tend to be the professional pursuits of anthropologists, philosophers, and psychologists—not lawyers or central bankers. But, we are convinced that culture is a topic worthy of attention, dialogue, and action in any profession, industry, or organization, including financial services. Culture in financial services is especially important because the decisions that bankers and other financial professionals make affect others (all of us, really) in powerful ways.

It may sound obvious, or overly modest, to say that "culture matters." Five years ago, the prevailing reaction to a suggestion that regulators and supervisors[1] should pay attention to culture was, in essence, "seriously?" This idea can still provoke skepticism. The word itself—culture—can prompt visceral aversion or quick dismissal as a "somewhat contested

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1. The United States regulates many industries, but subjects banks and certain other financial institutions to supervision as well. At the Federal Reserve,

> [r]egulation entails establishing the rules within which financial institutions must operate—in other words, issuing specific regulations and guidelines governing the formation, operations, activities, and acquisitions of financial institutions. Once the rules and regulations are established, supervision—which involves monitoring, inspecting, and examining financial institutions—seeks to ensure that an institution complies with those rules and regulations, and that it operates in a safe and sound manner.

BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM PURPOSES & FUNCTIONS 74 (10th ed. 2016).

academic concept," mired in theoretical or semantic disagreement,[2] not easily quantifiable and measurable as compared to, say, capital or liquidity. It is too subjective or "squishy" to merit serious discussion.

If you think culture is too squishy, please hear us out. In Part I of this Article, we set out what we mean by culture. In Part II, we explain why we are interested in culture and why it matters to us now. In Part III, we will survey the work of other public authorities in their efforts to address culture. In our view, these efforts fall into several categories along a spectrum from more advisory to more prescriptive. We do not endorse any particular method. All of these efforts are useful attempts to address a common problem: repeated ethical failures that undermine the trustworthiness of financial services. We hope this Part will direct interested academics to useful source material and demonstrate the value of the various different approaches. In Part IV, we will focus on what the Federal Reserve Bank of New York (the New York Fed) has done to address culture. These efforts fall on the advisory end of the spectrum of available tools covered in Part III. This reflects, in part, the New York Fed's role within the Federal Reserve, the central bank of the United States. Finally, in Part V, we pose a few questions for further discussion in academic forums:

1. What are we missing about culture?
2. What else should we and our colleagues at the Federal Reserve Bank of New York do?
3. How do we know if there has been progress?

This Article does not include the customary survey of scholarly literature; we leave that to the more academically focused. Our purpose is not to fill gaps in what theorists and researchers have written. In addition, we avoid stating how financial institutions have approached culture, except where their efforts are public or described by other public authorities. This approach avoids concerns about inadvertently disclosing any confidential supervisory information.

I.

As we use the term, culture means the shared norms within a group that are evidenced through behavior. There are four key concepts embedded in this definition: (1) shared, (2) norms, (3) evidence, and (4) behavior.

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2. *See generally* Daniel K. Tarullo, Governor, Speech at the Federal Reserve Bank of N.Y. Conference: Reforming Culture and Behavior in the Financial Services Industry: Good Compliance, Not Mere Compliance (Oct. 20, 2014), https://www.federalreserve.gov/newsevents/speech/tarullo20141020a.htm [https://perma.cc/3EYX-4GQX].

First, culture must be shared. Culture concerns groups, not individuals. Of course, we are all part of multiple groups within and apart from where we work. This makes assessing and managing culture difficult—that is the bad news. The good news, however, is that culture is ordinary. Every group has a culture. We all know this from the many groups of which we are a part—culture helps us fit in and get along. In our view, groups that pay attention to their cultures will be more effective—more successful in fulfilling their purposes—than groups that ignore their cultures and tempt fate.

Second, norms are customs or habits followed by a group. Norms are part of the human psyche. Each of us relies on group norms for mental efficiency because we cannot possibly reason through every choice. We look around us. We see what succeeds and what does not. And, hopefully, we model our decisions and conduct on the former, not the latter. If a person's behavior violates a group norm, the group may impose some informal discipline. Group norms are also gap-fillers and interpreters; they pick up where rules leave off. After all, rules cannot address every scenario and often require interpretive gloss. Group norms often supply that gloss.

Third, there must be evidence. We are suspicious of assessments or diagnoses of culture based on intuition. Intuition is often judgment based on incomplete and inadequate facts, unverified anecdotes, and secondhand rumors. Once we gather evidence, we can begin to think about commonalities, root causes, and their relationship to culture. Of course, interpretations of facts may vary, but a commitment to observable behavior supplies objectivity.

Finally, there is behavior. In our view, this is the best evidence of culture. Behavior is a transmission mechanism for norms, or "how we *do* things." In looking at a group's culture, we cannot just consider statements of values—what some call "tone from the top." Clear, simple principles and statements of purpose have their uses. To understand culture, however, we must observe what is done as well as what is said or written. Therefore, in assessing a group's culture, stated criteria for hiring, conduct, and promotion matter less than actual choices about who is hired, who is fired, and who is rewarded. It is critical to recognize that a group's narrative may differ radically from how members of the group actually behave.

An effective culture is one that enables an organization to fulfill its purposes. Speaking at the New York Fed in 2016, the philosopher Onora O'Neill urged the audience to consider the question: "What is banking for?”[3] And, more specifically addressed to bankers in the audience: “What is *your* bank for?”[4]

These questions require continuous attention. Some features of what it means to be a bank are enduring, but others change. Last year, the Office of the Comptroller of the Currency announced it would issue national bank charters for non-depository “fintech” companies.[5] More recently, the Hong Kong Monetary Authority announced it granted banking licenses to four companies that will operate “virtual banks.”[6] Many well-established financial institutions, meanwhile, promote themselves as “technology companies.”[7] If technology companies want to be banks, and banks want to be technology companies, What does this tell us about the purpose of banking?

Of course, many financial services firms comprise businesses beyond banks, strictly speaking. That may make Baroness O’Neill’s questions more difficult to answer, and perhaps more important. Whether a bank is large or small, complex or simple, these questions require careful thought. We will not attempt to answer them here. It is essential, moreover, that banks answer these questions for themselves. Supervisors should not supply the answers.

That said, supervisors can give suggestions. Over the years, the Federal Reserve’s supervisory materials have pointed to a consistent set of features that characterize an effective bank culture. These include consumer protection, compliance with laws and regulations, and the avoidance of conflicts of interest.[8] A good culture promotes conduct that an objective observer would consider ethical.[9] It will also promote

3. Onora O’Neill, Baroness of Bengarve, Remarks at the Federal Reserve Bank of New York’s Conference: Reforming Culture and Behavior in the Financial Services Industry: What is Banking For? 1 (Oct. 20, 2016), https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/ONeill-Culture-Workshop-Remarks-10202016.pdf [https://perma.cc/944D-MTCN].

4. *Id.*

5. News Release, Office of the Comptroller of the Currency, OCC Begins Accepting National Bank Charter Applications from Financial Technology Companies (July 31, 2018), https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html [https://perma.cc/GW5R-24DT].

6. Press Release, H.K. Monetary Auth., Granting of Virtual Banking Licences (May 9, 2019), https://www.hkma.gov.hk/eng/key-information/press-releases/2019/20190509-3.shtml [https://perma.cc/QVG5-RDUE].

7. *See* Matt Levine, *It’s Getting Harder to Tell Banks from Tech Companies*, BLOOMBERG (Feb. 14, 2018), https://www.bloomberg.com/opinion/articles/2018-02-15/lloyd-blankfein-wants-goldman-sachs-to-push-technology [https://perma.cc/Y7DS-BYQZ]; *see also* JPMORGAN CHASE, INVESTING IN OUR FUTURE 52 (2015), https://www.jpmorganchase.com/corporate/investor-relations/document/ar2015-lettertoshareholders.pdf [https://perma.cc/4MZW-QLKQ].

8. Letter from Bd. of Governors, Fed. Reserve Sys., to the Officer in Charge of Supervision at Each Reserve Bank and to Domestic and Foreign Large Fin. Insts. 5 (Dec. 17, 2012), https://www.federalreserve.gov/supervisionreg/srletters/sr1217.pdf [https://perma.cc/UKC7-5ZJ8].

9. Letter from Bd. of Governors, Fed. Reserve Sys., to Officer in Charge of Supervision and Appropriate Supervisory and Examination Staff at Each Fed. Reserve Bank and Certain Orgs.

objective thinking, questioning, and challenging of ideas.[10] Further, where appropriate, it will encourage escalation—raising one's hand, so to speak—so that problems receive appropriate attention and stay small.[11]

Many supervisors discuss culture with a limiting adjective: compliance culture or risk culture, for example. We tend to avoid those terms. For one thing, they may encourage thinking about culture from a perspective that is too narrow—for example, a perspective of controls. We like controls as much as any supervisor. But culture, as we use the term, consists of more than limits on discretion, the detection of mistakes, and concepts like fallbacks, backstops, and redundancy. We believe a good culture requires conscious choice, not merely reliable processes.[12] We want firms and bankers to make better decisions—that is, decisions that align with the public and private purposes of a bank in the near term and over the long term.

II.

A. So Why Culture? And Why Now?

Bill Dudley, the Federal Reserve Bank of New York's former president, has spent four decades in financial services—at the Federal Reserve and in the private sector. As he explained in late 2013, "[t]here is evidence of deep-seated cultural and ethical failures at many large financial institutions. Whether this is due to size and complexity, bad incentives, or some other issues is difficult to judge, but it is another critical problem that needs to be addressed."[13]

"Deep-seated cultural and ethical failures" is strong talk from a central banker. The evidence supports this assessment. In the years following the financial crisis, regulators and supervisors at the Federal Reserve tried to focus their resources on improving stability of the financial system and the "safety and soundness" of firms. These tasks—challenging at any time—were made more difficult by a litany of headline-grabbing scandals. Some of the misconduct in these scandals was illegal—a crime or regulatory violation. Other misconduct was arguably legal but

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Supervised by the Fed. Reserve (Oct. 16, 2008), https://www.federalreserve.gov/boarddocs/srletters/2008/SR0808.htm [https://perma.cc/ATE4-C68U].

10. BD. OF GOVERNORS OF FED. RESERVE SYS., BANK HOLDING COMPANY SUPERVISION MANUAL § 2126.0.5 (2019).

11. BD. OF GOVERNORS OF FED. RESERVE SYS., TRADING AND CAPITAL MARKETS ACTIVITIES MANUAL § 2150.1 (2011).

12. *See generally* CAPITAL FAILURE: REBUILDING TRUST IN FINANCIAL SERVICES 15–16 (Nicholas Morris & David Vines eds., 2014).

13. William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the Global Economic Policy Forum: Ending Too Big to Fail (Nov. 7, 2013), https://www.newyorkfed.org/newsevents/speeches/2013/dud131107.html [https://perma.cc/LP76-JYYA].

nonetheless unethical or reckless. Some misconduct pre-dated the financial crisis. Some coincided with it. And some occurred after 2009.

Many of our colleagues have particular examples that caused them to say, "Enough, already!" For Dudley, it was the manipulation of the London Inter-Bank Offered Rate (LIBOR)—arguably the most important benchmark in finance—and of foreign exchange (FX) rates.[14] At their core, these scandals involved the collaboration by traders at multiple firms to achieve benchmark or exchange rates that did not reflect actual market conditions. For LIBOR, multiple firms admitted to fraud in the submission of rates to the trade association that published LIBOR. The conduct by traders at Deutsche Bank, one of several banks that pleaded guilty to LIBOR-related violations, is indicative of similar conduct across the industry:

> [F]rom at least 2003 through early 2011, numerous Deutsche Bank derivatives traders—whose compensation was directly connected to their success in trading financial products tied to LIBOR—engaged in efforts to move these benchmark rates in a direction favorable to their trading positions. Specifically, the derivatives traders requested that LIBOR submitters at Deutsche Bank and other banks submit contributions favorable to trading positions, rather than rates that complied with the definition of LIBOR. Through these schemes, Deutsche Bank defrauded counterparties who were unaware of the manipulation.[15]

In the FX context, several firms pleaded guilty to conspiring to rig the foreign exchange market in violation of the Sherman Antitrust Act.[16] As the Department of Justice explained,

> Members of "The Cartel" manipulated the euro-dollar exchange rate by agreeing to withhold bids or offers for euros or dollars to avoid moving the exchange rate in a direction adverse to open positions held by co-conspirators. By agreeing not to buy or sell at certain times, the traders protected each other's trading positions by

14. *See* DAVID HOU & DAVID SKEIE, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 667, LIBOR: ORIGINS, ECONOMICS, CRISIS, SCANDAL, AND REFORM (2014); *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Announces Fines Totaling More Than $1.8 Billion Against Six Major Banking Organizations for Their Unsafe and Unsound Practices in Foreign Exchange (FX) Markets (May 20, 2015), https://www.federalreserve.gov/newsevents/pressreleases/enforcement20150520a.htm [https://perma.cc/72J7-G4R2].

15. Press Release, U.S. Dep't of Justice, Deutsche Bank's London Subsidiary Agrees to Plead Guilty in Connection with Long-Running Manipulation of LIBOR (Apr. 23, 2015), https://www.justice.gov/opa/pr/deutsche-banks-london-subsidiary-agrees-plead-guilty-connection-long-running-manipulation [https://perma.cc/XHF3-GP6N].

16. *See generally* 15 U.S.C. § 1 (2018).

withholding supply of or demand for currency and suppressing competition in the FX market.[17]

The firms that pleaded guilty also paid billions of dollars in fines as a result of this conduct. A number of traders were indicted for LIBOR and FX manipulation, and many (although not all) were convicted. Three features of these scandals stood out.

First, the misconduct was not limited to one particular firm. The essence of these scandals was collusion across multiple firms. The manipulation schemes depended on contacts among traders at multiple banks in order to be successful. To some extent, the misconduct reflected the labor market. Some traders changed jobs frequently. A professional network at multiple firms made it easier to find another job. The traders involved in these scandals may have perceived loyalty to peers as more important than loyalty to employers. The norms that existed among this group of traders—that made it acceptable to help each other regardless of obligations to firms or clients—signaled a cultural problem, not just a control or compliance failure.

Second, the misconduct undermined the trustworthiness of products on which the real economy relied. The investigations, however, produced no evidence that the traders involved considered the consequences of their decisions on others—at least, none so far as we are aware. LIBOR and foreign exchange rates were just numbers. Trading was just a game. But, as colleagues at the New York Fed have explained, "[t]he impact of employee misconduct extends beyond the individual and can [affect] the firm as a whole and the economy and financial markets more broadly."[18]

Third, these two scandals occurred sequentially. The bankers involved in FX manipulation knew that their firms were under investigation for LIBOR manipulation and that the investigations had found evidence of collusion in recorded chat rooms. They continued to use chatrooms anyway to exchange favors.

The financial crisis and subsequent scandals like LIBOR and FX manipulation prompted others to ask similar questions. In 2014, under the leadership of Sir David Walker, Barclays published a report by Anthony Salz on the root causes of misconduct at that bank.[19] Called the Salz Review, the report assessed root causes of an observed "gap between Barclays' articulated values and the way the bank operated in practice,"

17. Press Release, U.S. Dep't of Justice, Five Major Banks Agree to Parent-Level Guilty Pleas (May 20, 2015), https://www.justice.gov/opa/pr/five-major-banks-agree-parent-level-guilty-pleas [https://perma.cc/U948-B38H].

18. STEPHANIE CHALY ET AL., FED. RESERVE BANK OF N.Y., MISCONDUCT RISK, CULTURE, AND SUPERVISION 3 (2017).

19. *See* BARCLAYS, BUILDING THE 'GO-TO' BANK 126–29 (2014).

and recommended reforms.[20] The report concluded, among other things, that "the business practices for which Barclays has rightly been criticized were shaped predominantly by its cultures, which rested on uncertain foundations."[21] Around the same time, the United Kingdom's Parliamentary Commission on Banking Standards looked across the industry, and summed up its views:

> [T]he weakness in standards and culture that has contributed to the loss of public trust in banks has not been confined to isolated parts of a few sub-standard banks. It has been more pervasive. Trust in banking can only be restored when it has been earned, and it will only have been earned when the deficiencies in banking standards and culture, and the underlying causes of those deficiencies, have been addressed.[22]

Other central banks were early contributors to the discussion. Mark Carney, Governor of the Bank of Canada and, later, the Bank of England, was an early thought leader. He exhorted banks to safeguard their "social license"[23] and encouraged them to consider basic questions about their purpose. "Who does finance serve? Itself? The real economy? Society? And to whom is the financier responsible? Herself? His business? Their system? The answers start from recognising that financial capitalism is not an end in itself, but a means to promote investment, innovation, growth, and prosperity."[24]

Talk of banks serving society, or of having both public purposes and private purposes, made some observers uncomfortable. In our view, financial institutions—and banks in particular—are not like other corporations. Banks play a structural role in the economy. That position allows them to affect others, which, by necessity, requires them to make decisions in the interest of the system. In recognition of that role, banks

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20. ANTHONY SALZ, SALZ REVIEW: AN INDEPENDENT REVIEW OF BARCLAYS' BUSINESS PRACTICES 2 (2013).

21. *Id.*

22. 1 HOUSE OF LORDS & HOUSE OF COMMONS, PARLIAMENTARY COMM'N ON BANKING STANDARDS, CHANGING BANKING FOR GOOD 15 (2013).

23. Mark Carney, Governor, Bank of Eng., Speech at the Monetary Authority of Singapore: The Future of Financial Reform 12 (Nov. 17, 2014), https://www.bankofengland.co.uk/-/media/boe/files/speech/2014/the-future-of-financial-reform.pdf?la=en&hash=670D969367D2A4BA5D5881F1DF4F3172836F8706 [https://perma.cc/9UNF-87U4] ("[T]rust between the public and the financial system is needed to maintain the social license for finance to operate. . . . Without that license, the door will be opened to a level of regulation that constrains the ability of finance to innovate and support growth and trade efficiently.").

24. Mark Carney, Governor, Bank of Eng., Speech at the Conference on Inclusive Capitalism: Inclusive Capitalism: Creating a Sense of the Systemic 8 (May 27, 2014), https://www.bankofengland.co.uk/-/media/boe/files/speech/2014/inclusive-capitalism-creating-a-sense-of-the-systemic.pdf?la=en&hash=B727934359BD632AACCD4B65ACC36B9D7CD91966 [https://perma.cc/MSF5-W9J9].

receive tremendous operating benefits that are not available to other industries—access to the discount window, for example.[25] The receipt of these benefits is what the public thinks of as a critical stakeholder (and, in a distressed firm, as a shareholder or significant creditor), to whom banks are accountable. After all, if banks do not somehow act for the benefit of the public, why should they receive the benefits from the public? Finally, banks hold themselves out as trustworthy custodians, and people trust them with their resources for a better future. The costs of dishonesty are too high for people who entrust their savings to banks and who depend in so many ways on a properly functioning financial system.[26]

B. Limits of Statutes and Regulation

The attempted manipulation of LIBOR and FX were not the only scandals to make headlines following the financial crisis. Often, problems at one firm appeared at other firms. In our experience, many of these scandals shared a common root cause: the technical aspects of rules can obscure their social purposes. As lawyers, this pattern jumped out at us. But before we saw these scandals as failures of culture, we saw them as exposing the limits of what statutes and regulations can achieve.

For example, BNP Paribas and Credit Suisse faced criminal indictments for facilitating the evasion of U.S. sanctions and taxation, respectively.[27] In both cases, legal requirements were seen as technicalities—as games companies can outsmart. The moral salience of the sanctions against Sudan, or of paying one's taxes to the society in which one earns a living, was not relevant. Instead, the organizational goal of client service—in processing payments or facilitating flight capital—clashed with and superseded public policy.[28]

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25. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM PURPOSES & FUNCTIONS 42–44 (10th ed. 2016).

26. *See* Michael Strine, First Vice President, Fed. Reserve Bank of N.Y., Remarks at the Symposium Celebrating the 50th Anniversary of the Frank G. Zarb School of Business at Hofstra University and Looking Ahead to the Next 50 Years of Business Education: Forming the Next Generation of Bankers: The Future of Business Education and Ethics (Mar. 22, 2016), https://www.newyorkfed.org/newsevents/speeches/2016/str160322 [https://perma.cc/ER82-XYWK].

27. *See* Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent Pursuant to the Federal Deposit Insurance Act, as Amended, In the Matter of BNP Paribas S.A., Docket No. 14-022-B-FB (Bd. of Governors of the Fed. Reserve Sys. & Autorite de Controle Prudentiel et de Resolution June 30, 2014); Order to Cease and Desist and Order of Assessment of Civil Money Penalty Issued Upon Consent Pursuant to the Federal Deposit Insurance Act, as Amended, In the Matter of Credit Suisse AG, Docket No. 14-009-B-FB (Bd. of Governors of the Fed. Reserve Sys. May 19, 2014).

28. *See* Thomas C. Baxter, Exec. Vice President & Gen. Counsel, Fed. Reserve Bank of N.Y., Remarks at the New Compliance Landscape: Increasing Roles – Increasing Risks Conference: Reflections on the New Compliance Landscape (July 23, 2014), https://www.newyorkfed.org/newsevents/speeches/2014/bax072314 [https://perma.cc/UY98-6UWD].

A lack of "other-regarding" conduct[29] was also evident in an example of civil enforcement by the Federal Energy Regulatory Commission (FERC) against JPMorgan Ventures Energy Corporation, a direct subsidiary of JPMorgan Chase & Co. (JPMorgan).[30] A division of JPMorgan owned output contracts from several older power plants in California. These plants, which burned fossil fuels to produce power, were profit-generating in periods of high energy consumption.[31] However, they were overall money-losers because their cost of energy was much higher than solar- or wind-based power production. JPMorgan's traders discovered a loophole in bidding regulations published by California's state energy authority. If an older plant were selected to produce power in an auction among power providers for any given hour, it would also receive a contract to produce power for the two hours on either side. This was called "ramping up" and "ramping down" and was necessary because power plants cannot just be turned on and off—turbines need time to spin, both when coming on-line and going off-line.[32]

JPMorgan's traders knew that their aging plants could never compete on cost, so what could they do? FERC's enforcement order chronicles twelve bidding strategies that took advantage of the market administrator's bidding platform. In one of the strategies, the traders realized that if they submitted a below-market bid between 11:00 p.m. and midnight, California's auction algorithm would select it, even though the bid was money-losing. The purpose was not to win the auction for that hour, but to take advantage of "ramping up" and "ramping down" rules. In their submission for the following day, the traders would enter bids at the system maximum ($999/MWh) for the hours after midnight, even though the market price was $12/MWh range, knowing the bidding regulations required payment to these aging plants.[33] They made a fortune; JPMorgan ultimately agreed to a $125,000,000 disgorgement of unjust profits in addition to a $285,000,000 penalty.[34] They also increased the cost to consumers during those five hours. These and other facts stipulated to by JPMorgan led FERC's enforcement division to conclude that the firm's

29. *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, 217 (2013) (The "norm of 'other regarding' behavior within financial services firms, [as] one which, to the fullest extent possible, attempts to induce firms to take into account the private and social costs of their decisions.").

30. *See* Order Approving Stipulation and Consent Agreement, Make-Whole Payments and Related Bidding Strategies, 144 FERC ¶ 61,068 (Jul. 13, 2013).

31. *Id.* at 4.

32. *Id.* at 9.

33. *Id.* at 10–11.

34. *Id.* at 1.

> bids were not grounded in the normal forces of supply and demand, and they were expected to, and did, lose money at market rates. [JPMorgan's] purpose in submitting the bids was not to make money based on market fundamentals, but to create artificial conditions that would cause the [market administrator] to pay [JPMorgan] outside the market at premium rates.[35]

Who uses power in the middle of the night? Hospitals and other critical infrastructure—places like fire stations, police stations, water treatment plants, and other installations that cannot go off-line. Did the consequences of their trades ever occur to the energy traders at JPMorgan? Or were they playing a game that, in their culture, was independent of any real-world consequences?

In each of the foregoing examples, technical rules arguably obscured the reasons for enacting the rules in the first place. Or, at the very least, they appear to have induced bankers to adopt a posture of gamesmanship. Technical rules raise questions about the limits of what laws and regulations can accomplish. The variations of this principle will be familiar to those schooled in public policy. It is impossible to create a rule for every situation. Gaps in a regulatory regime are inevitable.[36] Groups will develop shared norms for filling those gaps. So, for that reason alone, we need to look to culture as well as laws for solutions.

In addition, the pace of rulemaking is not always commensurate with the pace of rule-breaking. Focusing exclusively on rulemaking creates a risk of fighting last year's scandal. What is more, laws are good at setting the outer limit of acceptable behavior—behavior that is clearly prohibited. They are less frequently and less reliably used to define what is optimal or what is good.[37] A regime dependent on bright-line rules may, strangely, entice people to walk right up to the edge of a rule—or to find creative ways around the rules. A proliferation of technical rules prompts us to ask what we *can* do, not what we *should* do. Another way of looking at this problem is that technical rules also present a bright line where little judgment is required. When individuals do not have to apply judgment often, they get out of practice. We do not make good judgments when we

35. *Id.* at 14.

36. *See* Awrey et al., *supra* note 29, at 199 ("It would be extremely costly in most cases, if not entirely impossible, to articulate legal rules which envision the entire universe of potential future states of the world. These costs invariably give rise to gaps between what the law *says*, on the one hand, and what its drafters (freed from the shackles of imperfect information, bounded rationality, and other constraints) would have *wanted it to say*, on the other." (emphasis added)).

37. Michael Held, Exec. Vice President, Fed. Reserve Bank of N.Y., Remarks at Yale Law School's Chirelstein Colloquium: Reforming Culture and Conduct in the Financial Services Industry - How Can Lawyers Help? 3 (Mar. 2017), https://www.newyorkfed.org/newsevents/speeches/2017/hel170308 [https://perma.cc/R2AM-63BD].

usually do not have to make judgments at all. Our moral or ethical muscle memory can grow weak without a workout.

Enforcement actions cannot be the only remedy. Enforcement is after-the-fact, and its power to deter future misconduct is uncertain. Criminal enforcement requires proof of state-of-mind, which can be difficult to determine in a corporate setting when many people (including lawyers) are involved in decision-making. Prosecutors and civil enforcement authorities must make difficult resource allocation decisions that preclude them from responding to every offense, thus limiting the deterrent effect of their powers.

In short, rules are necessary, but not sufficient. Culture—the shared norms of an organization—also contributes to behavior and decision making. We return, therefore, to a view espoused by Gerald Corrigan almost four decades ago: banks have "unique public responsibilities and may therefore be subject to implicit codes of conduct or explicit regulations that do not fall on other institutions."[38] There is arguably a need for greater emphasis on the implicit codes or norms that can support or undermine explicit regulations.

C. A Role for Prudential Supervision?

Other members of the New York Fed's working group on culture were in the Supervision Group. While the lawyers tended to look at the limits and unintended effects of laws and regulations, supervisors began to consider culture through the lenses of microprudential and macroprudential supervision.

As noted above, supervision is a distinctive feature of banking oversight.[39] Supervisors at the Federal Reserve and many other central banks generally speak of two types of supervision: microprudential and macroprudential. Microprudential supervision refers to supervision that is largely firm-specific. Its purpose is to make sure that banks are "run in a 'prudent' and 'safe and sound' manner and are not taking excessive risks."[40] This makes banks less likely to fail, avoiding adverse consequences to customers.[41] Macroprudential supervision, by contrast, refers to supervision of the financial system. Its byword is "stability," and it seeks to avoid another financial crisis by examining "(1) risks that can arise because of substantial interconnections among financial firms and (2) risks that can develop more broadly in the financial system, including at

38. FED. RESERVE BANK OF MINN., ANNUAL REPORT OF 1982: ARE BANKS SPECIAL? (1982).

39. *See* BD. OF GOVERNORS, *supra* note 1. Certain non-bank financial institutions are also subject to supervision, but we will discuss only banks here to keep things simple.

40. *See* BD. OF GOVERNORS, *supra* note 1, at 57.

41. *Id.* at 58.

other financial institutions, in financial markets, and in the general market infrastructures."[42]

From a microprudential perspective, an assessment of a firm's culture may provide insight into how to avoid certain risky behavior. One dimension of microprudential supervision where culture may be particularly relevant concerns a firm's legal and compliance risks.[43] Employee misconduct—which in many instances may be the result of a poor corporate culture—often has legal consequences for firms. At the very least, it may consume resources on internal investigations, lead to costly controls and regulatory penalties, divert management attention from revenue-generating projects, and damage a firm's public reputation.

Early in our work in culture, we held several conversations with prosecutors and defense attorneys (many of whom were former prosecutors) about why corporate employees commit financial crimes. We heard some of what is described as a "cost-benefit" approach to following the law—that is, a conscious or subconscious weighing of the likelihood of getting caught against the possible outcomes. Largely, however, the answers struck us as more "cultural" and less calculating than we expected. Peer pressure, or the desire to be liked, was one common explanation, especially for more junior employees. A misguided desire to "help the company" also drove many not only to commit misconduct, but also to cover it up. Employees with track records of success also commonly experienced a fear of failure. These employees who committed misconduct may have felt pressure to preserve a self-image, apart from any financial benefit. Finally, the allegiances of the traders involved in the LIBOR and FX scandals, in particular, appeared to run toward one another, almost as a guild of traders, rather than to their employers or customers. In sum, an individual employee's perceptions of peer practices, corporate expectations, professional loyalties, and personal reputation all contributed to poor decisions and behaviors. The factors, therefore, are relevant to the supervision of legal and compliance risk.

Preet Bharara, the former U.S. Attorney for the Southern District of New York, has presented a more structured view of the cultural factors that contribute to corporate crime. In his experience, three types of cultures

42. *Id.* at 99.

43. The Board of Governors defines "compliance risk" as "the risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution," and "legal risk" as "the potential that actions against the institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution." BD. OF GOVERNORS OF THE FED. RESERVE SYS., SUPERVISORY GUIDANCE FOR ASSESSING RISK MANAGEMENT AT SUPERVISED INSTITUTIONS WITH TOTAL CONSOLIDATED ASSETS LESS THAN $50 BILLION 1 (2016).

tend to yield misconduct: minimalism, formalism, and silence.[44] "Minimalism" is the attitude of doing as little as possible to comply with the rules. "Formalism" is the quality of equating what's right with what's legal. "Silence" is not raising your hand when you see something that is wrong. These three models of culture may also contribute to decisions and behaviors that are ill-advised, if not illegal. Remaining silent in a new product vetting meeting, for example, could limit the effectiveness of a discussion about the propriety of the product for certain types of customers. Focusing narrowly on technical minima in conducting customer due diligence reviews could lead analysts to overlook broader trends that may affect the firm's risk management.

There is another, perhaps more direct reason why culture matters to a firm's legal risk. Federal prosecutors consider a corporation's culture in deciding whether to indict the firm. Two of the ten factors in the Department of Justice's "Principles of Federal Prosecution of Business Organizations" expressly address culture.[45] When prosecutors consider a firm's "history of similar misconduct," one of the ten factors, they do so because "[a] history of similar misconduct may be probative of a corporate culture that encouraged, or at least condoned, such misdeeds, regardless of any compliance programs."[46] Similarly, in considering the "pervasiveness of wrongdoing," another of the factors, prosecutors are advised that "the most important [factor] is the role and conduct of management. Although acts of even low-level employees may result in criminal liability, a corporation is directed by its management and management is responsible for a corporate culture in which criminal conduct is either discouraged or tacitly encouraged."[47] Given the scale of penalties for corporate crime, it makes sense that firms manage their cultures as part of managing their legal risk.

Turning to macroprudential concerns, some aspects of culture appeared to be common to the industry, not unique to specific firms. Misconduct following the financial crisis was too frequent and widespread to blame credibly a few "bad apples." Some common cultural norms may have also contributed to the financial crisis itself. As the Financial Crisis Inquiry Commission observed, industry norms—in particular, the "erosion

44. Hon. Preet Bharara, U.S. Attorney, S. Dist. of N.Y., Remarks at the Federal Reserve Bank of New York's Conference: Criminal Accountability and Culture (Oct. 20, 2016), https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/PreetBharara-Remarks-Culture-Conference [https://perma.cc/FJA8-HRNZ].

45. U.S. DEP'T OF JUSTICE, JUSTICE MANUAL § 9-28.300 (2018).

46. U.S. DEP'T OF JUSTICE, JUSTICE MANUAL § 9-28.600(B) (2008).

47. U.S. DEP'T OF JUSTICE, JUSTICE MANUAL § 9-28.500(B) (2008).

of standards of responsibility and ethics"—were partially to blame for the crisis.[48]

The empirical case for considering culture as a macroprudential risk has not been highly elaborated. Still, around the time that the New York Fed's work on culture began, others were already persuaded that some connection exists. The Financial Stability Board, for example, argued in 2014 that "weaknesses in risk culture are often considered a root cause of the global financial crisis, headline risk and compliance events."[49] The same year, regulators in the United Kingdom observed that "the behaviour and culture within banks played a major role in the 2008–2009 financial crisis and in conduct scandals such as Payment Protection Insurance (PPI) mis-selling and the attempted manipulation of LIBOR."[50]

There were at least three arguments for treating industry culture as a macroprudential concern: *First*, a poor culture could undermine efforts to improve the stability of the financial system. Higher capital requirements, more realistic liquidity and funding analyses, and new compliance and reporting enhancements were important bulwarks against another systemic collapse. But, as the Financial Stability Board has stated, "fines and redress payments are losses that deplete the loss-absorbing capacity of a financial institution."[51] Moreover, if the people managing capital cushions fail to do so responsibly, or if powerful incentives exist to work around regulatory reporting requirements, these reforms could become illusory.[52]

Second, the industry has, in the eyes of many, become characterized by misconduct, which has eroded its trustworthiness. One report by the Financial Stability Board observed that "the scale in some financial institutions has risen to a level that has the potential to create systemic risks and undermine trust in financial institutions and markets."[53] Substitutes for trustworthiness tended to be expensive, putting pressure on

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48. THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, at xxii (2011).

49. FIN. STABILITY BD., GUIDANCE ON SUPERVISORY INTERACTION WITH FINANCIAL INSTITUTIONS ON RISK CULTURE: A FRAMEWORK FOR ASSESSING RISK CULTURE 1 (2014). The paper did not endorse a particular definition of "risk culture," but referred in a footnote to a working definition proposed by the International Institute of Finance: "norms of behaviour for individuals and groups within an organisation that determine the collective ability to identify and understand, openly discuss and act on the organisations current and future risk." *Id.* at 1 n.6.

50. BANK OF ENG. PRUDENTIAL REGULATION AUTH., STRENGTHENING ACCOUNTABILITY IN BANKING: A NEW REGULATORY FRAMEWORK FOR INDIVIDUALS 5 (2014).

51. FIN. STABILITY BD., STOCKTAKE OF EFFORTS TO STRENGTHEN GOVERNANCE FRAMEWORKS TO MITIGATE MISCONDUCT RISKS 1 (2017).

52. *See also* 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, 204 (2013) (pointing out that post-crisis statutes and regulations "share a common approach . . . which attempts to dictate or directly influence how market participants act. They do not, however, attempt to mold how people think when they act").

53. FIN. STABILITY BD., *supra* note 51, at i.

bank balance sheets and the ability of the industry to meet the needs of customers. As Bill Dudley explained,

> The short-term consequences of a lack of trustworthiness—such as supervisory orders, fines, or other civil or criminal penalties—may be finite and passing. The long-term consequences, however, may be more serious and enduring. Increased regulation—sometimes an inefficient substitute for trust—could limit the scope and scale of activities of financial firms. Employees may choose to apply their talents in other, less controversial fields instead of finance. Customers might look outside of traditional channels for financial services. Shareholders could downgrade their expectations about future returns and reduce their exposures to the financial sector.[54]

These are long-term risks to financial stability. We tend to think of the long-term challenges facing financial services as technological. They may also be cultural.

Third, and perhaps most important, pervasive misconduct erodes public support for intervention in times of crisis. Despite well-meaning efforts, financial crises appear unavoidable from a historical perspective. The public (or political) will to intervene depends on an assessment of the industry's utility. In times of crisis, the question is ultimately very simple: Are we better off with the industry? If owing to a loss of trustworthiness, that answer is "no," then financial stability may suffer. Our effectiveness to intervene in a crisis is limited by the public's will to allow an intervention. Why would the public want us to intervene to save an industry that is not trusted?

Regulators and supervisors should be concerned about the industry's culture because an industry characterized by misconduct reflects poorly on its regulators and supervisors. Accountability demands that the official sector answer the question: "If misconduct is a grave problem, are you doing all you can to stop it?" If we are not looking at all the possible root causes of misconduct, including organizational culture, we may not be able to respond to that question with an honest "yes."

III.

Central banks and other regulators and supervisors across the world have pursued varied approaches to culture. Volumes could be (and, in some cases, have been) written about these initiatives. Our contribution

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54. William C. Dudley, Former President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at Reforming Culture and Behavior in the Financial Services Industry: Strengthening Culture for the Long Term 1–2 (June 18, 2018), https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/Dudley-cultureconference-180618.pdf [https://perma.cc/8PZD-T5VT].

here is organizing these efforts into categories and giving them context by arranging them on a spectrum to facilitate a studied comparison. In our view, the official sector has pursued five distinct approaches to culture, listed here in order of increasing prescription: (i) convening, speaking, and publishing; (ii) offering official guidance; (iii) incorporating behavioral science concepts in supervision; (iv) mandating self-assessment; and (v) issuing new accountability regulation. These approaches are not mutually exclusive and are often used in conjunction.

A. Convening, Speaking, and Publishing

The most common and least prescriptive approach is to use central bank or regulatory convening power and the bully pulpit. Many authorities have summoned the industry (a captive audience) to panels and conferences about the importance of culture, and many public sector leaders have been outspoken about the importance of the subject. In addition to Mark Carney,[55] Norman Chan, the Chief Executive of the Hong Kong Monetary Authority,[56] and Christine Lagarde, the President of the European Central Bank and former Managing Director of the International Monetary Fund,[57] are two outspoken proponents of the importance of improving culture in financial services.

Some public authorities have reported publicly on the results of inquiries into supervised firms. The Central Bank of Ireland, for example, examined five retail banks in light of a post-crisis mortgage scandal.[58] Its report criticized the banks for a culture that prized short-term financial goals over consumer protection and created a sense of over-optimism when those short-term goals were exceeded.[59] In addition, the banks had failed to manage cultural norms ahead of misconduct, resulting in a "firefighting" approach to scandal.[60] The Central Bank of Ireland recommended that the five banks pursue stronger diversity initiatives to

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55. *See* Carney, *supra* note 23 at 13; Carney, *supra* note 24, at 9–10.

56. Norman T.L. Chan, Chief Exec., H.K. Monetary Auth., Speech at Asian Banker Summit: How Can the Banking Industry Regain the Moral and Ethical Highground it Once Enjoyed Before the Global Financial Crisis (Apr. 15, 2015), https://www.hkma.gov.hk/eng/news-and-media/speeches/2015/04/20150415-1 [https://perma.cc/23N3-TUBN] ("[T]here is considerable public interest in ensuring that banking, which remains the predominant channel of intermediation between savers and borrowers in our society, functions efficiently and effectively, with a high degree of professionalism and strong ethical standards.").

57. *See* Christine Lagarde, Managing Dir. of the Int'l Monetary Fund, Address at the Conference on Inclusive Capitalism: Economic Inclusion and Financial Integrity (May 27, 2014), https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp052714 [https://perma.cc/V69A-K7ZG] ("Trust is the lifeblood of the modern business economy . . . . To restore trust, we need a shift toward greater integrity and accountability. We need a stronger and systematic ethical dimension.").

58. CENT. BANK OF IR., BEHAVIOUR AND CULTURE OF THE IRISH RETAIL BANKS 5 (2018).

59. *Id.* at 1–5.

60. *Id.*

combat organizational silos and evidence of "group think" within those silos.[61]

Another example is the Australian Prudential Regulation Authority's report of its inquiry into the Commonwealth Bank of Australia, a bank with multiple misconduct scandals.[62] The report concluded that sustained success, especially through the financial crisis, "dulled the senses of the institution." Year after year, the firm under-valued and under-invested in compliance and other risk management functions. As a result, the firm made key decisions without adequate challenge, did not hold individuals accountable, and overlooked customer interests and complaints. These flaws were the product of "cultural factors," many of which were also identified by the Central Bank of Ireland in its report. Beyond complacency attributable to sustained financial success, the Commonwealth Bank of Australia suffered from a lack of self-reflection, a reactive approach to risks, and an overemphasis on consensus at the expense of diverse points of view.

B. Official Guidance

Beyond speeches and publications, several authorities have issued official guidance about culture. Guidance is an agency's official statement of policy. It often contains interpretations of laws and regulations, and recommendations for compliance, but it lacks the legal power to compel adherence.

For example, the Hong Kong Monetary Authority published guidance on culture in March 2017.[63] Its approach sets out three pillars for a sound corporate culture: governance, incentives, and assessment. The governance pillar emphasized traditional notions—"tone from the top," for example—and provided more granular recommendations, such as a board-level committee dedicated to culture. The committee would "review and confirm the effectiveness of the overall culture enhancement initiatives pursued by the institution."[64] Regarding incentives, the guidance recommended a separate performance rating for adherence to corporate values. A separate performance rating would focus the attention of managers and staff on demonstrating their embrace of those principles throughout the year. The guidance also recommended monetary rewards

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61. *Id.*

62. *See generally* AUSTL. PRUDENTIAL REGULATORY AUTH., PRUDENTIAL INQUIRY INTO THE COMMONWEALTH BANK OF AUSTRALIA FINAL REPORT (2018) (explaining the scandals associated with the Commonwealth Bank of Australia).

63. Letter from H.K. Monetary Auth., to the Chief Exec., All Authorized Institutions 1–3 (Mar. 2, 2017), https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2017/20170302e2.pdf [https://perma.cc/W3RE-KD4Z].

64. *Id.* at 2.

and recognition for staff demonstrating exemplary behavior. For the third pillar—assessment—the Hong Kong guidance encouraged firms to implement escalation policies that include confidential channels so that staff could raise concerns about illegal or unethical conduct without fear of reprisal.

Another example below explains the Financial Conduct Authority's guidance on the United Kingdom's new "Conduct Rules." The official rules are framed positively ("You shall," as opposed to "You shall not") and at a very high level (for example, "You shall act with integrity"). Official guidance, however, offers multiple examples, drawn from actual supervisory findings and enforcement actions, of how each of those principles may be violated—the "You shall nots." For example, Rule 1 is "You shall act with integrity." Official guidance supplements these principles with real world examples of potential violations. The rule of integrity would prohibit, among other things, falsifying documents, mismarking the value of investments or trading positions, providing altered prices on illiquid or off-exchange contracts, providing false or inaccurate information to a regulator, failing to disclose personal account dealings, designing transactions to disguise breaches of law or regulation, or failing to inform a customer about a material issue.[65]

C. Behavioral Science and Supervision

The Dutch central bank pioneered behavioral science into supervision (De Nederlandsche Bank, or "DNB"). Its supervisors literally wrote the book on incorporating behavior science in supervision.[66]

The DNB launched its Governance, Culture, and Organizational Behavior Supervision Program in 2010. The program team is comprised of experienced supervisors and industrial or organizational psychologists. Its premise is that behavior has a predictive value with respect to future performance—i.e., risky behavior may already be apparent before financial performance is compromised. Therefore, it makes sense to examine behavior to mitigate bad outcomes.

The Dutch approach focused on two aspects of culture: group dynamics and change. In the first, supervisors look for "patterns in decision-making, leadership, communication, group dynamics and mindsets of . . . management boards," assess the risks of those patterns to that particular institution, and recommend changes.[67] These groups tend to exhibit similar patterns of behavior, including CEO dominance, a lack of

65. FIN. CONDUCT AUTH., CODE OF CONDUCT § 4 (2019).

66. *See* DE NEDERLANDSCHE BANK, SUPERVISION OF BEHAVIOR AND CULTURE: FOUNDATIONS, PRACTICE & FUTURE DEVELOPMENTS (2015).

67. *Id.* at 19.

effective challenge, and a lack of self-reflection. In the second type of review, supervisors assess "the ability of financial institutions to implement major changes."[68] Changes are not only necessary in times of acute stress. Change has more generally become a way of life for financial services firms, which must contend with new competition, new customer expectations, and new technology. The key concern in this review is how firms are able to set priorities among the many dynamic conditions they face.

These reviews are data driven. To conduct a review, DNB specialists consult with the dedicated supervisory team to select one or two concrete decisions for review.[69] Examples might include a decision on strategy (whether or not to restart a particular line of business), personnel (a c-suite selection viewed by the lead supervisor as unsuccessful), or a cultural issue illustrating the mindset of the organization (people do not feel that they have job security). The team then looks at who was involved in the decision, what process, rationale, or influence was used to arrive at the decision, and any documents available about the decision. Much of the review comprises desk research,[70] but the DNB also uses self-assessment forms, interviews, and, to a limited extent, direct observations of board or executive committee meetings.[71] In presenting their findings, the DNB specialists do not opine on the wisdom or technical soundness of the outcome of a decision—although those aspects of a decision may be reviewed by supervisors for other purposes. Rather, the specialists offer feedback and suggestions on the process for arriving at a particular decision based on observable behaviors, the norms, and the group dynamics that those behaviors evidence. The DNB has implemented safeguards to avoid individual examiner bias and intuition from influencing supervisory conclusions, including rigorous peer challenge.[72]

D. Mandatory Self-Assessment

Since 2014, some foreign supervisors have made self-assessment mandatory for supervised firms. The United Kingdom's Financial Conduct Authority (FCA) introduced its "5 Conduct Questions Programme" in 2015.[73] It is, in our view, a practice leader. The five questions that target the risk of misconduct are:

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68. *Id.* at 20.
69. *Id.* at 76.
70. *Id.* at 75.
71. *Id.* at 77–83.
72. *Id.* at 85–86.
73. *5 Conduct Questions Programme*, FIN. CONDUCT AUTH. (May 28, 2019), https://www.fca.org.uk/firms/5-conduct-questions-programme [https://perma.cc/Z5BJ-E9QZ].

1. What proactive steps do you take as a firm to identify the conduct risks inherent within your business?
2. How do you encourage the individuals who work in front, middle, back office, control, and support functions to feel and be responsible for managing the conduct of their business?
3. What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?
4. How does the Board and [senior management] gain oversight of the conduct of business within their organization and, equally importantly, how does the Board or [senior management] consider the conduct implications of the strategic decisions that they make?
5. Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?[74]

The FCA poses these questions to banks in the wholesale market—approximately thirty firms. The purpose of the questions is to prompt discussion within firms about culture and conduct and their effects on risk management. For three years running, the FCA has published summaries of firm responses and a horizontal supervisory assessment.[75] The key message in the 2018 report was that some firms have fallen behind peers in their efforts to mitigate misconduct risk.[76] The report provided examples of both strong and weak approaches as a benchmark. A focus of the 2019 report was on "speak-up culture"—"the willingness and opportunities for staff to challenge and discuss issues as a normal day-to-day activity, including escalating issues where needed."[77] The FCA found that, in general, firms had programs that facilitated and channeled employee feedback and whistleblowing, but struggled to change the mindset that this manner of communication was acceptable and encouraged.

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74. FIN. CONDUCT AUTH., '5 CONDUCT QUESTIONS': INDUSTRY FEEDBACK FOR 2017, at 2 (2018).

75. *5 Conduct Questions Programme*, *supra* note 73.

76. FIN. CONDUCT AUTH., *supra* note 74, at 4 ("While many of the larger firms have marshalled the resources for these important initiatives, many firms still remain in early planning stages. Conduct is important for the whole of the financial services industry. Larger firms who have prioritised other initiatives and smaller firms that may lack the immediate resources to launch comprehensive programmes still face the downside risks that arise from poor conduct.").

77. FIN. CONDUCT AUTH., 'PROGRESS AND CHALLENGES': 5 CONDUCT QUESTIONS INDUSTRY FEEDBACK FOR 2018/19, at 5 (2019). Later in the report, the FCA described the related concept of "psychological safety" as confidence that employees "can speak up and won't be humiliated, ignored, or blamed." *Id.* at 10.

Mandatory self-assessment is a feature of the Hong Kong Monetary Authority's recent update of its supervisory program on culture.[78] Supervised firms must ask how their governance structures and policies influence their organizational culture, implement changes, and report on their progress. Firms are encouraged to include lessons learned in the course of their work as a way of avoiding a "check-the-box" approach to complying with the new self-assessment requirement. Supervisors will review reports, conduct focus groups to confirm their content, and provide feedback to firms.

E. Individual Accountability Regimes

Individual accountability regimes impose new statutory and regulatory duties on individual bankers and new oversight responsibilities on supervisors. A focus on accountability for senior leaders, in particular, may prompt them to invest time and other resources in understanding and mitigating the root causes of prior misconduct.

In recent years, the United Kingdom has overhauled its financial regulation to promote a culture of responsibility and trustworthiness in financial services. New legislation mandated regulators to introduce tougher rules in relation to individual accountability.[79] Those regulators, in turn, issued new rules designed expressly to "shape the culture, standards and policies of a firm as a whole and . . . promote more positive behaviours that actively support the regulators' statutory objectives."[80]

The United Kingdom's new individual accountability regime[81] has three parts. *First*, the regime utilizes enforceable "Conduct Rules" that apply to almost all bank employees.[82] As described above, the rules are high-level principles, written in general terms to allow for wide applicability across diverse lines of business and job functions. The FCA has encouraged firms to provide training tailored to how those rules apply

78. Letter from H.K. Monetary Auth., to the Chief Exec., All Authorized Institutions 1 (Mar. 2, 2017), https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2018/20181219e1.pdf [https://perma.cc/Z9U6-5BMP].

79. *See generally* Financial Services (Banking Reform) Act, 2013 (c. 33) (Eng.).

80. BANK OF ENG. PRUDENTIAL AUTH. & FIN. CONDUCT AUTH., CONSULTATION PAPER: STRENGTHENING ACCOUNTABILITY IN BANKING: A NEW REGULATORY FRAMEWORK FOR INDIVIDUALS 38 (2014).

81. The discussion of the U.K. "senior managers and certification" regime in this article focuses on that regime as it applies to banks. The regime also currently applies to building societies, credit unions, and insurers. All other regulated firms will become subject to a version of the regime from December 2019. The extended regime is meant to be proportionate, so different categories of firms will be subject to different requirements depending on their activities, size, and risk profiles.

82. *See generally* FIN. CONDUCT AUTH., CODE OF CONDUCT § 2 (2019). The express purpose of the U.K.'s new Conduct Rules is to "shape the culture standards and policies of a firm as a whole and . . . promote more positive behaviours that actively support the regulators' statutory objectives." BANK OF ENG. PRUDENTIAL AUTH. & FIN. CONDUCT AUTH., *supra* note 80, § 5.2.

in particular business areas.[83] Firms are required to report to regulators any disciplinary action[84] taken as a result of breaches of the Conduct Rules.[85]

Second, a new "Senior Managers Regime" requires candidates for certain board and executive management positions to receive pre-approval from a regulator.[86] Once appointed, they become subject to a "duty of responsibility" to take reasonable steps to prevent regulatory breaches in the areas of the firm for which they are responsible.[87] Senior managers may also face criminal liability for making a decision that causes a firm to fail,[88] albeit this would only apply in a relatively narrow set of circumstances. The keystone of the Senior Managers Regime is a mandatory and formally documented allocation of responsibilities. Firms must ensure that there are no gaps in accountability for their activities, as well as allocate a number of responsibilities that have been "prescribed" by the regulators, which represent priority areas of regulatory focus.[89] This process gives supervisors insight into the actual responsibilities of a firm's senior leadership. It also enables regulators to judge the appropriateness of an individual for a certain role. Moreover, it provides clarity as to who among a firm's leadership can be held individually accountable for illegal or otherwise unsound conduct in a particular area. In other words, the allocation of responsibilities answers the question of where the buck stops. Two of the prescribed responsibilities mandated by regulation address culture.[90] Including culture on a regulatory list of leadership responsibilities, make it very likely that "culture" will be on the permanent agenda of a firm's management committee and board of directors. It also places a personal onus on the relevant Senior Managers to demonstrate that they are taking reasonable steps to lead the development of a firm's culture and overseeing its adoption in day-to-day management.

Third, firms must administer a "Certification Regime" where they regularly assess the "fitness and propriety" of other individuals who could

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83. *Senior Managers and Certification Regime Banking Stocktake Report*, FIN. CONDUCT AUTH. (May 8, 2019), https://www.fca.org.uk/publications/multi-firm-reviews/senior-managers-and-certification-regime-banking-stocktake-report [https://perma.cc/6UJH-W2TT].

84. "Disciplinary action" for these purposes means a formal written warning, suspension or dismissal of the person, and/or reduction or recovery of any of the person's remuneration due to a breach of a conduct requirement. *See* Financial Services and Markets Act, 2000 (c. 8, § 60C) (Eng.). Suspensions imposed pending the results of an internal investigation are not considered disciplinary action. *Id.*

85. FIN. CONDUCT AUTH., FCA HANDBOOK § 15.11 (2019) [hereinafter FCA HANDBOOK]; PRUDENTIAL REGULATION AUTH., PRA RULEBOOK § 11 (2019) [hereinafter PRA RULEBOOK].

86. Financial Services (Banking Reform) Act, 2013 (c. 33, § 18) (Eng.).

87. *Id.* § 32.

88. *Id.* § 36.

89. FCA HANDBOOK, *supra* note 85, § 24; PRA RULEBOOK, *supra* note 85, at Allocation of Responsibilities.

90. PRA RULEBOOK, *supra* note 85, § 4.1.

pose a risk of significant harm to the firm or its customers.[91] An important element of certification is a requirement that firms check references for the past six years of employment history before certifying that employees are "fit and proper"[92] (the obligation to check references also applies to prospective Senior Managers and other non-executive directors). Like the New York Fed's database proposal, the U.K.'s new reference rules impose two new legal duties on regulated firms: a duty to inquire of past employers (including non-financial companies) and a duty to provide information. References must disclose all information that would be relevant to an assessment of whether an individual is fit and proper. Unlike the New York Fed's proposal, employers will not receive immunity for the contents of such references. They face the same liability to former employees that they would without any legal duty to disclose. They also owe a general duty to a prospective employer to write a reference that is accurate and, taken as a whole, not misleading. A firm may, therefore, find itself in the unenviable position of treble legal risk. A former employee may sue for including too much information in a reference, a prospective employer may disagree and sue for including too little, and a regulator may scrutinize the reference for compliance with legal minima.

IV.

The New York Fed's work on culture has proceeded along several lines decidedly on the less intrusive end of the spectrum.

A. Convening Power and the Bully Pulpit

From the outset, the New York Fed's goal has been to shine a spotlight on the issue of corporate culture. It has relied principally on convening industry participants and other interested parties and in advocating for heightened attention to culture through public speeches.

The New York Fed has hosted several major conferences for the industry and regulators on the topic of culture. Prominent officials have delivered keynote addresses. CEOs, directors, and asset managers participate on panels, with some participants returning year after year. The purpose of these discussions is to exchange ideas about what works and what does not and to identify opportunities for productive collaboration. For example, Betsy Duke joined two panels in which she discussed the challenges of being a director and later chairman at Wells Fargo following

91. FCA HANDBOOK, *supra* note 85, § 27; PRA RULEBOOK, *supra* note 85, at Certification.

92. FCA HANDBOOK, *supra* note 85, § 22; PRA RULEBOOK, *supra* note 85, at Fitness and Propriety § 5.

its customer account scandal.[93] Supervisors, prosecutors, and academics have also joined panel discussions to explain their approaches to culture. Detailed summaries for each of these conferences and many video excerpts are available on the New York Fed's public website.[94]

The conferences have also taught us just how difficult the topic of culture is. One recurring theme is the potential for ethics and markets to be irreconcilable. That is, there are only so many times a market participant can say "no" to a business opportunity based on an ethical principle and expect to remain in business. At some point, competitors will say "yes" seeing the business opportunity. Over the long-term, this dynamic can reduce standards in an industry. Federal Reserve Vice Chairman Stanley Fischer explored this theme at the New York Fed's annual culture conference in 2015.[95] He distributed to the audience a quote from a book by Nobel Laureates George Akerlof and Robert Schiller:

> Whether or not businessmen have good (or bad) morals is not the subject of this book, although sometimes both of these sides will appear. Instead, we see the basic problem as pressures for less than scrupulous behavior that is incentivized in competitive markets. They are terrific at incentivizing and rewarding businessmen heroes with innovative new products for which there is real need. However, unregulated free markets rarely reward a different kind of heroism, of those who restrain themselves from taking advantage of customers' psychological or informational weaknesses. Because of competitive pressures, managers who restrain themselves in this way tend to be replaced by others with fewer moral qualms. Civil society and social norms do place some brakes on such phishing; but in the resulting market equilibrium, if there is an opportunity to phish, even firms guided by those with real moral integrity will usually have to do so in order to compete and survive.[96]

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93. *See Reforming Culture and Behavior in the Financial Services Industry: Progress, Challenges, and the Next Generation of Leaders*, FED. RES. BANK OF N.Y. (June 18, 2018), https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/2018-NewYork Fed-Culture-Conference-Summary.pdf [https://perma.cc/JS99-XBWA]; *Workshop on Culture Measurement and Assessment*, FED. RES. BANK OF N.Y. (June 21, 2017), https://www.newyorkfed .org/medialibrary/media/governance-and-culture-reform/Summary-of-Workshop.pdf [https://perma .cc/3HSS-TN9D].

94. *See generally Governance and Culture Reform*, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/governance-and-culture-reform [https://perma.cc/86NF-TVWW].

95. *Reforming Culture and Behavior in the Financial Services Industry: Workshop on Progress and Challenges*, FED. RES. BANK OF N.Y., 4 (Nov. 19, 2015), https://www.newyorkfed.org/ medialibrary/media/newsevents/events/banking/2015/culture_workshop_summary_2015.pdf [https:// perma.cc/SE5K-YDPV].

96. GEORGE A. AKERLOF & ROBERT J. SHILLER, PHISHING FOR PHOOLS: THE ECONOMICS OF MANIPULATION & DECEPTION xi–xii (2015).

In a discussion with Christine Lagarde, Vice Chairman Fischer asked whether there was something fundamental in markets that was incompatible with ethics.[97] That is, does market competition inevitably lead to a race to the bottom? If one participant is not willing to do "whatever it takes" to make a buck, the next participant will. And, there are only so many times that a market participant can say "no"—only so many opportunities that can be passed up—before going out of business. If that is true, is postcrisis misconduct an inescapably downward trend?

The New York Fed has also organized two less publicized forums to discuss culture. The Supervisors Roundtable is a semi-annual meeting of senior supervisors from approximately twenty agencies from many jurisdictions. Its purpose is to share approaches to the supervision of culture and to develop a toolkit. The newest convening effort is a business school-industry working group called the Education and Industry Forum on Financial Services Culture.[98] Its goal is to encourage universities and financial firms to work on promoting ethics as a skill set, both in the classroom and in employer training. The initiative began a few years ago with some rather uncomfortable meetings, in which academics and bankers sat around a table saying, "It's your fault. No, it's your fault." Now, both sides are eager to work together and the New York Fed helps facilitate that discussion on an ongoing basis.

In addition to engaging bankers and supervisors, we have also tried to interest lawyers in the topic of the culture of financial services. For example, in 2016, we partnered with the Federal Bar Council in New York City to host a seminar addressing how banking lawyers can import professional, ethical standards to the clients they serve. The discussion picked up on discussions in the Netherlands and the United Kingdom about the wisdom of treating banking as a "profession"—complete with ethical codes, self-governing bodies, and entrance standards. Judge Jed S. Rakoff moderated a two-hour panel discussion that covered the following topics.

1. *Should banking lawyers have special responsibilities to the public?* This discussion challenged the traditional client-centric obligations by asking whether lawyers who work in an industry with so many public responsibilities should also owe a heightened duty to the public as well as to their clients. At the very least, under the Model Rules

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97. For a video of Madame Lagarde's discussion with Vice Chairman Fischer, see *Reforming Culture and Behavior in the Financial Services Industry: Workshop on Progress and Challenges*, FED. RES. BANK OF N.Y. (Nov. 5, 2015), https://www.newyorkfed.org/newsevents/events/banking/2015/1105-2015 [https://perma.cc/89YF-3HJY].

98. *See generally Education and Industry Forum on Financial Services Culture*, FED. RES. BANK OF N.Y. (Oct. 2019), https://www.newyorkfed.org/aboutthefed/education-industry-forum [https://perma.cc/ZN97-WTWE].

of Professional Conduct of the American Bar Association (Model Rules), a lawyer cannot "prudently ignore the interests of the investing public in advising . . . clients. . . . [I]n rendering advice, the lawyer must be conscious of the client's own duties to the investing public and the consequences to the client of violating those duties."[99]

2. *When do lawyers get in the way of reform?* We have observed that, when speaking to banking audiences, this topic generates a lot of interest. The panel discussion covered two scenarios: First, how does the increased assertion of the attorney–client privilege affect public sector inquiries? Second, in a private law setting, how does legal advice restrict a culture reform agenda—for example, through limiting what is disclosed about employee discipline?

3. *Should banks require their attorneys to advise employees on non-legal considerations?* This discussion debated whether banks should require in-house and outside counsel to advise on the social and moral dimensions of their decisions. Both the Model Rules and the Restatement (Third) of the Law Governing Lawyers (Restatement) *permit* attorneys to advise clients on the basis of non-legal factors, including the "moral" or "social" dimensions of a decision—that is, advice that beyond what is strictly illegal or arguably legal.[100] Panelists discussed whether giving attorneys an express mandate to raise the moral and social dimensions of banker decisions would increase awareness of the broader consequences of financial decisions. It was also observed that the mandate might combat the perception among some bankers that attorneys are purely "transaction[al] engineers."[101]

4. *Should Congress create a statutory self-evaluation privilege for financial institutions?* Every state offers hospitals an evidentiary privilege against the disclosure of "mortality and morbidity" evaluations.[102] The purpose is to enable discussion of errors and root causes without fear of

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99. ASS'N OF THE BAR OF THE CITY OF N.Y., REPORT OF THE TASK FORCE ON THE LAWYER'S ROLE IN CORPORATE GOVERNANCE 65–66 (2006), https://www.nycbar.org/pdf/report/CORPORATE_GOVERNANCE06.pdf [https://perma.cc/98GM-7QJH].

100. *See* MODEL RULES OF PROF'L CONDUCT r. 2.1 (AM. BAR ASS'N 1983) ("In rendering advice, a lawyer may refer not only to law but to considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 94(3) (AM. LAW INST. 2000) ("In counseling a client, a lawyer may address nonlegal aspects of a proposed course of conduct, including moral, reputational, economic, social, political, and business aspects.").

101. John C. Coffee, Jr., *Understanding Enron: It's About the Gatekeepers, Stupid*, 57 BUS. LAW. 1403, 1405 (2002). Indeed, postmortem evaluations of corporate bankruptcies have criticized lawyers who "saw their role in very narrow terms, as an implementer, not a counselor." ERIC A. CHIAPPINELLI, CASES AND MATERIALS ON BUSINESS ENTITIES 573 (4th ed. 2018); *see also* Final Report of Neil Batson, *In re* Enron Corp., et al., No. 01-16034 (Bankr. S.D.N.Y. Nov. 4, 2003).

102. *See* Jenkins v. Dekalb Cty, Ga., 242 F.R.D. 652, 660 (N.D. Ga. 2007); JEROME G. SNIDER ET AL., CORPORATE PRIVILEGES AND CONFIDENTIAL INFORMATION, § 6.01, n.14 (2019).

litigation. Two states—Delaware and Louisiana—offer a similar privilege to banks.[103] The panel and audience debated whether an assurance of confidentiality would promote thorough and candid discussions of mistakes and ways to avoid them in the future. A model statute follows this essay as Exhibit A.

In addition, senior leaders of the New York Fed have given more than twenty-five public speeches about culture in financial services.[104] This number does not include participation in panel discussions at various conferences held around the world. Our colleagues also attempt to collect significant speeches and reports about banking culture by other official sector leaders. This effort has produced a website dedicated to sharing information about the culture.[105]

B. Publication

Some of its staff have also published a whitepaper arguing that "cultural capital" as an intangible asset is a fair topic for supervision.[106] Cultural capital was one idea included by the FCA in a March 2018 discussion paper entitled *Transforming Culture in Financial Services*.[107] Contributors included not only supervisors and economists, but behavioral scientists, bank CEOs and directors, business professors and ethicists, and leaders of corporate governance non-profits. Essays in that paper covered the elements of a "good" culture in financial services, the roles of supervisors and regulators, and many ideas on how firms can make their culture initiatives more effective.

The New York Fed has also contributed to several international publications. Two that stand out are the development of the FX Global Code and recent work by the Financial Stability Board about misconduct, risk, and culture.

The FX Global Code (the Code) is a set of principles designed to improve conduct by participants in the foreign exchange market.[108] Staff from across the New York Fed contributed to the effort coordinated by the Bank for International Settlements' Market Committee's FX Working Group. Adherence to the Code is voluntary, and the central banks that

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103. *See* DEL. CODE ANN. tit. 5, § 940 (West 2019); LA. STAT. ANN. § 6:336(A) (2012).

104. *See generally Governance and Culture Reform: Resource List*, FED. RES. BANK OF N.Y., https://www.newyorkfed.org/governance-and-culture-reform/archive#speeches [https://perma.cc/L4U7-4CTH].

105. *Governance and Culture Reform*, *supra* note 104.

106. *See generally* CHALY ET AL., *supra* note 18, at 6.

107. FIN. CONDUCT AUTH., TRANSFORMING CULTURE IN FINANCIAL SERVICES 51 (2018).

108. *See generally* GLOB. FOREIGN EXCH. COMM'N, FX GLOBAL CODE: A SET OF GLOBAL PRINCIPLES OF GOOD PRACTICE IN THE FOREIGN EXCHANGE MARKET (2018).

contributed to the effort have strongly encouraged market participants to adopt it.

Staff from the New York Fed have also participated for several years in a Financial Stability Board project called the Working Group for Governance Frameworks. Beginning in 2016 and led by Jeremy Rudin, Canada's Superintendent of Financial Institutions, the group has since published two reports. The first was an overview of how misconduct risk is addressed across firms and regulators.[109] The report also included a review of scientific literature about the root causes of misconduct. It recommended three areas for further study: (i) "rolling bad apples," (ii) responsibility mapping, and (iii) cultural drivers and risk factors. A follow-up report published in 2018 addressed each area in greater detail.[110] Framed as a "tool kit," the 2018 report contained practical steps that financial institutions and their supervisors could take to address each issue. All of the options contained a common theme: Culture needs to be a priority among an organization's leaders who can bring the full resources of an institution to bear on the problem.

Even before the Financial Stability Board's work, New York Fed staff had paid attention to the "rolling bad apple" phenomenon for several years. The Financial Stability Board paper defined rolling bad apples as "individuals who engage in misconduct but are able to obtain subsequent employment elsewhere without disclosing their earlier misconduct to the new employer."[111] Banks, like many employers, do not volunteer information about their employees. Providing references creates a legal risk. A misstatement or omission in a report could provide a basis for employees to sue for economic injury to reputation or employment prospects. Even where some disclosure is required—for licensed broker-dealers, for example—the "official version" of events is often heavily negotiated and provides little insight into an employee's actual conduct.[112] This type of reference offers limited value to a future employer in considering an applicant's suitability.

We were aware at a high level that some areas of wholesale banking and trading are noteworthy for the frequency with which bankers find new employment at competing firms. For example, Thomas Hayes, the London trader who manipulated LIBOR at UBS, the Royal Bank of Canada, and Citi before being prosecuted for fraud, is one of the most notorious

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109. *See generally* FIN. STABILITY BD., STOCKTAKE OF EFFORTS TO STRENGTHEN GOVERNANCE FRAMEWORKS TO MITIGATE MISCONDUCT RISKS (2017).

110. *See generally* FIN. STABILITY BD., STRENGTHENING GOVERNANCE FRAMEWORKS TO MITIGATE MISCONDUCT RISK: A TOOLKIT FOR FIRMS AND SUPERVISORS (2018).

111. *Id.* at 32.

112. *See, e.g.*, New England Sec. Corp. v. Stone, No. 15575/11, 2011 N.Y. Misc. LEXIS 6082, at *3–5 (N.Y. Sup. Ct. Dec. 12, 2011).

itinerant traders to emerge from recent "reference rate" scandals.[113] Indeed, the movement of bankers across firms, but within pockets of the industry, may have facilitated the collusion seen in the LIBOR and FX scandals. In workplaces characterized by high employee turnover, employers come and go but relationships endure. Personal networks facilitate future employment. When loyalty to those networks supplants duty to an employer or customers, the risk of corruption increases.

A working paper from the National Bureau of Economic Research provided insight into misconduct by Financial Industry Regulatory Authority (FINRA)-registered brokers and investment advisors.[114] According to that paper, roughly one in thirteen registered brokers and investment advisors—who, as a group, constitute approximately 10% of total employment in financial services—had at least one instance of prior misconduct on their public records. What is more, 38% of registrants with misconduct records were repeat offenders. And, although 48% of registrants with misconduct records left their jobs within a year of disclosure, 44% of departed employees found work in the industry within a year, albeit at smaller or less prestigious firms. This is consistent with our anecdotal understanding based on LIBOR and FX investigations. The labor market may undo some of the effects of firm discipline.

To promote more effective references and more informed hiring decisions, several New York Fed officials have favored creating durable records of misconduct.[115] The idea, at its core, is to overcome the fact that when bankers change firms, they are often able to leave their conduct records behind. If there was a central database maintained by the official sector, but accessible by private banks, prospective employers could check whether an applicant had any record of misconduct that might raise legitimate questions about poor behavior in the future. Poor conduct would have consequences over a longer time horizon, and wrongdoers would

113. *See* David Enrich, *Former Trader Tom Hayes Sentenced to 14 Years for Libor Rigging: Conviction and Long Sentence Represent Major Victory for British Financial Authorities*, WALL ST. J. (Aug. 3, 2015), https://www.wsj.com/articles/tom-hayes-convicted-of-libor-rigging-1438610483 [https://perma.cc/662M-623X]. Mr. Enrich subsequently wrote a well-reviewed book in which he questioned the complicity of industry culture in Mr. Hayes's conduct. *See generally* DAVID ENRICH, THE SPIDER NETWORK: HOW A MATH GENIUS AND A GANG OF SCHEMING BANKERS PULLED OFF ONE OF THE GREATEST SCAMS IN HISTORY (2017).

114. *See* Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct* (Nat'l Bureau of Econ. Research, Working Paper No. 22050, 2017).

115. *See, e.g.,* FIN. STABILITY BD., *supra* note 109, at 38; *see also* William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry: Enhancing Financial Stability by Improving Culture in the Financial Services Industry (Oct. 20, 2014), https://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html [https://perma.cc/J7CB-Y8YL]; Held, *supra* note 37.

bear greater accountability for their misdeeds. We explain the idea for a database in greater detail below.

C. Propose Solutions

Finally, the New York Fed has used publications and speeches to propose ideas to the industry to help address persistent problems. In the fall of 2014, Bill Dudley proposed four ideas[116]:

1. *A standard industry survey of culture, which may create a benchmark for measuring behavior.* Most, if not all, large financial institutions—like most if not all, large companies—conduct internal assessments about their cultures. The word "culture" may not appear in the titles or descriptions of those assessments, but they aim to measure group norms and employee attitudes. That data, however, remains within firms. Even if they were compared side-by-side, the analysis might not be fruitful because the questions and methods vary from firm to firm. Undertaking a standard survey in addition to proprietary assessments would enable industry-wide comparison and, moreover, would be a sign of the industry's joint commitment to improving culture and conduct.

Although not attempted in the United States, the project is well underway in the United Kingdom. The Banking Standards Board recently published its third annual review, in which more than 72,000 employees in the financial services sector participated.[117] That report contains aggregated and anonymized results of a standard thirty-six question survey, broken down by key demographics. Participating firms also receive detailed private reports, including dynamic electronic dashboards that are tailored to the firm's specific information requests. While firm-specific information is strictly non-public, the quality of the analysis in the public report speaks to the value of the exercise. The lack of a similar project in the United States is glaring and, frankly, brings into question the industry's commitment to improving its culture.

2. *Longer deferrals of compensation, for up to ten years, and a performance bond for senior leaders and material risk-takers.* These were non-regulatory proposals that firms might undertake voluntarily to account for latent financial and misconduct risks in pay packages. Lengthy deferrals would allow time for tail risks to mature and make "claw-backs" easier to accomplish. Ten years was a conservative estimate of the length of time it could take for tail risk to mature or for misconduct to be uncovered. Since Dudley proposed the idea in 2014, the United Kingdom has, by regulation, imposed a seven-year deferral on at least 40% of

116. *See* Dudley, *supra* note 115.
117. *See generally* BANKING STANDARDS BD., ANNUAL REVIEW 2018/2019 (2019).

variable compensation for material risk-takers that are subject to the Senior Managers Regime, with vesting after three years on a pro-rata basis.[118]

"Performance bonds" operate like security deposits on a rental apartment. They promote prudent decisions and behaviors by placing a significant quantum of money at risk. Dudley's idea was that money deferred by bankers could be used to satisfy criminal or regulatory fines, partially removing the burden from shareholders, or to recapitalize a firm in a crisis. The annual amounts at stake for each employee need not be large. Small amounts, compounded over the years, could result in a significant resource for a firm.[119] Placing funds at risk, however, could lead to an overall increase in compensation to make up for the portion placed into a performance bond. Firms would have to balance performance bonds against pressures to limit the overall volume of banker compensation.

A version of the performance bond appeared in Citi's 2015 Proxy Statement as a shareholder proposal.[120] Executive officers would be required to defer a portion of their compensation for at least ten years, during which time the money could be used to satisfy fines for illegal conduct regardless of the personal responsibility of any officer.[121] Citi's management argued that the proposal would impede the firm's ability to attract and retain executives, and that the firm's claw-back policy already allowed the firm to cover fines and costs for illegal or imprudent conduct.[122] Ultimately, Citi's board recommended that shareholders reject the proposal, which was, indeed, the outcome.[123]

3. *A database of financial sector misconduct.*[124] The core of this idea is a new federal statute that would impose two legal duties on supervised financial institutions: a duty to report misconduct when an employee leaves the firm and a duty to check the registry before hiring. Together, these duties aim to combat the problem of "rolling bad apples," described above. The statute extends the time horizon for the consequences of misconduct by creating a record of bad behavior, hopefully creating a personal stake in the success of corporate controls and prompting more careful decisions. It does not, however, preclude future employment,

118. PRA RULEBOOK, *supra* note 85, at Remuneration § 15.17.

119. Hamid Mehran & Joseph Tracy, *Deferred Cash Compensation: Enhanced Stability in the Financial Services Industry*, 22 ECON. POL'Y REV. 61, 62 (2016).

120. *See generally* Letter from Citigroup, Bd. of Dirs., to Stockholders (Mar. 18, 2015), https://www.citigroup.com/citi/investor/quarterly/2015/ar15cp.pdf [https://perma.cc/D9F9-QEPK].

121. *Id.* at 89.

122. *Id.*

123. *Id.* at 90.

124. *See* Enrich, *supra* note 113.

although that may very well be the appropriate result of serious misconduct. It just makes it less likely that a future employer could plead ignorance of prior misconduct.

The keys to the success of a misconduct database are due process protections for employees, enforcement consequences for reporting misinformation or using the database for improper purposes, and a safe harbor for employers who report in good faith. We have addressed these features publicly,[125] and have included a further summary as an appendix to this Article.

Industry representatives on the Federal Advisory Council supported the idea for a misconduct database in 2015.[126] So far, however, no bills have been introduced in Congress.

4. *A mandatory industry ban against persons convicted of a crime of dishonesty.* Under current law—Section 19 of the Federal Deposit Insurance Act—a person convicted of a crime of dishonesty is prohibited from working in a federally insured depository institution, a bank holding company, and one or two other types of institutions.[127] Employment is not prohibited at broker-dealers, investment advisors, exchanges, or other firms overseen by the Federal Reserve, the Securities and Exchange Commission, and other federal regulators. Section 19 might be amended to cover any "activity that is financial in nature or incidental to a financial activity," a phrase borrowed from the Bank Holding Company Act.[128] So, it would no longer matter what type of financial firm a banker wants to work for—supervised or "shadow." If convicted of a crime of dishonesty, future employment in finance would be prohibited. The portion of Section 19 that permits courts to lift the ban would remain.

V.

John C. Williams, who succeeded Bill Dudley as President of the New York Fed in 2018, has argued that "good times" can feed the root causes of misconduct in the same way that Irish retail banks and the Commonwealth Bank of Australia experienced: "[It] can look like

125. *See generally* Held, *supra* note 37.

126. *Record of Meeting*: *Fed. Advisory Council & Bd. of Governors*, N.Y. FED. RESERVE 10 (May 8, 2015), https://www.federalreserve.gov/aboutthefed/fac-20150512.pdf [https://perma.cc/YT5Z-UQV9] ("At the industry level, one significant and immediate step would be a coordinated effort to establish a comprehensive employee database across banks that could prevent bad actors from moving from one firm to another and allow for consistent regulatory supervision . . . . A regulator-sanctioned or -sponsored mechanism . . . with consistent and transparent standards covering various industry sectors, could assist both regulators and the industry in monitoring and preempting recidivist behavior.").

127. 12 U.S.C. § 1829 (2018).

128. 12 U.S.C. § 1843(k)(4) (2018).

everything's coming up roses, even when an uncomfortable reality lies beneath."[129]

As we write this Article, roughly one year after John Williams added his voice to the chorus, the good times continue. Unfortunately, so do misconduct scandals. Recent headlines concern fraud in Malaysia's sovereign wealth fund[130] and money laundering through the Baltic branches of Scandinavian banks.[131] Or, even more recently, we have seen the conviction of the former head of HSBC's foreign exchange trading desk for lying to a bank customer about material facts in a foreign exchange transaction.[132] Even more troublingly, a similar case brought against the head of Barclay's foreign exchange trading desk was deemed legally insufficient because "BS-[ing]" was so common in the foreign exchange market that no one could have been reasonably induced to rely on a trader's misrepresentations.[133] Clearly, misconduct and cultures that contribute to misconduct remain an important and unresolved issue.

We previewed at the start of this Article some questions that would benefit from academic input. In light of the background we have provided on the work of the New York Federal Reserve and other public authorities, we return to them with some additional explanation.

1. *What are we missing about culture?* How can we make a stronger case that culture matters in financial services? Are there angles and insights we have overlooked? Are there aspects of our work that appear simplistic or uninformed? Are there canonical texts that would give a more solid foundation to our work? What are the really exciting areas of research about the root causes of behavior?

2. *What else should we and our colleagues at the New York Fed do?* Do you have ideas for projects that would help academics or the industry in their work on culture? Are there specific types of conferences that

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129. John C. Williams, President & Chief Exec. Officer, Fed. Res. Bank of N.Y., Remarks at Governance and Culture Reform Conference: Now is The Time For Banking Reform (June 28, 2018) https://www.newyorkfed.org/newsevents/speeches/2018/wil180618 [https://perma.cc/CS47-ZVBZ].

130. *See* Stefania Palma, *1MDB Explained: Timeline of Malaysia's Financial Scandal*, FIN. TIMES (Feb. 10, 2019), https://www.ft.com/content/fce8018c-2b4e-11e9-88a4-c32129756dd8 (last visited Nov. 10, 2019).

131. *See* Richard Milne & David Winter, *Danske: Anatomy of a Money Laundering Scandal*, FIN. TIMES (Dec. 19, 2018), https://www.ft.com/content/519ad6ae-bcd8-11e8-94b2-17176fbf93f5 (last visited Nov. 10, 2019).

132. United States v. Johnson, 939 F.3d 82 (2d Cir. 2019).

133. United States v. Bogucki, No. 18-cr-00021-CRB-1, 2019 WL 1024959, at *6 (N.D. Cal. Mar. 4, 2019) ("Viewing the evidence in the light most favorable to the Government, there is simply no evidence in the record that, in the context of an arms-length transaction in which the parties bluffed and 'BS-[ed]' each other, operated as principals, looked out for their own interests, and understood the other party to be 'posturing,' rather than providing strictly true information, someone in [the customer's] position could, objectively, be induced by the statements in this case to part with money or property.").

would be helpful? Can we help create research opportunities? Are there market shortcomings that would benefit from new proposals?

3. *How do we know if there has been progress?* In 2014, Bill Dudley argued that an absence of new scandals would be a good start.[134] That said, the absence of a catastrophe may not be proof of competence. Are there other indicators that would show the progress on culture? Are there ways for the industry to rebuild and demonstrate its trustworthiness?

We welcome your input on these questions.

134. Dudley, *supra* note 115.

Appendix A — Proposed Self-Evaluation Statute

(1) Peer Evaluation Program. Every supervised financial institution shall maintain a coordinated program for the identification and prevention of illegal, unsafe, or unsound practices (Peer Evaluation Program). Such a program shall include at least the following:

> (a) The establishment of a quality assurance committee with the responsibility to review the services rendered by the financial institution in order to improve the quality of financial services offered to the public and to prevent illegal, unsafe, or unsound practices, including violations of supervisory guidance, a code of conduct, or industry conduct standards. Such a committee shall ensure that information gathered pursuant to the program is utilized to review and to revise the institution's policies and procedures. At least one member of the institution's management committee must participate in the committee;
>
> (b) A financial services staff sanctions procedure through which a finding of intentional or repeated misconduct (i) is included in an annual employee evaluation and, (ii) in the case of illegal conduct, is reported to the appropriate regulatory and criminal authorities, both foreign and domestic;
>
> (c) The maintenance and continuous collection of information concerning (i) the financial institution's experience with negative risk and compliance outcomes and incidents injurious to the institution or its customers and (ii) customer complaints;
>
> (d) Education programs explaining the reviews conducted by the quality assurance committee and other issues related to consumer protection, fraud prevention, staff responsibility to report violations of law, regulation, or the institution's code of conduct, legal and regulatory compliance, and improved communication with customers; and
>
> (e) Continuing education programs for financial services professionals and the institution's management in their areas of specialty.

(2) Limitation on liability. Any person who, in good faith and without malice, provides information to further the purposes of the Peer Evaluation Program or who, in good faith and without malice, participates on the

quality assurance committee shall not be subject to an action for civil damages or other relief in any court or in any other proceeding as a result of such activity. Any financial institution, or any person acting on behalf of such financial institution who, in good faith and without malice, takes or fails to take any action as a result of a review conducted pursuant to subdivision one of this section, shall not be subject to an action for civil damages or other legal or equitable relief as a result of such action or failure to act.

(3) Confidentiality.

> (a) The information required to be collected and maintained pursuant to subdivision one of this section, and any review required pursuant to subdivision one of this section, shall be kept confidential and shall not be released except to state or federal banking supervisors.
>
> Notwithstanding any other provisions of law, none of the records, documentation, or committee actions or records created or maintained pursuant to subdivision one of this section shall be subject to discovery in any criminal or civil investigation or litigation pending in any state or federal court, except investigations or proceedings conducted by state or federal banking supervisors related to compliance with this section.
>
> (b) No person in attendance at a meeting pursuant to subdivision one of this section shall be required to testify as to what transpired thereat. The prohibition relating to the discovery of testimony shall not apply to the statements made by any person in attendance at such a meeting who is a plaintiff in an action or proceeding regarding the subject matter of which was reviewed at such meeting.

Appendix B — Term Sheet for a Banker Misconduct Database

- The proposal will create a searchable database to collect and share information among banks about banker misconduct.
- The database will be administered by the public sector and paid for by large financial institutions (greater than fifty billion dollars in total consolidated assets).
- A new federal statute will create two legal obligations:
  - Duty to report misconduct causally linked to departure from firm; and
  - Duty to inquire after conditional offer and before work commences.
- A report to the database does not bar future employment; it merely provides information that a prospective employer should consider.
- All federally supervised financial institutions and their subsidiaries and all Federal Reserve Banks must participate by reporting and accessing information. This includes:
  - Bank holding companies;
  - Non-bank financial companies supervised by the Board of Governors;
  - Designated financial market utilities; and
  - Combined U.S. operations of a foreign banking organization.
- Roll-out to other financial firms may be considered, either on a mandatory or opt-in basis.
- Triggering event for reporting is cessation of employment—via termination, resignation, retirement, or otherwise—for an enumerated reason. These reasons might include:
  - Violation of law, regulation, policy, or guidance;
  - The subject of regulatory enforcement action or criminal prosecution;
  - Violation of an employer's code of conduct; or
  - The subject of customer complaint.
- Reporting institution must provide the former employee's name, date of birth, title, dates of employment, and a narrative explanation of reasonable detail to inform a reader of the nature of the underlying conduct.

- Ongoing duty to update and amend information in a report, especially if new facts emerge following an employee's departure.
- Reporting obligation covers employees engaged in banking functions and other professional positions regardless of their level of seniority, but does not cover support staff.
- Database records may expire after some period of time (five or six years).
- The statute would provide a limited safe harbor for employers based on their reporting. Records may be expunged or amended, but no money damages may be awarded against an employer.[135]
- Due process protections for employees include:
  - Mandatory notice to the former employee, including a copy of the report;
  - Optional fast-track, low-cost administrative hearing to challenge the accuracy of the report;
  - Absolute right to seek injunctive relief from federal district court, regardless of whether first seeking administrative relief (i.e., no exhaustion requirement);
  - Availability of a temporary hold on report that is challenged by a former employee;
  - No limit on former employee's right to sue for wrongful termination or pursue any other employment claim; and
  - Banking supervisors may take enforcement action against participating employers for abuse or misuse of the system.
- Confidentiality protections for employees and employers include:
  - No public access (important trade-off for safe harbor);
  - A requirement that access to the database be on a need-to-know basis;
  - Participating firms must adopt confidentiality procedures to protect the information submitted to and obtained from the database; and
  - Use of database by supervised financial institutions subject to prudential supervision.
- Penalties for non-reporting or misuse of database:

135. *Cf.* 31 U.S.C. § 5318(g)(3)(A) (2018).

- Enforcement against supervised institutions (mandatory participants) available,[136] and if codified in the Bank Holding Company Act, heightened criminal and civil sanctions.[137]
- Criminal obstruction statutes[138] continue to apply as a backstop against intentional misreporting to the government.

- Conflict with non-U.S. law is to be resolved on a case-by-case basis, with participating firms obligated to make "all reasonable efforts" to comply with statutory duties.

136. *See* 12 U.S.C. § 1818 (2018).
137. *See* 12 U.S.C. § 1847(a), (b), (d) (2018).
138. *See, e.g.*, 18 U.S.C. §§ 1505, 1517 (2018).