

## **SYMPOSIUM**

### **THE CHANGING FACE OF CORPORATE COMPLIANCE AND CORPORATE GOVERNANCE**

#### *Editors' Forward*

We are pleased to present this Symposium on the revolution in corporate compliance and its evolution in the financial services industry. This is the annual symposium hosted by the *Fordham Journal of Corporate & Financial Law* on significant topics in the realm of business law.

The format of the symposium is as follows. It begins with an introduction by Professor Sean Griffith, followed by edited transcripts of the two panel discussions and the keynote address.

The first panel is “Revolution: Challenging Corporate Norms?” and addresses the question of whether the revolution in corporate compliance challenges the established norms of corporate law and corporate governance. The panel focuses on the trends in corporate compliance, the effects of compliance across multiple industries, and the different perspectives regarding compliance education and professionalization. The second panel is “Evolution: Impacting Financial Services” and analyzes how the compliance function has evolved within the financial services industry. The panel focuses on the current role of compliance and its impact on financial institutions.

We are grateful to our sponsor for the Symposium: The Corporate Law Center.

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THE CHANGING FACE OF CORPORATE  
COMPLIANCE AND CORPORATE GOVERNANCE<sup>†</sup>

## WELCOME AND INTRODUCTORY REMARKS

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PANEL I: REVOLUTION: CHALLENGING CORPORATE  
NORMS?

## MODERATOR

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## PANELISTS

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<sup>†</sup> The symposium was held at Fordham University School of Law on February 9, 2015. It has been edited to remove minor cadences of speech that appear awkward in writing and to provide sources and references to other explanatory material in respect to certain statements made by the speakers.

i. Sean J. Griffith is the T.J. Maloney Chair in Business Law and Director of the Fordham Corporate Law Center at Fordham University School of Law. Sean J. Griffith—Biography, [http://www.fordham.edu/info/23142/sean\\_j\\_griffith](http://www.fordham.edu/info/23142/sean_j_griffith) [<http://perma.cc/2PE8-Y8DZ>].

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**PANEL II: EVOLUTION: IMPACTING FINANCIAL SERVICES**

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**WELCOME AND INTRODUCTORY REMARKS**

SEAN GRIFFITH: My name is Sean Griffith. I am the T.J. Maloney Chair and Professor of Law. I direct the Corporate Law Center and I am the faculty adviser for the compliance programs at Fordham University School of Law. It falls to me to welcome you to this interesting symposium on the changing face of compliance and corporate governance organized by the *Fordham Journal of Corporate & Financial Law* and also by the Corporate Law Center. We are especially proud of our *Journal of Corporate & Financial Law*, which is the number one cited student periodical on banking and financial regulation, and we are very grateful for the help of the *Journal* in organizing this event.

Fordham Law School, I am proud to say, is a leader in the area of corporate compliance. The Law School offers a number of courses in the area of compliance and two degree programs in corporate compliance. In addition to offering a number of compliance programs for our JDs, the Law School launched the first LLM in corporate compliance in the United States just this past fall. Fordham Law School is also attempting to put together a degree program for non-lawyers, a Masters in Science of the Law, in the area of corporate compliance.

This is an exciting area for us. Fordham Law School is a true believer in the importance of the compliance field. The School is just so pleased today to have so many real leaders in the business area, chief compliance officers from major financial institutions, and real thought leaders in this area in our panels. We are going to have two panels today followed by keynote remarks. Panel I will be academic in focus. It features three academic commentators in the area of compliance. Panel II will be more practitioner-focused with a greater real world orientation. It will be moderated by Gerald Manwah, a managing director in financial crime at Barclays and one of the directors of our compliance programs at Fordham. At the end of the morning, we will have keynote remarks by Tom Baxter, who is general counsel and executive vice president at the Federal Reserve Bank of New York. I want to thank you all for being here and I want to turn the festivities over to my colleague, Steve Thel.

STEVEN THEL: Hi, I am Steve Thel. I teach here at the Law School and I want to welcome you too. As Sean said, Panel I, entitled “Revolution: Challenging Corporate Norms?,” is a group of academics and the first speaker is Sean. After that, Geoff Miller from New York University School of Law and Miriam Baer from Brooklyn Law School will speak. Then we will have time for questions. With that, let us start out with Sean.

**PANEL I: REVOLUTION: CHALLENGING CORPORATE NORMS?**

SEAN GRIFFITH: I have fifteen minutes to present a paper that I have been working on for some time about the relationship between corporate governance and compliance as a legal academic in the area of corporate law. I have long focused on corporate governance, and the question I sought to answer is, what is the relationship between corporate law and corporate governance? The paper is partially motivated by a quotation that appeared in the New York Times about two years ago. The quotation is from somebody who is close to a banking board of a big financial institution. He joked, “the only thing bank directors have more of these days is meetings.”<sup>1</sup>

Regulators have all but stripped the board of the main powers that they had before the crisis. If the board has been stripped of its main governance powers, who is governing? I think a lot of who is doing governance in major financial institutions and other types of corporations is the compliance function.

What I would like to talk about and hopefully persuade you of today are the following four points with some sub-points. The first one is that compliance is important, and I probably do not have to spend a lot of time with folks in this room emphasizing that compliance is important. We are here because we know that compliance is important. However, I do want to try to persuade you that compliance is governance and that it is a big deal because it will create implications for how we think about governance, implications for how we think about corporate law theory, and implications for how we should think about doing compliance. Then at the end, there will be a little policy suggestion. What I really want to focus on is a theoretical problem.

Point two covers the definitions of compliance and governance. What is compliance and what is governance? We can take a definition of compliance from Geoff’s book where he says that compliance is “the processes by which an organization seeks to ensure that employees and other constituents conform to applicable norms—which can include either the requirements of laws or regulations or the internal rules of the

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1. Susanne Craig, *At Banks, Board Pay Soars amid Cutbacks*, NY TIMES: DEALBOOK (Mar. 31, 2013, 9:57 PM), [http://dealbook.nytimes.com/2013/03/31/pay-for-boards-at-banks-soars-amid-cutbacks/?\\_r=1](http://dealbook.nytimes.com/2013/03/31/pay-for-boards-at-banks-soars-amid-cutbacks/?_r=1) [<http://perma.cc/RVA6-NM84>].

organization.”<sup>2</sup> What is compliance? Compliance is the means by which firms adapt their behavior or the behavior of actors within the firm to a relevant universe of norms. That relevant universe of norms is important because it can include not only the legal strictures that the firm operates within but also things like reputation, internal ethics, policies, goals, and aspirational norms.

As an operational matter, what is compliance? It is a department, right? Something new about compliance is that there is a whole department headed by an officer or the chief compliance officer with a staff. In many organizations, the chief compliance officer is the co-equal of the chief legal officer and that is a big deal, right? This new department exists within the organization. You might say, “Well, so what? There is also an IT department in organizations and nobody talks about information technology and governance.” But compliance is different from information technology for two reasons. One is that compliance does core governance functions. What is governance? Geoff also defines it in his book. Governance involves the structure of control within an organization and it is defined by reference to the process of decision-making which has the ultimate control of the firm.<sup>3</sup>

Now, when we talk about governance in corporate law, we normally talk about two different ways of thinking. One is what happens inside the firm, also known as *intrafirm* governance. If you are a Delaware corporate law junkie, this is the stuff of the duty of care. *Intrafirm* governance involves the question of how to engage in monitoring and overseeing the internal affairs of the business. Then there is another aspect of corporate governance which involves ownership-type decisions such as takeovers and proxy fights. *Intra-firm* and corporate governance are essentially identical. Monitoring and overseeing the internal affairs of the organization is what compliance does, and that is a core corporate governance function and that is a big deal. Compliance is different from information technology in the sense that it has a core governance component. It is also different from

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2. GEOFFREY P. MILLER, *THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE* 3 (2014).

3. *Id.* at 2.

information technology in the sense of who the author of that department is. I will come back to that in a second.

This furthers the point that compliance is really governance. This is an organizational chart of the compliance function for the Wal-Mart Corporation.<sup>4</sup> Wal-Mart is a retailer and not in a heavily regulated industry like financial services or pharmaceuticals. Wal-Mart got in trouble for bribery and completely revamped its compliance function. What does this show you? It shows you that there are all these different compliance officers with all these different responsibilities in all these different regions around the world. Then there is this part, which is the part that I like best. When Wal-Mart revised its compliance function, it nested within compliance fourteen areas: anti-corruption, anti-money laundering, anti-trust, consumer protection, environment, food safety, health and safety, health and wellness, labor and employment, licenses and permits, privacy, product safety, responsible sourcing, and trade.<sup>5</sup> All of these functions come within the Wal-Mart compliance department. These are general internal control functions; the general processes which involve how Wal-Mart conducts its business on a day-to-day basis. That is part of what compliance can be and has become for many organizations. Compliance exerts a broad governance function. That is this point.

A second part of what is interesting about compliance is where compliance comes from. Here is a model of the firm. We normally think of corporations as boxes. Sitting on top of that corporation is a board of directors. Inside the box, there are the executive functions of the firm—the chief officer positions. Normally, when corporate law academics like me talk about the ways in which we influence the governance of firms, we talk about influencing the board of directors. For example, the Sarbanes-Oxley Act of 2002 requires that the audit committee members of the board be wholly independent.<sup>6</sup> That is a governance change in that it is a change directed at the board of directors' level. What is different about compliance is that the governance changes are aimed at the executive level. The changes are aimed at the functional level of the

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4. WAL-MART, WALMART'S GLOBAL COMPLIANCE PROGRAM REPORT ON FISCAL YEAR 2014, at 3 illus. Global Compliance Organizational Structure (2014).

5. *Id.* at 4 illus. 14 Global Compliance Subject Matter Areas.

6. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-77 (codified as amended at 15 U.S.C. § 78j-1(m) (2012)).

firm where the business actually operates. For example, after a money laundering failure, a financial institution must hire hundreds or thousands of employees to engage in the monitoring and surveillance of transactions. That is a governance change, but it is also a change within the organization. That is to say, within the structures of how the firm actually conducts its business, as opposed to just oversight structures on the top.

What else is different? Those changes come from the federal government. They come from incentives under the sentencing guidelines, where you do not get as much of a sanction if you have an effective compliance department. They come from incentives under the charging function of prosecutors and they also come under prosecutorial agreements. What does that mean? Well, there is a big implication here too. Here is a model of corporate governance. The shareholders are on the bottom and the evil managers are on the top. Normally, when we talk about how corporate governance is made, we talk about a process of negotiation between the shareholders and the managers, but that is not what we are talking about here. We are talking about compliance because compliance is really a function of government intervention, often by a prosecutor. Compliance is not made by agreement between prosecutors and shareholders because these people never meet and they never agree. Compliance is made in an agreement between prosecutors and managers. The agency cost issue is all over the place. Where corporate law academics normally consider agency cost problems as between managers and shareholders, here, we have agency cost problems where the shareholders are not even involved. There is no vote to approve compliance changes that the government prosecutor brings into the firm.

This makes me think about a variety of the Coase Theorem. There is a famous line from Ronald Coase's article, *The Nature of the Firm*.<sup>7</sup> In *The Nature of the Firm*, Coase writes, "If a workman moves from department *Y* to department *X*, he does not go because of a change in relative prices, but because he is ordered to do so."<sup>8</sup> When I think about

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7. R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

8. *Id.* at 387.

compliance, I think we have to revise that view of why people move around in the firm, and here is how I would revise it. If a workman moves into the compliance department, he does not go there because of a change in prices, but because the government has ordered the company to hire him. What does that mean? It means that the government is making corporate governance. It is an executive level function. What should we think about that? Well, what do we think about government lawmaking in general?

Here we can juxtapose the interest of the United States with the interest of Delaware, which is a traditional corporate governance regulator. One thing that academics have pointed out about Delaware is that there are only about two constituencies at play in the making of corporate governance under Delaware law: shareholders and managers. Those are the only two parties that make the choice about where the firm incorporates. As a result, shareholders and managers are the only two parties that Delaware law seeks to appease. That is not the same in the federal government. The United States Government, through the Securities and Exchange Commission and other types of regulatory organizations, does worry about shareholders and managers, but the federal government has many other constituencies that it protects such as laborers, creditors, consumers, and social responsibility-type interests.

What is interesting about the federal government is that there is a disincentive for the federal government to be overly active in corporate governance. The disincentive arises because legislators get worked up after scandals when they feel like there is a broad consensus for reform. But those are legislators. If corporate governance via compliance is made not primarily by legislators, but by individual prosecutors, there is a question about when prosecutors get motivated. What motivates a prosecutor to act? Does that mean that a government prosecutor is more likely to enforce the other constituencies that the federal government is responsible to more aggressively than a legislator?

All right, I am just waving at these issues. I am obviously not closing them for right now. My third big implication is for compliance itself. What does it mean that we have compliance coming into organizations as a result of prosecutorial interests following periods of corporate scandal or corporate failures? What are the implications specifically for compliance? One implication is that we do not really know for sure whether the compliance functions that these outside influencers are bringing in are cost effective from the organizational

point of view. Is the growth of compliance costs justified by the value that they produce to an organization? There are a couple of different ways that you can break that question down. One is whether the infrastructure that we build around compliance creates value that we can show regulators to cause them to forbear in the event that they become interested in our organization versus whether that infrastructure really produces benefits net of costs. How do we demonstrate the effectiveness of that infrastructure?

Again, there are two ways of thinking about this. How do we demonstrate effectiveness to a regulator? One answer might be to show them how busy we are in our compliance department, how many training hours our employees have been through, what percentage of completion our employees have finished compliance modules, and so on. How would we demonstrate the effectiveness of compliance, not necessarily to a regulator, but to a CEO or an investor?

The other question might be, is compliance really the highest and best use of our time and resources? To put it in a less provocative way, is there an additional marginal investment in compliance? Let us say that we are going to have some compliance. How do we know that this additional investment is really the highest and best use of our resources? What is the right level? For example, let us say that a bank gets in trouble for an anti-money laundering violation and is ordered by the federal government to increase staff compliance from 80 to 1000. Eighty might not be enough, but what is the theoretical support for 1000 being the right number and what level of support is there for any of these things being at the right level? How do companies pick? How should they comply?

One answer might be that there is compliance creep going on here. What is compliance creep? Compliance creep occurs when different organizations look at other peer organizations and the infrastructures that they have built around compliance. Whether they want to or not, they have to build similar infrastructures. Why? Because if you are bank X and you get in trouble, the enforcer is going to say to you, "Well, look at bank Y and Z. Look at their compliance infrastructure. Yours is forty percent less and now you are in trouble." *Post hoc ergo propter hoc*. "You are in trouble because you are forty percent leaner in compliance than they are." How can you do that? The answer is thinking about that

ex-ante. That bank knows that that is a possible argument it is going to face and therefore has an incentive to up staff even if it is not worth it.

What should we do about this? This is an assumption, by the way, that there is anything to be done or that we should do anything. One possibility is that we should just accept that this is how governance works now. Delaware corporate law has abandoned intrafirm corporate governance because of the business judgment rule. Thus, Delaware is out of it. The regulatory state enforced a vacuum. The feds are in it and it is just the way it is going to be, and we have to learn to live with that. If we wanted to put the genie back in the bottle, how could we do it? It is not that complicated. One way is to take away the incentive structure for government-sponsored corporate therapeutics so that there are no more incentives for effective compliance. Organizations would no longer get a sentencing act reduction and no longer get a charging reduction for having an effective compliance function. Just take it off the table. “We cannot give you a reduction for that. We are not even going to look at it. We are not even going to ask and we are not going to ask in our DPAs [deferred prosecution agreements] and NPAs [non-prosecution agreements]. We are not going to ask you to implement compliance reforms because we, the federal government, do not know what good compliance reforms are and we think you might not know either. Thus, we certainly cannot foist them upon you.”

What is the result of that? What if we did that? Would companies stop complying with the law? The answer is no because we are not asking the federal government to just stop bringing enforcement actions. The government should bring enforcement actions to the full extent of the law and extract sanctions as much as it possibly can. If companies no longer had the federal incentive of building effective compliance programs, companies would build compliance programs that are cost effective and that make sense from the organizations’ perspective. Another thing we could do is get judges more involved in the termination of investigations. A lot of these DPAs and NPAs happen without significant, or any, judicial supervision. Judges should be involved. In other words, there is not an adverse party here. Judges should become that adverse party. Maybe judges should permit shareholder objections to DPAs and NPAs.

Finally, I would say that we should have public disclosure of the details of company compliance programs. One of the reasons that we do not know whether compliance works or know what works in compliance is that companies do not report what they do in compliance. It is not

possible to run studies about the effectiveness of anti-money laundering structure X versus anti-money laundering structure Y. We cannot run those studies because we do not have that data because companies do not report. Why do we not take the compliance incentive out and make companies report what they do in compliance so that the capital markets can create a compliance incentive in place of more direct federal intervention? Those are my provocative remarks.

STEVE THEL: Thank you, Sean. Once again, Sean speaks for himself, not for Fordham Law School. Our next presenter is Geoff Miller who is the Stuyvesant Comfort Professor of Law at NYU and director of their program on corporate compliance enforcement, and also the author of the first casebook on compliance. Geoff?

GEOFFREY MILLER: First of all, thank you for the invite, Sean, and also to the student editors. I think it is a testament to the importance of this topic that on a snowy day in New York, so many people have come to this event. The event itself bespeaks the importance of the topic. Congratulations to the organizers. As Steve mentioned, I am interested in compliance in part because NYU has a program. It is not quite the same as Fordham's program. It is not a degree-offering program, but it is an academic program on corporate compliance and enforcement that I run with Jennifer Arlen, another professor at NYU.

Also, we have recently had the good fortune of the American Law Institute [ALI] initiating a project on principles of governance, risk management, and compliance, of which I am the chief reporter, so that, hopefully, will develop some principles that might be useful in assessing compliance. Also, we hope it will respond to the concerns that Sean mentioned, namely that compliance today is often developed from a sort of ad hoc, back-of-the-envelope way through enforcement proceedings. We are hoping to have a somewhat more systematic analysis in the ALI project.

I would also like to second Sean's remarks about the importance and novelty of this topic. Compliance really is something new in governance, and it is not only something new in governance but it is also emblematic of broader changes in the governance of complex organizations that are really significant, and that we in academics have only begun to get our hands around. This is something that people who are in organizations know about, but believe me, most of us in

academics have not known about it. It is something new for us, and we are only beginning to grasp the significance of the changes that have occurred. It is also something new in academics. There were no courses in compliance, no book on compliance. Over the past year, this is changing very rapidly. I published a book, as Steve mentioned, that can be used as teaching materials, and compliance courses are developing all over the country. Also, there is scholarship in compliance, as Sean's paper illustrates. Miriam has also done excellent scholarship in this area as well as others.

Compliance is theoretically and practically interesting and beginning to become a real academic field with real substance and real literature. Compliance is important because it has practical consequences, among other things. There are many jobs in compliance, but compliance is also very important to the welfare of highly regulated institutions such as banks and other firms. There is also an important theoretical aspect. If you think about it, what is law but the effect that rules have on people's behavior? Until recently, the compliance function has been a black box. We have not seen into it, but we have observed the output, which is people behaving in certain ways. You might have rules on insider trading, but those rules get filtered through compliance departments into concrete rules for action that may only have a tangential relationship to the rules themselves. The compliance department has to deal with traders who are not sophisticated in law and need to have workable standards for conduct that can be administered and enforced. This is something we have known nothing about, but it is really a very important part of American law and we are only beginning to study that.

Also, I believe this is a new field that goes beyond law because, as many of you know, compliance departments have lawyers, but they also have non-lawyers. The compliance function is partly a legal function, partly a management function, and partly involves other important topics such as sociology, psychology, and other fields. This is a multidisciplinary area of study that is not limited to law. We are into something that is interesting and changing rapidly. Now, my paper is quite academic, but it is motivated by practical concerns. I would like to say that part of the academic interest in this topic is that we academics need to learn from you—at least those of you who are here in the audience who work in compliance. It is not that you need to learn from us, even though we are teachers. We need to learn from you because you have the information that we lack, and we are late in catching up to the

importance of this topic. A lot of what we are hoping to do is learn from people who are in the area about how it actually works.

Now, the paper I am going to present has to do with the concern that Sean mentioned, which is the concern for the efficiency implications of compliance. I am going to try to do this looking at the concept of an effective compliance program, but not considering this issue in the way it is ordinarily understood. We will look at it through a little bit more of a fundamental lens.

The standards for effective compliance programs take the form of lists. There are many of them out there. The Bank Secrecy Act has four elements: internal policies, compliance officer, training, and internal audit.<sup>9</sup> The Volcker Rule has six requirements: written policies, internal controls, framework of accountability, independent audit, training, and maintaining records.<sup>10</sup> The Foreign Corrupt Practices Act has ten requirements and some are the same, but other ones include third party due diligence, confidential reporting, pre-acquisition due diligence, and post-acquisition integration.<sup>11</sup> Leslie Caldwell of the Department of Justice recently gave a speech where she identified either nine or ten requirements of effective compliance programs, depending upon how you read the speech.<sup>12</sup>

These are all quite interesting, but notice that they are lists. Lists have great value because we can look at the lists and see the things we need to do. Lists also have some shortcomings. The shortcoming is, in part, that we do not know what is truly important and what is less

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9. Bank Secrecy Act of 1970, Pub. L. No. 91-508, 84 Stat. 1114 (codified as amended at 31 U.S.C. § 5318(h) (2012)), *amended by* USA Patriot Act of 2001, Pub. L. No. 107-56, § 352, 115 Stat. 272, 322 (codified as amended at 31 U.S.C. § 5318).

10. 17 C.F.R. § 255.20 (2014).

11. Foreign Corrupt Practices Act, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended at 15 U.S.C. § 78dd-1); *see also* CRIMINAL DIV. OF THE U.S. DOJ & ENF'T DIV. OF THE U.S. SEC, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT 57-62 (2012), <http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/01/16/guide.pdf> [<http://perma.cc/2K98-BL5K>].

12. Leslie R. Caldwell, Assistant Attorney General, Criminal Div. of the U.S. Dep't of Justice, Remarks at the Compliance Week Conference (May 19, 2015), <http://www.justice.gov/opa/speech/assistant-attorney-general-leslie-r-caldwell-delivers-remarks-compliance-week-conference> [<http://perma.cc/FYH7-QS7W0>].

important. There is no weighing of the lists. Also because the lists vary, you get the idea that some things might be included in some lists that other lists left out. We do not know the comprehensiveness of the lists. Lists are valuable. They share common themes. They are concrete and can be implemented. They are adapted to specific issues. They probably reflect the agencies' stake, but they do have these shortcomings: not systematic and not comprehensive. They do not provide guidance on how factors are weighed and they seem to reflect slightly different standings of the topic. That is where we are about. If you want to look at the standards for an effective compliance program, you look at these lists and try to derive information from them.

These lists are not quite as chaotic as the ones referred to in Borges' short story, *Celestial Emporium of Benevolent Knowledge*, which categorizes all the animals in the form of a list. The list includes animals belonging to the emperor, embalmed ones, those that are trained, suckling pigs, mermaids, fabulous ones, stray dogs, those included in this classification, those that tremble madly, innumerable ones, those drawn with a camelhair brush, those that broke the flower vase, and those that resemble flies from afar.<sup>13</sup> The lists that have been developed to define effective compliance programs are not crazy and chaotic like this, but they have some resemblance in that they do not identify the central quality that makes a compliance program effective.

As a useful supplement, not as a replacement by any means, and not even as something that can always be of practical use, but as an intellectual exercise, it is useful to try to get to the fundamental core of an effective compliance program with a simple economic analysis. Now, there are going to be some equations. We start with an assumption that employees of a profit-maximizing firm engage in random illegal conduct. The government imposes a fine for proven violations that is administrated with a defined probability  $z$ . The sanction that the firm experienced is the probability of sanction multiplied by the fine, which in this formula is called  $pf$ . We assume that the government sets the sanction for violations of social cost. Of course, the government does not do this, as Sean pointed out, but tries to do it to some extent.

The social cost equals  $pf$ . If the government imposes the full social cost with violations on the firm, then the firm's incentive is to do what is

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13. JORGE LUIS BORGES, *The Analytical Language of John Wilkins*, in *OTHER INQUISITIONS: 1937-1952* at 101, 103 (Ruth L. C. Simms trans., 1964).

socially optimal because it has to bear the social cost of any violations that occur. We now have a firm that is profit maximizing, but also incentivized to engage in optimal action from a social point of view. What is the firm going to do? First, it is going to spend money on compliance, what I call  $C$ .

How much is the firm going to spend? The first step is understanding that the more money the firm spends on compliance, the more violations the firm deters. But, this feature occurs at a decreasing rate. At the beginning, the firm achieves a lot through compliance expenditures, and then there is a decreasing deterrence of violations as the spend goes up. Eventually, the firm will achieve little or nothing for each additional compliance dollar spent.

Now, if you have compliance, what is the firm's cost of violations? It is simply the cost of the violations that remain with compliance:

$$(1 - z)(pf) + C$$

That is the firm's cost of violations with the compliance program in effect. Now, when will the firm engage in compliance? It will do this if the cost of sanctions with compliance is less than or equal to the costs of sanctions without compliance. The cost of sanctions with compliance has to be less than or equal to  $pf$ . If you improve cost by having a compliance program, you are going to implement the program. This is mathematically equivalent to the proposition that the firm will spend on compliance if the cost of compliance is less than or equal to the cost of the sanctions you avoid.

As long as the cost of your compliance program is less than the cost of the sanctions you avoid, you are going to spend on compliance. That makes sense because that is the profit-maximizing thing to do. How much will the firm spend on compliance? It wants to expend resources up to the point where the marginal cost of compliance equals the marginal cost of the sanctions avoided. That optimal point of compliance I call  $\hat{C}$ . It generates a benefit to the firm as compared to the situation without compliance equal to  $z(pf) - \hat{C}$ . That means that cost of sanctions avoided minus the cost of the compliance program is the benefit to the firm from an optimal compliance operation.

$\hat{C}$  is the optimal amount a firm will spend on compliance. At least there is a first approximation and it maximizes the social surplus. It is the efficient thing for the firm to do and it is what society wants the firm to do. Society does not want the firm to spend more than  $\hat{C}$  because if the firm spends more than  $\hat{C}$ , you get more cost of compliance than you get benefit in terms of violations avoided.

That gives us some definition of an effective compliance program within this framework. An effective compliance program is the set of policies and procedures that a rational, profit maximizing firm would establish if it faced an expected sanction equal to the social cost of violations. That is what we like to look for.

Now, that is the basic path of the paper. I do not have time to go into detail, but I will just spend the next three minutes describing this.

The one very interesting implication of this has to do with Gary Becker's theory of punishment.<sup>14</sup> Becker suggested that the optimal punishment is one where you have a low probability of detection and a high fine. You get the same degree of deterrence with the low probability of detection and a high fine as with a high probability of detection and a low fine. But you get this deterrent at a lower expenditure because the government needs fewer policemen on the beat if you have a low probability of detection.

Becker's theory is commonly interpreted to say that the optimal enforcement regime involves a low probability of detection and a high fine. What this interpretation misses is the fact that if there is a low probability of detection and high fine, the firm that is subject to the enforcement is going to adopt costly compliance programs. The Becker optimal enforcement model, suggesting a low probability of detection and high fine, needs to be qualified by the fact that we have to take into account the cost of compliance.

Let me turn to the concern, voiced by Sean and others, about the government imposing too much compliance spend on companies. Why is the government likely to do this? Government officials do not spend that money, but experience a reputational cost if there is a violation. As a result, government officials want the firm to spend an inefficient amount on compliance in some cases. This theory would provide some

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14. Gary S. Becker, *Crime and Punishment: An Economic Approach*, in *ESSAYS IN THE ECONOMICS OF CRIME AND PUNISHMENT* 1 (Gary S. Becker & William M. Landes eds., 1974).

support for the proposition that firms should spend less in compliance than what the government would prefer. Obviously, they should not adopt less than the socially optimal amount, but less than the government would prefer because the government would prefer firms to spend more in compliance than is socially optimal.

This is not to say that we should not have compliance. It is important that we have compliance. But we do not have to have compliance to the point where society is worse off with the compliance program in place than it would be without the program in place.

Thank you very much.

STEVE THEL: Thank you Geoff. Our next speaker is Miriam Baer from Brooklyn Law School. She is also active as a corporate scholar and has a history as a prosecutor. Thus, she offers, perhaps, a perspective that the first two speakers felt was overheard, but I think she is going to have perspectives that you have not yet heard.

MIRIAM BAER: Thank you so much. As Steve's introduction indicated, I am a lawyer and I identify with lawyers. I highlight that because what I am going to say may sound somewhat crazy or anti-lawyer. Although I was a prosecutor, I also worked for Verizon in compliance. So, I have some perspective from the compliance side, and I am sympathetic to the challenges that the corporate compliance officer typically faces on a daily basis.

Sean and Geoff very nicely laid out for you the big issues for compliance at 30,000 feet. I am interested in a much narrower issue that is closer to the ground, which is the corporate investigation. When we talk about compliance, we mean many things. We mean education and training. We mean the inculcation of norms and the creation of policies. We also mean how well the corporation investigates itself, identifies wrongdoing, and reports that wrongdoing to authorities. I am particularly interested, not just in the corporate investigation, but in the corporate attorney-client privilege. I am going to talk a little bit about some recent cases that have arisen in the last year or so, and then consider the normative implications of the corporate attorney client privilege. Namely, if we step back and remove our cloaks as lawyers, do we really think the privilege is worth preserving, at least as it arises within the corporate investigation? That is my question for today.

Let us just start right now. There is a very big structural compliance debate out there that many of you are aware of. We all understand that there is a general counsel's office. There is something out there that we think of as the corporate compliance office. There is a great debate whether the compliance function should be separate from the general counsel's office and have a direct line to the corporation's board of directors. Then we ask who should be conducting the corporation's investigations? How do these two functions join together to conduct the corporation's internal investigations?

There are also smaller issues. When I say smaller, I do not mean smaller as in less important to the firm, but, certainly, narrower issues. Should we have in-house counsel playing a role in the investigation? Should we have outside counsel? Should we, in fact, have independent outside counsel, meaning we have a law firm that has never had any kind of relationship with the company before? Now, to some degree, the situation itself will dictate the outcome. If you wake up the next morning and the *New York Times* has some huge blockbuster piece detailing how your subsidiary in Mexico was paying lots and lots of bribes to government officials, you will probably ask someone other than in-house counsel to investigate that.

Nevertheless, these are the types of debates that one frequently hears. Certainly among legal scholars, there have been a number of debates regarding the appropriate structure of corporate investigation. Underlying these debates is the assumption that legal counsel ought to direct the investigation in order to retain and protect the company's attorney-client privilege. In this talk, I want to take the step back and ask, well, what *about* the attorney-client privilege?

Let me start with just a little bit of background, which many of you here already know. If you were to climb into your DeLorean and go back in time, the big issue in the 1970s and 1980s before the Supreme Court decided *Upjohn*<sup>15</sup> pertained to the identity of the privilege holder. Who represented the corporation? Who was it that could speak to the corporation's attorney such that we would say this person's communication was privileged? At the time, some courts had held that the employee had to be within some sort of control group of the corporation for his communication to be privileged. *Upjohn* upended these lower court decisions. In *Upjohn*, the Supreme Court confirmed

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15. *Upjohn Co. v. United States*, 449 U.S. 383 (1981).

that the corporation retains its own attorney-client privilege.<sup>16</sup> The Court rejected the control group test as overly narrow and emphasized how important it is for the corporation's lawyer to be able to consult with as many employees as possible so that the lawyer can obtain the factual information he needs to provide effective legal advice. A broader privilege, the Court advised, was necessary to encourage full and frank communication throughout the organization.

Upjohn was a company that had received information that suggested wrongdoing and then used its own internal lawyers to investigate these allegations. The company's attorneys distributed questionnaires to the company's employees, who in turn, provided information about the alleged wrongdoing. The employees knew that there was an investigation and the company eventually disclosed the result of its investigation to the SEC and the IRS. The IRS did not quite trust Upjohn's recitation of what had happened so it decided to conduct its own investigation and sought direct access to the questionnaires and corresponding memoranda of employee interviews. Were these investigation materials privileged? Answering in the affirmative, the Supreme Court explained that a broad privilege was necessary to encourage the corporation's employees to come and talk to its attorneys. Free communication, in turn, would improve compliance.

*Upjohn's* holding rests upon two major assumptions: First, that the privilege improves internal disclosure, and second, that internal disclosure improves compliance. That the Court is thinking, in 1981, about corporate compliance is quite remarkable. But is the Court correct in its intuition that lawyers improve corporate compliance? Yes, we as lawyers think of ourselves as improving compliance, but we should consider whether this claim is as firm as we desire it to be, or whether the privilege generates other unintended consequences, such as the efficiency concerns, which may relate in part to what Geoff and Sean were talking about, although in a much narrower way.

Now, one thing the Supreme Court does not do in *Upjohn* is provide us a bright line. The Court does not say, in effect, "Okay, corporations, from now on, if you want to make sure your

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16. See *id.*

communications fall within the privilege, here is what you have to do.” As a result, because of the Court’s holistic approach to privilege, one often comes across lower court opinions that inquire how closely a particular investigation resembles the investigation in *Upjohn*. Based on that determination, courts will then determine whether the privilege applies.

Now, let’s talk about corporate privilege debates throughout the 1990s and 2000s. The big issue was waiver, which arose when the United States government, through the Department of Justice and United States Attorneys’ offices, began to place pressure on companies to comply with the law. Remember, in federal law, the corporation can be very easily prosecuted for a crime. Why? Because if you are a corporation and one of your employees commits a crime with an intent, not *the* intent, but *an* intent to aid the corporation, for example, keeping the company’s stock price high, you as the corporation can be held criminally liable, under *respondeat superior* principles, for what the employee did. That means for most corporations today, if you have 10,000 employees or 50 employees, it is not all that hard to imagine that one of them is actually committing a crime with an intent to help themselves, but also to help the corporation. This means corporations can very easily come under fire if prosecutors want to, in fact, prosecute them for their employees’ crimes.

One of the issues that arises in the 1990’s and 2000’s is, of course, the deferred prosecution agreement and the prosecutor’s exercise of discretion in offering an agreement in lieu of seeking formal charges and an indictment. In deciding between an indictment and a deferred prosecution agreement, prosecutors consider certain factors. One of those factors is how cooperative the corporation has been in regard to the government’s investigation of wrongdoing, and one of the ways the government measured cooperation in the 1990s and part of 2000s was by asking whether the corporation had waived its attorney-client privilege.

Initially, the question that corporations were most worried about was whether a waiver of privilege executed with the government would apply equally to everyone else. If a shareholder plaintiff’s attorney wished to sue the corporation, would that attorney gain access to otherwise privileged materials from which the government determined there was no crime? This was the “selective waiver” question that was initially circulating when the government first began to demand waivers from cooperating corporate defendants in the 1990’s. Ultimately, a

majority of courts rejected the selective waiver doctrine, leading most corporations to conclude that a waiver of privilege would be broadly construed.

During the 2000s, a different problem surfaced, which one might call the “involuntary waiver” problem. Prosecutors reportedly sought waivers too often and a “culture of waiver” became pervasive. Additional issues arose relating to how the corporation paid for attorney’s fees for its employees. Eventually, Congress threatened legislation, culminating in hearings held by Senator Arlen Specter. Faced with the prospect of an Attorney-Client Privilege Protection Act,<sup>17</sup> the Department of Justice retreated and revised its charging policies. The Thompson Memo,<sup>18</sup> which previously encouraged corporations to waive privilege, was replaced by the McNulty Memo,<sup>19</sup> which offered a softer, lighter touch with regard to corporate privilege. It too was replaced by the Filip Memo,<sup>20</sup> which eventually was incorporated into the United States Attorneys’ Manual. The Filip Memo explicitly directs prosecutors not to request core attorney-client communications, but maintains the importance of prosecutorial fact-gathering.<sup>21</sup>

Thus, the claim that prosecutors commonly make is some variant of the following: “Look, we are not trying to find out what you said to your

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17. See Attorney-Client Privilege Protection Act of 2009, S. 445, 111th Cong. (2009); Attorney-Client Privilege Protection Act of 2009, H.R. 4325, 111th Cong. (2009).

18. Memorandum from Larry D. Thompson, Deputy Att’y Gen., U.S. Dep’t of Justice, to Heads of Dep’t Components, U.S. Att’ys, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003), [http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20\\_privwaiv\\_dojthomp.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20_privwaiv_dojthomp.authcheckdam.pdf) [<http://perma.cc/VN7Y-G58H>].

19. Memorandum from Paul J. McNulty, Deputy Att’y Gen., U.S. Dep’t of Justice, to Heads of Dep’t Components, U.S. Att’ys, *Principles of Federal Prosecution of Business Organizations* (Dec. 12, 2006), [http://www.justice.gov/sites/default/files/dag/legacy/2007/07/05/mcnulty\\_memo.pdf](http://www.justice.gov/sites/default/files/dag/legacy/2007/07/05/mcnulty_memo.pdf) [<http://perma.cc/6F9X-9TNQ>].

20. Memorandum from Mark Filip, Deputy Att’y Gen., U.S. Dep’t of Justice, to Heads of Dep’t Components, U.S. Att’ys, *Principles of Federal Prosecution of Business Organizations* (Aug. 28, 2008), <http://www.justice.gov/sites/default/files/dag/legacy/2008/11/03/dag-memo-08282008.pdf> [<http://perma.cc/RR6P-U5G5>].

21. *Id.*

attorney. We do not really want to be in the boardroom and find out what happened when the board members were talking to the attorney and asking for advice. What we are really worried about is the nondisclosure of facts to the government.” That, at least, is the argument that one often hears. “We just want the facts.”

That brings us to the present day. What are the contemporary corporate attorney-client privilege-related issues that concern us today? Two cases stand out. One is *In re Kellogg Brown & Root*,<sup>22</sup> which involved a defense contractor that used to be a part of Halliburton (I am referring to it as “KBR.”) The other case involves Wal-Mart.<sup>23</sup> The case relates to a newspaper article some of you may recall from 2012, when the *New York Times* detailed how a Wal-Mart subsidiary, Walmex, allegedly engaged in bribery, and further claimed that the investigation of Walmex by Wal-Mart was inappropriately quashed.<sup>24</sup> These allegations led to a 2014 lawsuit in the Delaware courts concerning the proper application of the privilege when shareholders seek documents in order to evaluate the possibility of filing a shareholder derivative lawsuit.<sup>25</sup>

As the *KBR* case demonstrates, courts and litigators still debate whether a given investigation is just an “investigation” or whether it is an attorney-client privileged investigation. As Geoff previously stated, corporate compliance has become big business and it has expanded beyond the general counsel’s office. That means we have a lot of people conducting investigations and not all of them are attorneys. Now, there is no rule that says it must be an attorney who asks the questions of a given employee for the privilege to apply. For example, if I am an attorney investigating what occurred, the exact questioner does not have to be me. I might supervise an investigator.

Nevertheless, in determining whether the purpose of the investigation was to secure legal advice, courts tend to look at the fact that there were a lot of attorneys doing these kinds of investigations or,

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22. *In re Kellogg Brown & Root, Inc.*, 756 F.3d 754, 757 (D.C. Cir. 2014).

23. *Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Tr. Fund IBEW*, 95 A.3d 1264 (Del. 2014).

24. David Barstow, *Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle*, N.Y. TIMES: BUSINESS DAY (Apr. 21, 2012), [http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?pagewanted=all&_r=0) [<http://perma.cc/HF8R-RPAJ>].

25. *See Wal-Mart Stores*, 95 A.3d at 1267.

conversely, whether most or all of the questioners were *not* attorneys. It tends to matter who is doing the questioning, and whether the person doing the questioning is working under the close supervision of an attorney, or not really communicating with an attorney all that much. As Judge Posner tells us, “there is no private investigator’s privilege.”<sup>26</sup> In other words, if the investigation is the brainchild of a private investigator, there is no privilege.

In *Kellogg Brown & Root*, attorneys played a role in the investigation, but the lower court denied the privilege on the grounds that KBR’s investigation was not undertaken solely for the purpose of securing legal advice. KBR had investigated an employee’s allegations that it had overbilled the United States on a defense contract.<sup>27</sup> The investigation, according to the lower court, was ineligible for the privilege because the company undertook the investigation for “regulatory reasons.” Since Department of Defense regulations required the company to conduct internal investigations, it would have sought the relevant information anyway from its employees. The lower court opinion makes a point of observing how different KBR’s investigation looks from the investigation conducted in *Upjohn*.

The DC Circuit eventually overturned the lower court’s decision on mandamus.<sup>28</sup> In doing so, the Circuit declared that seeking legal advice need not be the sole purpose of an investigation. Thus, the Circuit rejected the narrow “but-for” test that the lower court favored. Presumably, the Circuit felt that it had to do this if it was going to keep the corporate compliance function intact. No company today can genuinely say, “The only reason I executed this investigation was to secure legal advice.” Or, more formally, “But for seeking legal advice, the company never would have conducted this investigation.” *Every* company that investigates itself today does so, not only to secure legal advice, but also as part of its overall attempt to comply with legal or regulatory regimes. Meanwhile, the DC Circuit also discussed the

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26. U.S. Dep’t of Educ. v. Nat’l Collegiate Athletic Ass’n, 481 F.3d 936, 938 (7th Cir. 2007).

27. United States ex rel. Barko v. Halliburton Co., 37 F. Supp.3d 1, 5 (D.D.C. 2014).

28. See *In re Kellogg Brown & Root, Inc.*, 756 F.3d 754 (D.C. Cir. 2014).

resemblance between KBR's investigation and Upjohn's, and unlike the lower court, found KBR's investigation "indistinguishable" from Upjohn's.

The DC Circuit's discussion of the lower court's ruling in *KBR* portrays the lower court judge as coming up with this but-for test all by himself, but, in fact, the lower court judge was relying on an earlier district court case, *ISS Marine*,<sup>29</sup> which also involved an internal investigation relating to a defense contract.

Now, in *ISS Marine*, the defense contractor initially contacts Arnold & Porter and in response, the law firm sends an engagement letter detailing what it will do and how much its work will cost. Concerned that an investigation conducted entirely by Arnold and Porter will be very expensive, ISS Marine decides instead that it will conduct its own investigation (with some initial input by Arnold & Porter), and then remit the results to Arnold & Porter, who can then advise ISS Marine what to do. The issue then becomes: Is ISS Marine's internal investigation privileged? The court in *ISS Marine* declares that it is not, in part because the privilege claim appears "premised on a gimmick [to] exclude counsel from conducting the internal investigation but retain them in a watered-down capacity to consult."<sup>30</sup>

*ISS Marine* was never overturned and presumably remains good law. Accordingly, if you are a company and you are looking at what goes on in these various courts, you have to be aware of the fact that efforts to make your investigation cheaper by, for example, using fewer attorneys, may well place the investigation within some non-privilege category. Then again, even when the corporation unabashedly uses attorneys to conduct its investigation, it still may find itself losing the privilege's protection.

Consider another case: Wal-Mart. In 2012, a *New York Times* article announced allegations of bribery by Walmex, Wal-Mart's subsidiary.<sup>31</sup> The *Times* article includes an allegation that certain members of management intentionally short-circuited the company's internal investigation of wrongdoing. Thus, the wrongdoing itself relates to how the internal investigation was conducted. Shareholders ultimately filed a request for books and records under Section 220 of the Delaware

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29. United States v. ISS Marine Servs., Inc., 905 F. Supp. 2d 121 (D.D.C. 2012).

30. *Id.* at 129.

31. Barstow, *supra* note 24.

code.<sup>32</sup> The purpose of seeking these materials was to see if the shareholders could make out a potential fiduciary duty claim against Wal-Mart's management, a precursor to what might become a derivative lawsuit. Not surprisingly, Wal-Mart claimed the materials were protected by the privilege. In 2014, the Delaware Supreme Court affirmed the Chancery Court's order, which forced Wal-Mart to produce much of what the shareholders are seeking, including privileged materials.<sup>33</sup>

Here, the privilege was trumped by a different doctrine. *Garner v. Wolfenbarger*, a case decided back in 1970 by the Fifth Circuit.<sup>34</sup> It holds that under certain circumstances, shareholders may obtain access to the company's privileged documents. The Chancery Court further determined that under Section 220, the shareholders have shown essential need to execute a proper purpose, which is to determine whether Wal-Mart's management engaged in the kind of behavior that would warrant a derivative lawsuit.

So, the current state of affairs is that the privilege is alive and well but that atmospheric still matter. And, under the *Garner* doctrine, shareholders may obtain access to documents that everyone agrees is otherwise privileged.

So with the legal summary out of the way, let me get to the normative question. What is the ideal privilege rule for corporate investigations? That question is best answered by asking what is the optimal corporate investigation? It strikes me that the ideal corporate investigation is one that spends the company's resources optimally. The ideal corporate investigation is also one that conducts the investigation in a legal manner. This is particularly the case for an international investigation. And the ideal corporate investigation is one that identifies and discloses criminal conduct properly and that enables the corporation to learn from its previous mistakes.

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32. DEL. CODE ANN. tit. 8, § 220.

33. See *Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Trust Fund IBEW*, 95 A.3d 1264, 1283 (Del. 2014).

34. *Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970).

Now I am assuming that if you have a broad-based corporate attorney-client privilege, two things happen. One is that the privilege causes the corporation to hire and include more attorneys in the investigation than it otherwise would. Two is that attorneys are, on average, more costly to the corporation than non-attorney investigators. Assuming those claims are accurate, how ought we to feel about the privilege? If we are interested solely in optimizing resources, a no-privilege rule is better than a broad privilege rule because under a no-privilege rule, you still might hire attorneys, but you will not hire attorneys just to secure the privilege.

With regard to optimizing disclosure, I would argue that the effect of the privilege is more ambiguous than the Supreme Court and others suggest. In terms of executing the investigation in a legal manner, there is no question that it is better to have attorneys conducting the investigation, and in terms of optimizing learning, one can assume that attorneys improve the corporation's behavior, particularly insofar as they are able to identify incipient legal issues and enable the firm to deal with those while they are still small.

To return to disclosure: it is extremely difficult to conclude that the attorney-client privilege maximizes internal disclosure. If the attorney conducting the investigation delivers what is commonly referred to as an "*Upjohn* warning" wherein the attorney explains that the privilege belongs solely to the corporation and the corporation maintains the sole discretion to waive it, it is far from clear how such a rule maximizes disclosure because the warning effectively communicates to the employee that he has no legal protection whatsoever. Concededly, the privilege may increase disclosure from the corporation to a government agency or prosecutor, since an attorney in the boardroom will likely draw upon his legal experience and expertise in arguing why the corporation should disclose its wrongdoing to government authorities. But in that case, the corporation's reason for disclosure has fairly little to do with the privilege, and is instead tied to its determination of benefits that arise out of disclosure, as well as the costs that will ensue if it fails to disclose and is caught anyway.

So, this discussion suggests three possibilities for the future. First, we might conclude that there should be a privilege for *all* investigations, since that would remove the impetus to populate an investigation unnecessarily with attorneys. Presumably, that proposal would be dead on arrival, since courts and commentators believe sincerely that the

attorney brings something special and important to the corporate investigation.

Aside from keeping the status quo (the second possibility), we could also move to the opposite end of the spectrum and decide there should be *no* privilege for any type of investigator, conducting an internal corporate investigation. This option also seems doubtful, but it raises an interesting question. Would the world really be so bad if we did not have privilege for at least that part of the investigation that focused on whether certain wrongdoing occurred? Keep in mind that were courts to apply broadly the aforementioned *Garner* principle to shareholder requests, this is the result we would likely reach. Shareholders would routinely seek access to corporate investigatory materials, and investigators (be they attorneys or non-attorney investigators) would act accordingly. Would such a result reduce internal disclosure or ultimately redound to the benefit of the corporate shareholder? Perhaps we will learn the answer to this question when and if shareholders more frequently seek materials pursuant to Section 220. Through such activity, we might learn whether the corporate attorney-client privilege truly benefits the shareholder by maximizing internal disclosure and remediation, or in fact protects other constituents, such as the corporation's managers. Thank you.

STEVE THEL: Thank you, Miriam. I will take a few questions from the audience, but first I will give the other panelists a chance to comment on anything that anyone else on the panel said.

GEOFFREY MILLER: My question is for Miriam. The lower court in the *Upjohn* case stated the idea, as we called it, that there should be a privilege only for the control group, but not for ordinary line employees. This idea sounds like the rather transient criticism you made of the attorney-client privilege and of the fact that the conducts of compliance are really applicable to the lower level employee, who does not understand what is going on, and in any event is not protected by privilege. Someone at the control group does understand what is going on and probably has their personal interests aligned with the company a lot more than, let us say, somebody who is on the ordinary line. We do endorse the lower court opinion and *Upjohn* giving the privilege to the control group.

MIRIAM BAER: One problem that immediately creates is the issue of defining who is in the control group. You will have litigation forever about who is in the control group, particularly since a lot of companies have changed and we do not necessarily have these hierarchical structures involving the shop floor, the middle man, and then the senior guy. That was the kind of company we imagined in 1980. Today, we have a lot of flatter companies. I am not sure even that administratively works so well.

I do not know because, on one hand, I do find that this disclosure argument just does not work when you think about the lower level employee. In fact, I am bothered by the fact that the lower level employee might be talking to the lawyer because of a misperception, meaning he is given an “*Upjohn* warning” and he does not hear it. What he hears is, “Oh, is this a lawyer? Yeah, I can talk to him.” I think that is something that should bother us if he ends up speaking simply because of that misperception, although I must say that is exactly what happens, speaking as a prosecutor. That is exactly what happens with *Miranda*.<sup>35</sup> You have a police officer who gives a *Miranda* warning and someone sits there and talks his head off thinking somehow it is good for him and we get to benefit off of that.

I guess my answer to that is no; I would not endorse it only because I am not sure that it works. However, I do agree that it seems to make more sense in some ways to think about the control group as more representative of the company. Normally, you think of the board member as being aligned with the corporation when there is no actual crime involved. I am not sure in the criminal context if the board member is actually aligned. I am not sure if anybody should have privilege is probably where I am going, which, as a lawyer, I find admittedly unsettling.

GEOFFREY MILLER: Miriam, did you have a question?

MIRIAM BAER: I had a question for Sean regarding the disclosure idea. Would it not be better if corporations disclosed a lot of stuff about their compliance programs? Two questions for you. First, is there not a risk that you are going to end up with the same problem that we have seen in executive compensation, which is that it ends up being a big data dump? It might even cause corporations to actually spend more, and spend more unnecessarily, so it ends up being a best practices work

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35. *Miranda v. Arizona*, 384 U.S. 436 (1966).

behavior, but not good behavior. Second, could corporations make a legitimate argument that they do not want to reveal the stuff that really works because that is a trade secret? Should compliance be protected as a trade secret? Should we take the argument that compliance should be protected as a trade secret seriously? If I spent a lot of money figuring out what works, then I should get to keep the benefits for me.

SEAN GRIFFITH: Two great questions. The first one I had not thought of; although, I do have this concept of compliance creep, which is that we all will look at our peer companies and see what they are doing. With regard to that concept, I suspect that it already occurs, so if there is public disclosure, it will not cause more compliance creep because I suspect that companies already look to the compliance processes of their peer companies.

The trade secret question is an interesting one. If a company actually discovered the secret sauce on how compliance actually works, would the compliance details be in this public disclosure? My argument on public disclosure is a derivative of a prior argument I made about directors' and officers' liability insurance [D&O insurance]. Companies have to disclose, in that context, premiums, retentions, and limits. That would cause the capital markets to be able to see the gauge of wrongdoing that D&O insurance is inside the company and that would be good for capital market placing.

In this context, what are the metrics that we would want to force disclosure in order to make compliance work better? I am not sure so I cannot answer the second question because I do not even know what I would ask them to disclose. The idea, I think, is that there ought to be some sort of compliance variables that we would know about and that assist the capital markets in gauging wrongdoing. What if they thought that it was worthwhile to have separated the chief legal officer from the chief compliance officer?

STEVE THEL: Thank you. We have time for a few questions from the audience for the panel members. Any questions? We do have one. Thank you.

AUDIENCE MEMBER: It seems to me that you were pushing more for no privilege in the context of investigations. Would that not undercut what the attorney privilege idea or theory stands for? You would expect that in the context of attorney privilege, people would be

more forthcoming in terms of the investigation or at least seek advice because that privilege is there? I am wondering, how do you juxtapose that with no privilege for investigations in general?

MIRIAM BAER: Two things. One, when we are talking about no privilege, I definitely would not suggest not having a privilege for, for example, transactions or any kind of true ex-ante advice seeking. In other words, if you are an attorney and I want to know in advance if we are about to do this deal, and they are asking me to send the money to this government officer's wife, what do you think of that? I want a rule that encourages me to come to you and ask that question and feel good about asking that question. There is a very old paper by Louis Kaplow and Steve Shavell that talks about when it comes to ex-ante advice, privilege is good and socially desirable.<sup>36</sup> We want to encourage it.

The problem with ex-post advice, after I have already done it, now I come to you as an employee and I say, "Just so you know, I sent all that money to the government officer's wife, and I hid it in the following way. I employed her as a consultant. What do you think about that?" You are not going to say to me, "By the way, we have this great privilege, and I am going to protect you, and all is well." The most you are going to say to me is, "I should let you know, it is the corporation's privilege." If you are an ethically responsible attorney, you are going to say, "It is actually the corporation's privilege, and it is really up to the corporation what we are going to do."

In fact, based on everything we know, it is quite likely that you are going to fire me, or you are going to give my name to the government, or any of those things. I do not understand then, when we are talking about ex-post behavior of what happened, how the privilege really gets people like me, if I am the sort of person who did the bad thing, to actually talk to you. Unless it is that I think that you are going to somehow protect me and keep your mouth shut. If that is the case, that is not socially desirable. That is where I am coming from.

STEVE THEL: Anyone else?

AUDIENCE MEMBER: To follow up on your question, I worked in my career at CA, which is a rather large corporation. One of the compliance function mottos was that you could report any wrongdoing, totally anonymously. In fact, employees were specifically encouraged to

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36. Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961 (2001).

report wrongdoing. I have a lot of comments, but I will just stick to this one. Specifically, to go ahead and report anything because confidentiality and privacy was going to be maintained if they did so did seem to encourage employees to report wrongdoing. It was not that you, yourself, necessarily engaged in the wrongdoing, although you could be the one anonymously reporting, but there was a general feel that given that statement, a lot more people would come forward, which they did. As you said, in a 10,000 employee corporation, things did happen, not all of them drastic. If that were to be taken away, clearly a lot less of that would have occurred. So, can you comment?

MIRIAM BAER: No, I understand that, although I wonder with your company whether someone made an actual statement along the lines of, "By the way, I engaged in insider trading and I thought you should know. Me and the gang are doing insider trading. Here is what we have been doing." I find it hard to believe that general counsel's office is saying, "That is fine. Thank you for letting us know. We will investigate this, and since you came forward, you will have confidentiality. We will never, ever remit your name to any authority." I can not believe that your company's policy did not have some little exception built in there that said, "Under certain circumstances, we are going to have to reveal what you did criminally." That seems unlikely to me.

STEVE THEL: All right. I will ask you now to join me in thanking our panelists.

**PANEL II: EVOLUTION: IMPACTING FINANCIAL SERVICES**

GERALD MANWAH: Thank you all for coming back to the second part of our program. I am Gerald Manwah, and Sean had introduced me earlier on in the first session. I would like to introduce the panelists for this session. To my extreme right, I will start with Allen Meyer from Barclays, then Henry Klehm, followed by Martin Grant, Alan Cohen, and Stuart Breslow.

I would like to start this off by asking the panelists to talk about a couple of things that came out of this morning's session, but also to give their views in terms of the evolution of compliance with regard to a number of defining moments over the last ten to fifteen years. As many of you know, the regulatory landscape for compliance has changed considerably. There have been a lot of defining moments over the last ten to fifteen years. We all remember the events of September 11th. We also recall the events of 2008 and the financial crisis. We have seen censures in the financial services world that have gone beyond hundreds of millions of dollars to now in the billions of dollars, and what I will ask the panelists from my right, Stuart, going down, is to talk about how have you seen compliance change, particularly with regard to the reporting lines of compliance?

In many institutions in the past, compliance was part of the legal function, but we are seeing a different, evolving model with regard to the independence of compliance sometimes being associated with the risk function, and more so, in some institutions, with part of the legal department. Stuart, we will start with you, and we will go on to see what models exist today, and what you think the future model will be.

STUART BRESLOW: I am the chief compliance officer of Morgan Stanley. I guess I am the grand old man of compliance because my perspective goes back more than fifteen years because I am two months short of being the chief compliance officer for twenty years. Having worked in compliance for some time now, and having begun at a time when there were not many lawyers who were leading compliance efforts, I have certainly seen the evolution over the course of the two decades, and I do agree that over the course of the last six or seven years there has been the greatest change in compliance.

I do report to the chief legal officer. I am a lawyer by training. I spent eight years at Morgan Stanley as a litigator before the fickle finger of fate pointed at me in April 1995, and I became the chief compliance officer. What I often muse about is how to do somewhat the same job

for twenty years. My job has not been the same job for twenty years. I became head of compliance for Morgan Stanley, the old investment bank, with about five thousand employees. In 1997, we merged with Dean Witter Discover, where I became head of compliance. In 2001, the civil war that erupted found its way to me, and I moved to Credit Suisse First Boston, and went to work as head of compliance for a Swiss-headquartered organization, and, clearly, there is a very different corporate ethos in a Swiss organization.

In 2005, Morgan Stanley was going down in flames because of a bunch of legal regulatory issues. The CEO was caused to leave and John Mack returned. The day he came back, he called me and asked me if I wanted to rejoin. In 2008, we became a financial holding company regulated by the Federal Reserve Bank. We also became a nationally chartered bank regulated by the Office of the Comptroller of Currency [OCC]. I do remember, and I am not so sure that Tom will remember, but we came down on the Monday following our conversion to a financial holding company. We put the application in on Friday, we got it accepted on Sunday, which was not the usual course of affairs at the Federal Reserve Bank, and on Monday morning a whole bunch of us tromped down to the Federal Reserve Bank. We went down the row. I was probably about eighth or tenth in the group, and Tom had not asked me any questions at that point. He got to me, and Gary Lynch, the general counsel, was introducing each of the people that were in the room: the CFO, the chief risk officer, and down the line. Tom's first comment in that meeting was, "So who do you report to?" At that point, I said, "I report to the chief legal officer. Are you okay with that?" He said, "I am okay with that."

We have since then re-validated that several times. Clearly, we are in a growing minority, as housed within the legal department. I report to the chief legal officer, who in turn reports to the chief executive officer. I am on the firm's management committee. He is on the firm's operating committee. We meet with the operating committee periodically. I meet with the board independently. It has worked for us. We have had a remarkably good run in the compliance space. I attribute it uniquely to my genius in the space. I am joking, but we have had a very good run.

That is it in a nutshell. The other thing to note is in size. When I rejoined Morgan Stanley in 2005, there was probably a fifty-fifty split

between legal and compliance. There were 900 people in the group with 450 in legal and 450 in compliance. Now, we are about 1300 people. Compliance is “to infinity and beyond,” in the words of Buzz Lightyear. We continue to grow every year. That is us.

ALAN COHEN: I am older than Stuart is, but I have not been at it as long. First I was an academic. If we go with the chief ethics officer, I am probably the only guy on the panel with a PhD in political theory, so I may qualify. I left being an academic, law school, and the rest, and became a federal prosecutor for nine-plus years. Then I became a white collar regulatory defense lawyer for twelve-and-a-half years. Then I got the opportunity to join Goldman Sachs.

That was in 2004, after the firm, with the help of Boston Consulting Group, completed a major study as to how to create an independent compliance function. The firm was probably much smaller. Today, it is roughly between 30,000 and 33,000 employees, but in 2004, a much smaller firm decided that they needed to figure how to have a truly empowered, independent compliance function. If I showed you all the questions that were asked at the time, you would find the same questions prevalent today, and in a lot of speeches by a lot of people on these panels, and in other forums. The questions were, where should we report? What should they look like? What are the right sizes, functions, and the rest? When I came, as a result of that study and conversations, I joined the management committee of the firm, which is the most senior committee of the firm. It was at the time, say, twenty-plus people. It has grown to thirty employees today.

I sit there, as do the general counsel, chief risk officer, the chief financial officer, the heads of the operating divisions, and the rest. That is a different model, concededly, than what Stuart has just described. I report to the CEO. I have always reported to the CEO and have truly unfettered access to the audit committee. Nearly each audit committee, there is a presentation, but more importantly, before each audit committee occurs, I am at the prep sessions with the board. There is direct access and an ongoing dialogue with our board of directors as well. That decision was made in 2004. I think that the structure for each organization will be different, but for Goldman Sachs, that was the right structure. When I got there, there were, call it, 200 to 300 full-time employees in compliance, augmented by 50 to 100 consultants from a variety of firms.

Fast forward to today, I will probably hit 950 people across the globe. What has happened in the intervening years? It is marked by

financial crises and other major disruptions in the city and in the world, as well as in the capital markets. Just focusing on compliance, it is the expectations of compliance that have so dramatically changed. I am sure we will talk about it on the panel. The things I do, and the panel with whom I work with today, are so radically different. Some of them are the same, but the breadth and scope of those activities and the depth are so radically different today that I can say that compliance has been transformed several times throughout the period that I have seen it up close and personal.

MARTIN GRANT: I am Martin Grant. I have to first issue a disclaimer on my behalf and Tom Baxter's behalf for his speech later that the views we express are our own, and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System. That said, I started at the Federal Reserve Bank in 1990 as a banking lawyer, became a litigator, and worked in enforcement for the first fifteen years of my tenure at the bank.

In 2005, we began a compliance program with maybe three people. This was after a study with Deloitte regarding whether we could benefit from a compliance program and based on the guidance of our general counsel, our audit committee, and our board of directors. We were also thinking about Sarbanes-Oxley, and the failures of WorldCom and Enron in the years before, and whether we could also impose some sort of discipline on ourselves.

We are an organization transformed by the financial crisis. We started at three, then became ten, and now have about forty-five employees. We have made huge investments in technology. Much of what we think about in terms of compliance is public integrity and trying to perform intake measures that are consistent with regulatory practice and that will ensure the public integrity of our organization. I will stop there.

HENRY KLEHM: My name is Henry Klehm. I am a partner at Jones Day. I started my legal career after an abbreviated business career with the SEC. I spent ten years at the SEC in the enforcement section here in New York before joining Prudential, now Prudential Financial, in 1999. I spent three years there as the deputy general counsel, and then six years at Deutsche Bank as the global head of compliance, before I saw the light and got out of it. I went into private practice.

With respect to the fundamental question of what is the optimal organizational structure for compliance, when I got to Prudential, we had just resolved, or were in the process of resolving, the first big multistate settlement and some other issues involving limited partnerships. It was obvious at that time that the compliance department needed to be part of the legal department, primarily for reasons of protecting privilege. It made a lot of sense.

Two-and-a-half years later, the then-general counsel absolutely hated having compliance reporting to him and that got changed. He was very much a lawyer and enjoyed the advisory part of being a lawyer and the proactive counseling, but did not so much enjoy counting how many policyholders had defects in their policy execution documents and things like that. That is a microcosm of what I think has driven a lot of organizational structure. That is to say, is compliance about being an advisory function on a trading desk or is it about making sure that everybody takes their anti-money laundering [AML] training every year? Are we counting noses or are we counseling proactively on transactions? I think when I was at Deutsche, talking about organizational creep and other things, we went from 400 to 780 compliance people in six years, and that number is even higher today. A lot of that related to increased regulatory obligations.

Since I have been in private practice since 2008, I probably counseled thirty or forty of the Fortune 500 companies about compliance programs. The answer, I think, is that it depends on what works for your organization, the expectations of your board, your audit committee, and the people that are involved. If the general counsel does not want to deal with counting noses of how many people took AML training, then he is probably not the right person to be doing that.

I know I have had some discussions with general counsels of major financial institutions that are not here today, and right now, they are very happy to not have compliance reporting to them because it is an operations and systems implementation game. We are spending enormous amounts of time developing and implementing global surveillance systems, global training systems, and things like that, which are not the core competencies of most people, other than Stuart Breslow, who have law degrees.

I think that is the way of the future, and when I talk to public and private companies not in the financial services sector about how to do this, that is really what it is about. What do you want that function to be? I know we are probably going to talk about what is effective

compliance. I think that is a question that people have to answer before they decide to whom your compliance officer is going to report.

ALLEN MEYER: My name is Allen Meyer, as Gerald reflected at the beginning, and I work for Barclays. I have a group called Global Compliance Services and Strategy, which is a bit of a mouthful. We call ourselves GCS&S, and we are essentially the central utility for all of the common parts of compliance. I will not get into the details of it, but I will walk you through my background before that.

I have all sorts of interactions with other panel members going back in my history. I was the global co-head of compliance at Credit Suisse, and during some of that period at Credit Suisse, I worked with Stuart. Before that, I worked at UBS, and before that, I worked as an enforcement attorney at the SEC, where I bumped into my neighbor on the left here quite a few times.

I have been in a senior compliance role since 1996, so I have, like many of my panelists, been on the journey to where we are today and where we are going in the future. It is simply going from the fringe to the center. Compliance, whether you are talking about the reporting line, investments, staffing, or stature within the organization, has continually moved upwards for a period of time. Around the financial crisis, that climb accelerated. The expectations were higher from the regulators. The expectations of senior management and the attention paid by senior management all grew over that period and uplifted quite dramatically around the time of the financial crisis.

The reporting lines of compliance at Barclays changed a couple of years ago to be directly to the CEO. The size of the department is 1200-plus for compliance, excluding the AML population, which would bring us to an overall number of about 2000 employees.

Addressing Henry's point, I think it is both. It started, maybe, as an advisory function where people sat on the trading desk from compliance and advised on daily transaction flows. I think it is still a key component to be at the table, being engaged with business people, knowing what is going on, on a daily basis. But I also think the check and challenge piece has become more important. There has been huge investment in it and technology associated with it, and I think to get to where you are going, and again, it is a continued evolution, you need to be working on both of those and taking both of those to the next level.

STUART BRESLOW: Look, we are all in financial services. I think financial services is far more mature when it comes to compliance than virtually any other industry. Maybe pharmaceuticals and aerospace are comparable, but there has long been a structure for compliance in financial services, so you see the numbers. We all have a thousand or so people doing compliance. That is not ordinarily the case. I am sorry, except for Martin, who has got three. It is a very different game in financial services and it has led to a very robust set of programs. Obviously, there is still some work to do, but it is very technologically based with a lot of arms and legs doing the work.

GERALD MANWAH: On that point, Stuart and I will just ask a few other people, in terms of if you were to look at industries outside of financial services and pharmaceuticals, what do you think is the future of compliance programs in large Fortune 500 companies? Especially, we have seen an uptick in Foreign Corrupt Practices Act<sup>37</sup> violations and a number of things that everyone trying to build a compliance program is doing. Do we see that there can be some benefits from learning from the financial services group, in terms of building those compliance programs? Alan C.?

ALAN COHEN: I'll yield to Allen, the other Allen on the panel. In my career before coming to Goldman Sachs, and since, I have seen companies really across the economy. Pharmaceuticals and aerospace are, if you will, the other highly regulated industries, though not nearly as regulated except in the accounting and government contracting space. Anybody who contracts with the government needs super high compliance because getting that right is incredibly important. In pharmaceuticals, it is much too easy to be crushed by running afoul of those regulations.

The truth of the matter is, and again, I have seen this before, and during my experience at Goldman, in companies we interact with, if you are doing business in global markets you better have a very strong compliance program because the world is a really complicated place. If you are shipping, if you are going in and out of a port, or if you are interacting in parts of the world where there are different expectations around who gets paid for what, even if it is just a ministerial act, the

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37. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended at 15 U.S.C. § 78dd-1 (2012)).

world in which we live has gotten very complicated as a money laundering matter, as a bribery matter, and as a sheer compliance matter.

A case that I dealt with before I even came to Goldman Sachs, towards the end of my private practice career, was a person who had been indicted in China for providing meals to doctors who would come into their tent basically on their break. The world and its laws is a very complicated place. Even though this is a very United States-centric panel, the laws around the world and around these very issues are equally complex and sometimes inconsistent, but all need to be attended to.

The UK Bribery Act<sup>38</sup> may just be the easiest way to punctuate that sentence. This Act is a UK law that effectively takes the United States Government's approach to governmental bribery and applies it broadly to governmental and commercial bribery.

STUART BRESLOW: As a standard-setter in corporate non-prosecution agreements in the Foreign Corrupt Practices Act space, we have seen our group raided by Fortune 500 companies who are suddenly looking for the secret sauce. That has been interesting to see, but we have all attended meetings of compliance professionals of other industries, and we go there, and we tell them that we have 850 employees in compliance or we have 950 employees. They say, "I have four," or "I have six." Other industries have to learn. They have to really understand it and embrace it, and not just because of bribery. There is a whole set of corporate ethics you would be concerned about that others do not seem to enforce and reinforce the way that we do.

To put it a little bit more generically, I think it is about the level of legal risk that the enterprise is willing to withstand. As Alan said, if you are dealing globally and internationally, you have to pay attention to how you reconcile those regimes. It is no longer just about the financial services industry. If you are an automobile company and you are shipping parts internationally, there are a lot of opportunities for mischief. Increasingly, the conversation involves whether you understand the legal risks that are facing your company. The hardest part of that for a person who has the two, three, or four people in his

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38. Bribery Act 2010, c. 23 (UK).

compliance department is looking ahead and saying we are doing this business now, and we are shipping auto parts to Brazil and stuff like that. Five years from now, what are the legal risks that are going to be associated with that?

I think it is also reputational risk and regulatory risk. I think we have seen so many cases of industrial corporations where there have been very lax manufacturing processes because the cultures in those organizations do not really understand the expectations of management. That really does get communicated through the compliance groups.

ALAN COHEN: Pretty much every manufacturing company has an embedded compliance function. It may not be a separate compliance function that stands alone, but an embedded compliance function. You just run through the list of activities you could get wrong. Think vitamin manufacturers. They thought they were fine because they thought they had the manufacturing process covered. They forgot that when people went on the golf course, they could actually violate the anti-trust laws pretty wantonly. The entirety of large United States companies and global companies, Siemens, Daimler, and the rest, all have learned the lesson that having strong compliance programs, and strong compliance and value cultures, is of critical importance today.

MARTIN GRANT: The one thing I would say, though, is agreeing with what everybody has said, I think that when you sit down with people outside our industry, we always go in thinking we are really special. It is really different, but the basic principles of what are the rules and regulations, what are the policies that are articulated, how do we train people on them, and what is the check and challenge to make sure people are doing it, and it might be slightly different, but the manifestation of who is doing the check and challenge, are really very universal issues and universal challenges.

STUART BRESLOW: Yeah, but the concept of lists is not relevant. I sort of disagree with that concept. I do think that every organization has to have some document called a code of conduct that it publicizes broadly to all of its employees. They know what the organization expects of them and what they can be measured against. There are a bunch of other things, whether it is an integrity hotline, training program, policies and procedures, or things that, if you do not have them, you look awfully unwise when there is a problem, not just because the prosecutors are looking for it and you are looking for the credit under the federal sentencing guidelines, but also because that

reinforces a corporate ethos. It is really critical to the success of a corporation.

GERALD MANWAH: Maybe I will just ask Martin. Because you are in compliance within the Federal Reserve of New York, how do you think that is consistent with other units within the Federal Reserve and your counterparts, the OCC and the SEC, in terms of building internal compliance programs like what you have built at the Fed?

MARTIN GRANT: The Federal Reserve Bank of New York combines a supervisory agency with an operating arm of a financial institution. So while our colleagues in Washington write the rules and guidance for the industry, we have to implement the best practices and guidance internally. We have a lot of lessons that we learn by doing what our colleagues broadly in the federal government have not experienced. Starting with a code of conduct, we are all subject to the same government ethics rules, but we have invested much more significantly in an ethics program that is comprehensive and employs a lot of people in order to make sure that our staff is knowledgeable, and to ensure that they have all the tools to do well in the operation in their day-to-day jobs.

GERALD MANWAH: I will pose these two questions to each panelist that came out of this morning's session. Should compliance programs be treated as trade secrets or should there be public disclosure on compliance programs? Just continuing the conversation from a practitioner's perspective, and I will start with you, Stuart, provide your views with respect to more transparency in terms of those programs, and maybe consistency and uniformity vis-à-vis your peers in other industries that are highly regulated.

STUART BRESLOW: A least from the start, going back two decades, we have always taken the view that compliance is not a trade secret and that, in fact, the entire financial services industry suffers when any of our peers suffer. We try to share best practices. Over the years, Alan, Allen, and I have spent many hours together trying to figure out the secret sauce, to the extent that there is one. I still remember when I first took over the job back in 1995 that I spoke to peers in other firms, and, without violating anti-trust laws, we took the view that, in fact, best practices were important and we should all engage in them.

We have lots of forums for doing that. We have always done that, and I would never treat compliance as a trade secret. In fact, from my perspective, the more we have industry standards, the better served we are, so that we know that everyone is actually behaving to a similar standard. The biggest problem we run into is when our employees say, “They are doing this at XYZ Bank, why can we not do it here?” The answer is that they really are not doing it at XYZ Bank, and if we all knew that we had similar standards, we would be in better shape. I do not see that one as a runner.

On the other question of disclosure, I thought the interesting point there was that there would be more data to do more research on the value of the programs. I thought that was interesting, although once you get into the world of SEC disclosure and the quality of disclosure, I think Sean is right; it becomes an issue of what is it that is being disclosed. What is the format for doing it? What is the ability to generate comparability around it? I would be in favor of it, but I just hope it does not become another one of these exercises in routine disclosure.

GERALD MANWAH: Alan?

ALAN COHEN: I actually think that I have probably spent more hours with these guys, and I am going to include Martin in some of this, talking about best practices and how to do various aspects of the job that we all do over the years. That has all been enormously helpful.

I will say that I think one of the places where the regulators broadly could do a better job is, and I have made this point in one-on-one conversations and I am not embarrassed or afraid to make it here, drawing from the lessons that they learned by going across different institutions and saying, “Here are some best practices, and here are some things that we learned.” Every one of these institutions represented here is entirely different. We all have different cultures. We are very much en vogue when talking about institutions, but each one of the institutions has a different culture.

We at Goldman, because of size, can have a partnership culture and share those values through forums with all of our MDs, led by our chairman. We can do that with all of our MDs and vice presidents. That has been going on since I got there in 2004, although at the present, they just keep rolling on different themes. We can do that because we are 32,000 people. You cannot do that if you are a couple hundred thousand people. You can articulate values and train people in those values broadly, but how you go about it will have to be different. I use that just as an example of what are the best practices around modified and

adapted for different institutions. What are the best practices around surveillance? Or insider trading? Every institution has insider trading risk.

AUDIENCE MEMBER: Need a lawyer?

ALAN COHEN: The most useful thing I remember the SEC publishing recently was when Steve Cutler went around and did the conflicts review in...?

AUDIENCE MEMBER: October 2003.

ALAN COHEN: Even though he promised to do so, he left beforehand, but subsequent to that, on different rounds, we have had some best practice documents. I actually think that disclosure from our respective institutions will never be good enough to actually be much helpful to the investing community, in my humble opinion, given its nature. We need a lot more disclosure by our regulators around best practices, the ability to go in and see what happens in different institutions. One of the best documents, and I recommend it to you, is the senior supervisory group review that came after the financial crisis. Global regulators went into institutions across the world that were impacted by the crisis and, concealing their names, they talked about the different things that worked well and did not work well at different institutions leading up to and during the financial crisis. Incredibly important, penetrating documents around risk management, compliance, control, governance, and the rest.

MARTIN GRANT: I had somewhat of a counterpoint on developing communities of practice in that ethics and compliance professionals have organized themselves in associations and those associations have grown tremendously. There is tremendous sharing. I think they could be more supported by large organizations. The second thing is that consulting firms have partnered with some publications to develop surveys so that there is some amount of information sharing. It may be at too high a level for the kind of world that Sean is talking about in terms of measures of effectiveness that can be used by shareholders.

HENRY KLEHM: I guess the reason I am in private practice is because I am the skeptic on all of this. First, on the issue of trade secrets and benchmarking, and sharing all of that information, it is great if you are right in the middle of that pack. If you are at the bottom of the pack,

your regulator is saying, “Klehm, why haven’t you got more resources?” If you are at the top of the pack, your management is saying, “Klehm, you are way too expensive.”

It gets very difficult to have a principled conversation. The reason we are different is we have people in forty-two different countries, and the people that you are comparing me to have people in twenty or ten countries. The benchmarking, trade secret issue, I think, becomes very difficult. I do think, to Martin’s excellent point, there are lots of societies, such as SIFMA, the Institute for International Banking, and the American Bankers’ Association, that I think are ideal formats for sharing that kind of stuff.

With respect to the best practices and promulgations by regulators, I agree with Alan that the Senior Supervisory Group report was fantastic. The problem that I see a lot of times though, when you know the underlying facts of some of this, is that fact gets a little lost in aspiration. The regulators have an agenda that they are trying to drive. It is very difficult. Even if they do not, sometimes boards or senior management have a skeptical view of that and so they are going to take that with a grain of salt.

With respect to the disclosure idea, the public disclosure idea, I guess my first question is, disclose what? We have seen in the wake of Dodd-Frank, the enhanced risk disclosure required in registration statements and 10-Ks, and proxy statements about Compensation Disclosure and Analysis, and the like. What I see happening a lot on the private practice side is people managing to the disclosure, which is not thinking necessarily what is the best for our organization, but how do I disclose it in a way that makes me look just look like everybody else.

To me, the proof of that was, believe it or not, when that rule first went into effect, CVS’s parent, Caremark, was the only company that year to disclose that it thought that its compensation systems drove inappropriate risk-taking by management. Of course, the next year it was gone. That had changed, and nobody that I am aware of has a disclosure saying, “Our compensation system drives too much risk.” It just does not happen. People will morph to the disclosure standard in a way that, I think, over time becomes somewhat counterproductive.

GERALD MANWAH: Thank you. Allen?

ALLEN MEYER: Being the last guy in the line sometimes has its disadvantages, having not much left to say that has not been said. But other than just as a practitioner, the more sharing best practices and lessons learned from the industry, whether from the regulators or among

ourselves, has a huge value. As a senior compliance leader, you are coming in every day asking how to do it better. You have the changing regulatory landscape, the latest thing in the newspaper that happened to a peer firm. It is the absolute challenge for us in senior leadership positions and compliance to keep evolving. You do not have a lot of time or money to make mistakes and chase down blind alleys. Generally, the direction of travel should be sharing and transparency, but I guess there are a lot of issues in terms of how to effectuate that.

GERALD MANWAH: Over the last few years, there has been a lot of evolving thoughts and changes in terms of what is known as the lines of defense. Who owns the first line of defense for a large corporation, an entity or highly regulated financial services company, especially when they are global in nature? With respect to the first line of defense, the second line of defense, the third line of defense, and the independence of the compliance function, there is a lot of discussion about the culture of firms.

What I would like to get from each of the panelists is your thoughts on organizations, particularly large organizations, having a culture. What does that mean today, especially with the evolving regulatory environment and regulatory expectations? Maybe I will do it in the reverse order, Allen M., so that you can speak first?

ALLEN MEYER: I guess I walked into that. I think there has been, for financial institutions, a lot of focus over the last few years on the overall risk management framework, which has a lot of implications. Going back to my comment before, there is a lot to do. There is a lot to do for operational risk. There is a lot to do for the compliance department—the first line of defense. Everything is changing. I think it is a great value to define your overall risk management framework. Who is doing what? What is the borderline between the compliance function and the operational risk function and the market risk function and the credit risk functions? That is sort of worth doing. What are the borderlines? Who is responsible for what? That is across the horizontal axis. The vertical is really the first line, which is business, people that run businesses, and their responsibilities. Second line is the risk functions. The third line is usually internal audit. I think it is also worthwhile to sort of clarify the vertical axis. Addressing what is the first line of defense's responsibility and ensuring they are responsible

for managing that risk across that waterfront. You have problems when they do not feel like they own it. They are waiting for compliance to tell them what to do. While you can never tease it out to “What do I do this day?,” if you are sitting in one of those chairs, a business chair, or a second line of defense compliance type chair, it is worth setting out, clearly, roles and responsibilities and making sure people understand it. It is when it is not clear when things start going wrong.

HENRY KLEHM: I think in terms of organizational culture, every large organization on the planet is ultimately driven by how people at the top of the organization are compensated. What are the key metrics or the key performance indicators about how they are compensated? If there is a perception that my friend, Allen here, is in a second-tier function, and therefore is compensated in a different way, or on a different grid, then the frontline function is taking business risk, or theoretically taking real business risk, not legal risk. There is going to be a natural stature issue there.

I think it is a very challenging thing for a board to look across an organization and think about how to put everybody on the same grid. The fact is you are all supposed to be doing different things, whether you are the first or the second or the third line of defense. When you get into that nomenclature that I know everybody is into right now, I think it really starts to say, “I am a tier-one guy. Therefore, I count more, and my compensation should reflect that.” What does the tier-two guy have to say about your compensation? What does the tier-three guy have to say about your compensation? How are those measures put back into that? That will have the biggest impact overall on organizational culture.

The other thing I will say is everybody talks about the Johnson & Johnson credo that has been around forever, and has only had very minor modifications.<sup>39</sup> It is worth reading that story, and it is worth understanding the whole Tylenol thing, and how that fit together because that is a true issue.<sup>40</sup> The leader of the organization, at a critical point in time, was willing to take zero risk. He did not take profit risk on

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39. See JOHNSON & JOHNSON, OUR CREDO, [http://www.jnj.com/sites/default/files/pdf/jnj\\_ourcredo\\_english\\_us\\_8.5x11\\_cmyk.pdf](http://www.jnj.com/sites/default/files/pdf/jnj_ourcredo_english_us_8.5x11_cmyk.pdf) [<http://perma.cc/4VKC-ZTR7>]; *Our Credo Values*, JOHNSON & JOHNSON, <http://www.jnj.com/about-jnj/jnj-credo> [<http://perma.cc/AX5G-72M8>].

40. See Jennifer Latson, *How Poisoned Tylenol Became a Crisis-Management Teaching Model*, TIME (Sept. 29, 2014), <http://time.com/3423136/tylenol-deaths-1982/> [<http://perma.cc/3D4L-TQS7>].

this at all. He put the potential consumers of Tylenol absolutely first regardless of how that panned out for the organization. That is an extraordinary leader. It takes an awful lot of guts to do that. When you have a leader that is willing to do that, or Jack Welch, who used to have the 9-blocker at GE, which was a miserable day or two for everyone in the operating businesses, when he, the head of internal audit, the head of legal, the head of compliance, and the head of HR sat down people and went through all the metrics of their business organizations on all of these kinds of things. You have got to have that type of engagement from the top to do that. When you get into a huge organization like Wal-Mart, with 2,000,000 employees, it is even more difficult to do.

MARTIN GRANT: We have been thinking about culture a very long time. We have been aided by people like the late Rush Kidder, and he always says that the culture is the stories that organizations tell about themselves. In the story of Johnson & Johnson and the story of Wal-Mart, the leaders' actions matter as do their words. Incentive structures matter as do the risk appetites of firms, so they can be organized in a way, and it has to do with the leaders of the organization stressing and emphasizing that compliance is everybody's responsibility. Good behavior is everybody's responsibility.

There are lines of defenses. The business people are often at the first line, and they have responsibilities to escalate issues and seek advice from both lawyers and compliance professionals as the matters arise. There is a role for everybody. While there is a lot of line tending, like this is our risk management responsibility or a control responsibility, I think the more organizations stress that good conduct is everybody's responsibility, and escalation is a key part of it, I think organizations are going to be better off. I will leave it there.

ALAN COHEN: I actually agree with what these guys said. I do think often the conversations are on lines of defense. This is Martin's point, which is that everyone in the organization must agree on what those values are. We set out fourteen. John Whitehead, who passed

away yesterday, had fourteen business principles that basically laid out the values of the firm that our firm has tried to live by.<sup>41</sup>

After 2008, we went through great soul searching around those values, and did a lengthy report with a series of seventy-nine recommendations to reinvigorate and give very concrete action steps around them, but that was a report of the firm. The ownership and execution of those action items as well as those principles belongs to the firm, driven from the top. I talked earlier about having the chairman of the firm sit down in groups of MDs and VPs. Unless the shared values are, one, articulated, and, two, become owned by the senior management, there is a risk that this lining up of defenses says, “I do not have to worry about that. That is her job.”

I think unless people—and we have actually changed the charters of every one of our committees—unless everybody understands that everyone’s job is reputational risk and protecting the firm, there is a risk. I think it is a risk that people will say compliance is the ethics officer’s job because that is who is supposed to stand up and say, “That is unethical.” You have to make sure that the values and the principles that the firm has agreed to live by are well understood and embedded, along with the consultation process and the review process, and the rest. Then the question is, what does compliance have to do with that? Guess what? Compliance at Goldman Sachs gets asked whether Sally should be promoted. Is there a reason Sally should not be promoted? Has Mary engaged in conduct that should be taken into account in connection with her compensation this year? What are the review scores? Unless you embed it throughout, there is this risk with lines of defense that it minimizes different people’s roles when they should be shared roles.

STUART BRESLOW: Going back to Sean’s comments earlier that if compliance were as omnipotent as he would have it be, and we have subsumed and subverted all corporate governance, I quibble with Allen on the three lines of defense. What compliance does is it facilitates and oversees compliance by the organization. Going to Martin’s point, compliance is everybody’s job. It is not just the compliance department’s job.

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41. See Goldman Sachs, *Goldman Sachs Business Principles*, GOLDMAN SACHS, <http://www.goldmansachs.com/who-we-are/business-standards/business-principles/index.html> [http://perma.cc/D72C-WS55].

The mistake would be that we are compliance or ethics housed in a group of you guys. You are the ethical conscience of the organization—you and you alone. What the first, second, and third lines of defense have really done is made clear to the business lines that they are first and foremost. It is their business. They are transacting. They are on the line. They have to make sure that it gets done right every day. “If they have questions about it, come see us. By the way, we will be watching them to make sure they do it, and internal audit will be watching us to make sure that we do it.”

I do agree too that these are not philanthropic organizations. People go to work for financial services to get paid money. I guess that is a real surprise for most of you in the room, but people actually get paid to work at these places. We look at people who have done bad things. We try to figure out whether or not they should have their compensation in some way, shape, or form docked. We also are very much involved in the annual evaluation process. We look at employees who have low scores on their annual evaluations in their ethics and compliances competencies that are rated. We too have the same sort of partnership culture, a little bit further removed from Goldman Sachs, as we went public in 1986, but at the core of Morgan Stanley is an old partnership.

I still remember when I was at Credit Suisse and the Morgan Stanley regime was going down in flames in 2004. My colleagues were saying, “You seem to care. Why do you care?” The answer was because I had been there for so long, and those of us who were there and were members of the partnership really cared passionately about it, not the same way you care about it if you are at a Swiss organization, or perhaps even a German organization, or even some of the larger UK banks. In our world, we were partners and it mattered passionately to us. In the end, when that regime went down in flames, we saw it coming and we knew it was going to happen.

MARTIN GRANT: I think the main point though is that values and culture are essential. You can have the best compliance department in the world, the greatest risk management structure in the world, but if the values and culture are not there, then it is going to be very difficult.

STUART BRESLOW: Our elevator speech is not, no offense, fourteen points. It is a first class business in a first class way, as the people who are the true successors to the J.P. Morgan legacy say very

simply and very straightforwardly, and we have four very simple points that have been our expositions of that. It is very clear to all employees what is expected of them.

GERALD MANWAH: I will ask the panel now a number of things because I am mindful of the time, and we would like to open up the floor for a few minutes so that people can ask questions. I will ask a number of things in one question.

In terms of the challenges for compliance for the future, we have seen the demands for compliance officers far exceeding the supply of people who are trained in the space. We also see the importance of technology, but not whether or not the investment in technology gives you the bang for your buck, and whether it is consistent across the board in terms of its effectiveness. We have also seen a trend to looking at behaviors and practices. What causes people to behave badly? When you look at some of the regulatory censures, it is not an organization filled with 300,000 employees that are all culpable. It is a small group of people that are actually doing some bad things. Of course, that corporation is liable and pays these hefty fines, as we have seen the criminal actions in some of the recent cases with Credit Suisse and BNP Paribas. The future of compliance is based on this landscape, and I will just ask the panelists to talk about where they see compliance as evolving based on some of these challenges. Stuart, I will start with you.

STUART BRESLOW: Challenges. I think the Federal Reserve has it right. One of the big questions is, how do we ever demonstrate program effectiveness? That remains for me the holy grail. We have all kinds of performance metrics. We have the things we do. We do make sure that every employee at the firm, from James Gorman on down, acknowledges their code of conduct every year. We do make sure that every employee from James Gorman on down does his anti-money laundering training and other training that we get around to the firm. We do have our metrics around surveillance and testing, but in the end, do we know if we have an effective program? We have not figured that out yet. We do know we have a program in size. We just cannot definitively demonstrate that it is effective. We do know that for purposes of the federal sentencing guidelines we have a program that ticks all the boxes. We have had independent law firms come in and validate that for us. We do know how our size compares to others because we have had consultants come in and do that for us. We have had horizontal reviews by our regulator. We know where we stack up that way. In terms of whether we have made that impact on the organization that is

demonstrating effective culture, we do not know, but we do know that we have a strong culture at its base.

Second thing is that there are a lot of jobs for compliance professionals right now. The number, and I am looking at the HSBC results a couple of weeks ago, is ten percent of their 258,000 employees are in risk and compliance associated with anti-money laundering. Where do you find those people? What do you do with them? How do you make sure they are doing their jobs properly? If it is tough here in the States, it gets tougher in Europe, and even tougher in Asia. We run a global business and it is very hard to find qualified staff, but we are doing the best we can. We have all been hiring a lot of young people, both young graduates of colleges and young graduates of law school, and train them up. Finding the bodies to do that is very difficult.

ALAN COHEN: I agree with what Stuart said. We all have the core elements and beyond in each one of them, whether it is certifications, training, a lot of focus on culture, and the rest, or in the job of preventing and detecting the firm, engaging in combat that would violate rules, cause reputational damage, or in other ways result in a bad impact. I think only results tell us that. The reason I say that only results tell us that is because if nothing ever happened in the world, you would say your compliance programs were perfect. It may or may not be true, but oftentimes, when bad things do happen, there is a strong compliance program over here that missed what happened over there. It did not ignore it. More often than not, it was not that someone knew it was going on. In those instances, it was just egregious, and that falls into my bad people will do bad things category. People miss things.

If you read the conversations that come out around LIBOR, as an example, those conversations which occurred in chat rooms lead me to not ask whether there are effective programs. We have effective programs, but they are not perfect. They cannot be. They will miss things. What I actually worry about going forward is how to get better at finding where the problems are that I otherwise will have missed.

That goes to your technology question. Every month, every year, there are a billion e-communications that occur at Goldman Sachs. How do I find that chat, or series of chats, associated with prices? In some cases, it is voice. In some cases, it is electronic communications. I need to associate that data with a market price, maybe with a voice

conversation and maybe with better knowledge as who the conversations are between and among and the rest. How do I get a better view of that? In order to do what? In order to find instances where I should be preventing bad behavior, or knowing that it is not bad behavior. How to do a better job of that? That goes to the crush of compliance talent.

Tentatively, I am not so sure, to go back. I am not sure what the return on investment is on hiring thousands and thousands of new graduates to look at account opening documents. We might be better off hiring thousands and thousands of technologists who could actually figure out how to find the money launderer, or the person who is engaging in misconduct. We have not gone that way, in large part, because nearly most of these settlements have resulted in people staffing up in easy—and it is hard to staff up—or in easier ways than solving the problems that I am worried about, which is how to find potential misconduct and stop it. I think that is one of the greatest challenges.

STUART BRESLOW: Just by way of comparison, we have 3,000,000 e-communications a day at our organization that occur globally. I think we are all in the same boat in this in terms of trying to use big data providers, the guys who figured out the Boston bombers, and tried to pull together lots of information from lots of different data sources within the organizations.

ALAN COHEN: Just to take away, a billion emails? Every month we record, if you played it end to end, ten years' worth of voice.

STUART BRESLOW: Although it is digitized now.

ALAN COHEN: It is digitized, but the United States Government cannot even record that well.

MARTIN GRANT: I was going to talk about smaller challenges: onboarding new staff and the importance of training and education on the culture. How do you make sure that the people who join your organization share your values and understand the key message? That is a core challenge. A lot of institutions find it a good thing for many junior staff, at least in trading desks, to have dialogue about misconduct, to the extent that you can get them early on the company culture and values.

HENRY KLEHM: I am going to go from that to very high-level observation. I think globalization of business transactions poses a number of risks that make the life of compliance very difficult. I think one of the biggest challenges, and you can look at the emails in the BNP case or you can go back to see when Alan C. was doing anti-trust

defense, is developing in a global organization mutual respect for all countries' laws and regulations, and how they are enforcing them. That, I think, is a very big challenge. I think if the BNP executive that had written the incredibly unfortunate email had really appreciated the seriousness with which the United States Government takes that conduct, I think he would have had a far different outcome. How compliance can convey that in a multicultural organization, and I know that some of us have worked for organizations with Germanic or Swiss roots, is a huge challenge, particularly if the systems are really rooted in different notions of what a corporation exists for.

I know here, despite what Professor Griffith said earlier, that corporations still do exist for the benefit of the shareholder. I think the European view, or the Germanic view, that the corporation exists to better society, lead to vastly different value systems around how you do that. Getting multinational businessmen to understand that you have to respect United States law the same way the French expect me to respect data protection law when I am doing business in France is an enormous challenge for compliance.

ALLEN MEYER: I am going to even take it at a higher level than Henry. I think the challenge is like the big bang theory. The universe just keeps expanding, and us, as compliance professionals, keep trying to contain something that continues to grow indefinitely. I think the challenge is to, and I think Alan sort of alluded to it, work smarter, whether you have to come up with different ways of looking at hiring and onboarding compliance talent and training them or better uses of technology where we are looking for detection of a bad actor rather than just compartmentalizing a person sitting all day, looking for one type of word or something like that that comes in our lexicon. How do we use our resources, which we have continued to grow with the greatest leverage at the points of the most impact in the organization, to impact in the culture? Trying to take away from the daily flow of challenges that come at you and sort of continue to return back to being strategic, how do you work smarter and have more impact?

GERALD MANWAH: Thank you all. At this point, we would like to open up the floor for questions.

AUDIENCE MEMBER: There is a lot of talk about culture and it is salutatory. It strikes me though that it is also ex-ante. If you have an

adult employee whom you have to teach integrity to, is it too late? Maybe there should be more of a focus on hiring practices? I am not saying you have to hire all Eagle Scouts who believe in God and love the United States uniformly, although maybe that would be good, but is there an ability to emphasize employment practices and who you are hiring if you have to teach them culture? For example, if there is a law against it or not, I am not going to trade with the enemy of the United States, but it seems that some of your organizations have problems where people not only do not recognize that there is a law, but they need a law to tell them not to do it.

MARTIN GRANT: I was thinking about hiring practices. Issues around grade inflation in college and that everybody is great, and when they come to work that they all want to be great, and then, especially with trading floors, your performance is measured every day. Will people look for an edge? How do you prevent that? Did they in their past life? It is hard to tell. "You cannot do that here," is something that you want to emphasize and stress. I do not know if there is a great failing in moral education in America, but we do see incidents, repeated incidents, of misconduct by fairly junior people.

ALAN COHEN: I am going to separate your two points just to start. I actually think there is enormous focus on hiring people who are, in fact, ethical, moral, great in their job, and the rest. I think it is a bit of a straw man that you set up on that one. The amount of time that is spent on that is enormous. That being said, nobody can get that perfectly. That would be point one.

AUDIENCE MEMBER: Straw man? Nobody mentioned it except to the gentlemen to your right.

ALAN COHEN: The reason I think it is a straw man is I think you should know that the amount of time that is spent in hiring people who are the right people for the job, both by talent and temperament, is basically enormous. I think it is like thirty interviews before somebody ends up getting a job at most of these places. There is no litmus test that anyone has found for someone who, notwithstanding shared values in a place, will not lie, cheat, and steal. Guess what? In any town of 100,000 people, somebody will do that even if everybody around them is telling them not to. West Point is an example. A lot of Eagle Scouts, but they have a lot of cheating. I was an Eagle Scout, by the way, just for the record. It happens in places where you would have certified to the culture, and we, because we are on the detective side, are still spending

enormous amounts of time trying to find the people who, notwithstanding that we thought would do the right thing, do not always.

ALLEN MEYER: People do not always tell the truth. That is the bottom line. I think when people are under stress over a protracted period of time to, let us say, make the trading profit or something like that, I think it is virtually impossible in a hiring scenario to determine when somebody is going to be willing to cut a corner.

STUART BRESLOW: Beyond that, making sure you have clear guidance to all employees what you expect of them is no different than saying to a first-grader, "Here is what we expect of you." There is no doubt about what is expected of every employee of the organization straightforwardly, and setting up cultural norms and behavioral norms for the organization, and if people get out of line, then they punished for it. The harder part is that you incentivize the good behavior, and demonstrate the incentivization of the good behavior, which is another thing we struggle with within this organization.

ALAN COHEN: I think there is a regulatory problem here as well. This is not so much in the United States, but outside the United States where people leave one firm and go to another firm, you will never know whether the person who you hire has left the other firm. Certain regulators around the world, I am being slightly careful here, actually receded, in my view, from their obligation to collect that information and disseminate it. There have been a lot of incidents. I will bet we can compare notes on this panel where people have left each of our firms for cause, in substance, and have been hired by the next firm with knowledge of the supervisory authorities that that was going on. I think that is probably something that people ought to be addressing as well.

AUDIENCE MEMBER: Following up on that, it strikes me that there are two types of groups that, if you were in compliance, you would be most worried about. One is what you might call the meticulous planner. This is like the bad guy who plans out his wrongdoing from day one, and because he knows he is engaging in wrongdoing, he covers his tracks. That is really the hard guy to find.

Then the other type of person, which I imagine is more prevalent, is the falls-into-it guys. He falls prey to temptation. There is something right there, and he is under pressure, and he takes that thing, that magic thing that is hanging there when he should not. It strikes me that there

are different ways that you might want to respond differently to the meticulous planner than you would to the fall-prey-to-temptation. Is that something that you have thought about in your respective practices? Where you say to yourself, “We are not necessarily going to worry so much about the Bernie Madoff, who may be in our firm, but we are worried about the guy who falls off the wagon.”

ALLEN MEYER: I think it is a great way to ask the question. I think, through the panel, we have been thinking about both of those people. The second one, the inadvertent drifter into misconduct, that is really about culture and making clear what the firm expects of you. Having compliance, having a powerful role, and them understanding that drift to get an edge is not acceptable. That is a cultural point. I think the second point when we talk about surveillance and detection, we are evolving that, trying to listen to voice and electronic communications and marrying it together with trade data. That is sort of the detection one, where we are stepping up on both levels at all of our firms, taking them both seriously.

ALAN COHEN: We need to figure out what in the world it looks like. It is really hard to get into people’s heads to figure out whether they are thinking they are the meticulous planner or the opportunistic actor. Since I know I cannot largely get into their head, I can tell them, make sure they understand what the value proposition is and what the expectations are, but after that, accepting the two categories, I am trying to figure out what it will look like. What the aberrational conduct would look like just as fast as I can. I cannot prevent it. I have stipulated that based on these two cases, but I want to be able to know what that little—in the sea of data—what that little blip is going to look like when either one of those motivations leads somebody to do something that is beyond the norm.

How do I know that? How fast can I know it? I am not going to be able to get into their head. I have had people. There is some great technology out there, where people have come to us and have said, “I can tell you, just by listening to their voice or analyzing their emails, who is the disgruntled employee.” Everybody that has had a disgruntled employee in the room should be laughing right now, because it never happens. I said, “Here is a test. I am going to give you a bunch of voice.” I have done this. I said, “Here are two terabytes of voice. Tell me who is disgruntled. I happen to know one who is in the pot.” Nobody has told me. I keep hoping that somebody will do that because then I have lots of digits for them to look at.

HENRY KLEHM: I think it is almost a dichotomy because the end result is the same. If you think back to a case that Alan and I have spent a lot of time on. Joe Jett had problems with other firms and tumbled to Kidder Peabody, and realized that this was his last shot at Wall Street. He saw an aberration in the computer system, which he then exploited to the extreme. It is not like he went in there knowing that that aberration existed. He spotted it and then engaged in a course of conduct over eighteen months that was devastating ultimately to the firm. I think all you could see at the end was the classic rogue trader.

GERALD MANWAH: Anything anyone else wanted to add? Did we have any more questions?

AUDIENCE MEMBER: We heard from Professor Miller earlier this morning about trying to figure out, with all his equations, what the most efficient spend on compliance is. My question to you is, how does regulatory pressure affect that spend? I think what he was trying to say earlier was that firms will try to spend the optimal amount of money, but how true is that or how exactly can that happen when there is extreme pressure from regulators to actually beef up or do other things for departments?

HENRY KLEHM: I think, if I remember correctly, he was talking about probability and the size of the fine. I think the pressure from the regulators increases the probability. I think the impossible, in his equation and in my mind, was predicting the fine. I think if you looked at AML enforcement in 2008, I do not think anybody would have predicted an \$8 billion fine. I think there were other externalities, for example the advent of the Department of Financial Services, that wound up driving that fine to an incredible level. Looking back at the conduct, we now see what it is. I thought it was an interesting idea. I think it is virtually impossible to do.

GERALD MANWAH: Anyone wanting to add anything? If not, I would like to thank all of the panelists for their contribution this morning. We will now move on to the next session. Sean is going to introduce the next speaker.

KEYNOTE ADDRESS<sup>42</sup>

SEAN GRIFFITH: It is my great honor and pleasure to introduce Tom Baxter from the Federal Reserve Bank of New York. Tom Baxter is the general counsel and executive vice president of the legal group at the New York fed. He has also served as deputy general counsel of the Federal Open Market committee. Mr. Baxter supervises the day to day operations of the New York Fed's legal group which includes the Federal Reserve's law enforcement unit, the corporate secretary's office, the compliance and ethics function, the banking applications function. He also serves in the bank's management committee. Mr. Baxter, as you may know, has published many books, many articles, relating to legal aspects of banking, as well as a number of important articles in what works well and what we should be doing different in compliance. So, it is my great pleasure to turn the podium over to Tom Baxter.

THOMAS BAXTER: Let me begin by thanking Professor Sean Griffith, the director of the Corporate Law Center, and Robert Lyons, editor of the *Fordham Journal of Corporate & Financial Law*, for inviting me to participate in this symposium about corporate compliance and corporate governance. Let me also thank Fordham Law School for hosting the symposium. I would also like to recognize a colleague who is with us today. He is Martin Grant, who is the New York Fed's chief ethics and compliance officer. I have had the privilege of working with Martin for the last twenty-five years, and much of what I have learned about compliance I have learned from him.

In the space sometimes labeled compliance, we have come a very long way in a relatively short time. In about twenty years, compliance has transformed from a nice idea to an important component of most major corporations. This is especially true in the highly regulated industries, including the industry where I have made my career, financial services. We could spend much time discussing how this transformation happened. From my vantage point, it happened because of the combined effects of the Federal sentencing guidelines, the Delaware Chancery Court's Caremark decision,<sup>43</sup> and the post-Enron

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42. The views expressed by the speaker are his own and do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System.

43. *In re Caremark Int'l Inc. Derivative Lit.*, 698 A.2d 959 (Del. Ch. 1996).

legislation known as Sarbanes Oxley.<sup>44</sup> Of course, other events also fueled the transformation, and in the financial services industry, the worst financial crisis our country has seen since the Great Depression became a burning platform.

While it is always important to look back at the road traveled, I am not going to spend any more time on that particular topic. Instead, today I intend to look forward at where compliance is going, and to forecast for our future some things we should pay attention to now. I will discuss five different items, and I predict that some of the greatest accomplishments for compliance are not in the recent past but in the not-too-distant future. If we plan ahead, and if we can successfully adapt to changing circumstances in our respective industries and in the national and global economies, then twenty years from now you will listen to another keynote speaker remarking on further amazing progress for the compliance profession. In short, we are on our way to another level.

Most of my remarks today will be devoted to the things that I believe will get us to the next level. Let me turn to them now.

The nomenclature that is used in compliance to describe the company officer responsible for compliance has changed, and the change in nomenclature is a clue to revealing a material, substantive change. Twenty years ago, we called this officer the “compliance officer”, and I emphasize the singular. Over several years the title morphed, as compliance programs developed and compliance jobs multiplied, both with respect to subject matter expertise and the types of skill sets needed to make compliance programs “take”. Consequently, companies found that the compliance officer turned into the chief compliance officer, because in major companies, it took a village to get compliance done. Compliance, you see, turned from singular to plural.

More recently the title has again changed. In many companies today, the title is chief ethics and compliance officer, or CECO, reflecting a salutary trend on the part of many companies to integrate ethics and compliance. Why is this happening? In my view, it is happening in recognition of the fact that it is easier to have an effective

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44. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended at 15 U.S.C. § 78j-1(m) (2012)).

compliance program in a company that nurtures a strong ethical culture. In a recent speech, Daniel Tarullo, a governor of the Board of Governors of the Federal Reserve System, accurately observed that “culture” is a “somewhat contested academic concept.”<sup>45</sup> Yet, the evidence is growing that an ethical culture produces tangible benefits, including making compliance more effective.

Recent studies attempting to assess the effectiveness of compliance programs have developed a measure called the “PEI”, or Program Effectiveness Index. Early work with the PEI shows that companies combining their ethics and compliance programs tend to have better PEI scores. The reason for the higher effectiveness measure seems to be something that I find perfectly rational. Ethics programs, consisting of measures taken to inculcate organizational values, help to create a culture that is not only conducive to following rules that are embedded in law and regulation, but also conducive to compliance with company mores. A strong ethical culture breeds a more compliant culture.

The symbiotic relationship between ethics and compliance arises because of the close connection between values and rules. Ethics is about values and compliance is about rules. You obtain the beneficial symbiotic effect when the values and the rules live in harmony. A different result is obtained when you have organizational values that conflict with the rules.

One of the very exciting areas in compliance today relates to how a company’s strong ethical culture can impact corporate behavior. One aspect of this behavioral change relates to the greater tendency of corporate constituents to follow the applicable rules when the culture is right. Looking to the future, I envision we will see much more empirical research that shows the benefits of merging ethics with compliance, and placing both in the hands of a trusted corporate officer with a catchy new name—the chief ethics and compliance officer. As we move to the next level, ethics and compliance will increasingly become a part of a single program.

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45. Daniel K. Tarullo, Governor, at the Federal Reserve Bank of New York Conference, “Reforming Culture and Behavior in the Financial Services Industry,” New York, New York, *Good Compliance, Not Mere Compliance* (Oct. 20, 2014), <http://www.federalreserve.gov/newsevents/speech/tarullo20141020a.htm> [<http://perma.cc/YX7F-CAGQ>].

The last twenty years have demonstrated the benefit of ethics and compliance in identifying legal risk and taking operational measures to keep that identified legal risk within the organization's accepted risk appetite. In most applications, though, compliance has been the vehicle that prompts the organization to reduce risk by constraining activity. In the financial services industry, correspondent banking provides an illustrative case.

Correspondent banking is the business of effecting funds transfers for other financial institutions. Because the U.S. dollar is the international medium of exchange, financial institutions throughout the world have a need to effect dollar-denominated transfers of funds. Ethics and compliance professionals in U.S. banks have pointed out that this type of business presents several different legal risks: money laundering, terrorist financing, and sanctions evasion are the most obvious and the most notorious. There is no doubt that these compliance professionals are correct. One consequence of their being right, however, is that U.S. correspondent banks decided to "de-risk". To execute on the de-risking mandate, many U.S. correspondents stopped providing correspondent banking services to those perceived to present such risk.

As a result, certain elements of the global financial services industry now find it increasingly difficult to transact business in dollars. There is a concern by the U.S. correspondents transferring funds for Middle Eastern customers that the correspondents might unwittingly be providing services to a terrorist organization, or be enabling a person or affected sovereign to evade economic sanctions. So, the correspondents close accounts for many banks in the Middle East. Similarly, there is a concern by the U.S. correspondents transferring funds for Latin American customers that they might unwittingly be providing financial services to drug traffickers, a money laundering risk. So, they close accounts for many banks located in Mexico, Venezuela and Colombia. The de-risking exercise succeeds in its risk-reducing objective, but it succeeds in an overly broad manner by cutting services indiscriminately to so many.

The adverse and unintended consequences for certain regions of the world are clear and present. There are also implications for U.S. policy with respect to the role of the dollar as the international medium of

exchange. These issues, while highly consequential, are not the object of my remarks today; rather, they are a symptom of what compliance can lead to—namely, a reason to restrict business activity. Given the size of penalties for violations, and the potential reputational damage associated with this business, it is easy to understand the business judgment to avoid risk.

The success of compliance over the last twenty years has conditioned business leaders to think about compliance as a pathway to terminate or constrain a risky business relationship. However, it is possible to look at compliance in a very different way, as a two-way street and not a “one-way” street. Let me explain what I mean. A sound and effective compliance program can be used, appropriately in my view, as a tool that would permit on-boarding of what is seen as risky business.

To continue with the example of correspondent banking, if a U.S. correspondent had a sound and effective compliance program that was well tailored to identify and control the risks of money laundering, terrorist financing, and sanctions evasion, this correspondent might become sufficiently confident to on-board risk. This means that instead of closing many accounts in a specific geographic area, it would continue with some of these accounts, or even open new accounts. Now, I do not want anyone to think I am saying that all correspondents can reasonably have such confidence now. At this point in our journey, I concede the need to develop greater confidence that the identified risks can be controlled at a reasonable cost. With that said, I believe that we will reach a place where ethics and compliance programs are sufficiently developed so organizations can make considered decisions to on-board risk and keep it within the accepted risk appetite by using effective controls. I look forward to that time as we move to the next level.

I mentioned earlier one of the promising new tools to assess the effectiveness of ethics and compliance programs, and that is the PEI, the Program Effectiveness Index. The excellent report by the Ethics Resource Center, *The Federal Sentencing Guidelines For Organizations at Twenty Years*, has drawn attention to standards for assessing program effectiveness.<sup>46</sup> The report states: “Altogether, the lack of assessment

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46. ETHICS RESOURCE CENTER, *THE FEDERAL SENTENCING GUIDELINES FOR ORGANIZATIONS AT TWENTY YEARS: A CALL TO ACTION FOR MORE EFFECTIVE PROMOTION AND RECOGNITION OF EFFECTIVE COMPLIANCE AND ETHICS PROGRAMS*

standards and guidance on how the quality of a compliance/ethics program should influence the outcome of a matter create the impression, validated by the [Ethics Resource Center] and Conference Board studies . . . that too many judgments are being made inside a black box.”<sup>47</sup>

While we seem to be on the cusp of a number of promising indicators, like the PEI, the truth is that we are not there yet. We simply do not have a tool that will give us an accurate and reliable measure of program effectiveness. Instead, we have a situation where enforcers (including those agencies with civil enforcement authority, such as the banking agencies) tend to be result oriented. When we see that a particular organization has experienced a major compliance failure, we tend to view the failure as evidence of the ineffectiveness of the ethics and compliance program. We reason backward, “if the program were effective, this would not have happened.” I think this is natural and understandable for the enforcement community, but it is not necessarily good policy. To borrow an observation from Senator Ted Kennedy concerning the Federal sentencing guidelines, this creates “a risk that companies without substantial compliance programs will get a free ride, and those with strong programs will not receive the credit that they deserve.”<sup>48</sup>

Alternatively, if there were a reliable and acceptable measure of program effectiveness, this kind of backward reasoning would be replaced by reliance on the effective measure. Institutions could use the measure when making arguments for leniency, again assuming that the measure demonstrated that their programs were effective. It might, of course, show just the opposite. And there are other, perhaps even more important, benefits. If an industry and its regulators came to have great

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(2012), <http://www.ethics.org/files/u5/fsgo-report2012.pdf> [<http://perma.cc/GVA8-PPDG>].

47. *Id.* at 51.

48. Edward M. Kennedy, Senator, U.S. Sentencing Comm’n, *Proceedings of the Second Symposium on Crime and Punishment in the United States*, “Corporate Crime in America: Strengthening the ‘Good Citizen’ Corporation,” at 120 (Sept. 7-8, 1995), [http://www.ussc.gov/sites/default/files/pdf/research-and-publications/research-projects-and-surveys/economic-crimes/19950907-symposium/WCSYMPO\\_opt.pdf](http://www.ussc.gov/sites/default/files/pdf/research-and-publications/research-projects-and-surveys/economic-crimes/19950907-symposium/WCSYMPO_opt.pdf) [<http://perma.cc/C85M-FDF3>].

confidence in a particular effectiveness measure, this might provide a foundation for building a program that could be used to on-board risk. Put differently, a particular organization could have confidence that its ethics and compliance program would be protective because the program had been validated by a well-accepted measure of effectiveness.

Some of the skeptics will say “you are dreaming”. When I hear them, I am reminded of the words of George Bernard Shaw, and specifically the reminder to dream things that never were and ask “why not”.<sup>49</sup>

Over the past twenty years, as ethics and compliance has moved through infancy and into early childhood, we have become committed to the process and procedure that is emblematic of a program. There is much about this progression that is good. The building of compliance programs has produced real benefits,<sup>50</sup> and these benefits have created the compliance profession. There is a risk too. The risk is that the process and procedure that is the substance of the compliance program will become a kind of iron cage, restraining innovation so that the organization cannot adapt to changing circumstances. In short, the process and procedure can stifle speed and agility.

One place where this has occurred recently is in financial services. Some institutions witnessed some malefactors violating the law and engaging in anti-competitive practices with respect to the setting of the Libor rate. Those institutions responded to very specific rate fixing abuses, but they did not envision that the abuses with respect to Libor could also be occurring in other businesses, like foreign exchange. Compliance, in this particular instance, was not adaptive. Compliance professionals, in this instance, did not show the needed speed and agility. They did not reason along the lines that “if it is happening concerning Libor then it might be happening concerning foreign exchange.”

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49. GEORGE BERNARD SHAW, *Back to Methuselah: In the Beginning*, act 1, in *Selected Plays with Prefaces*, vol. 2, at 7 (1949).

50. A survey sponsored by the Ethics Resource Center from 2011 “shows that employees in companies with effective, meaningful codes of conduct and programs . . . witness fewer incidents of misconduct, and are far more likely to report misconduct when observed.” ETHICS RESOURCE CENTER, *supra* note 46, at 2.

As compliance becomes increasingly routinized and subject to what the consultants would call the “repeatable process”, the process can have a tendency to drive out creative thought. As creativity dissipates, so does the ability to connect related occurrences. In the next 20 years, we will need simultaneously to perform repeatable processes and to think innovatively. We will need to continue to build the routines and repeatable processes. Yet, we will also need to be sufficiently flexible to see around corners, to where new problems are emerging, and new risks to our franchises are developing. This is what it will take to be successful at the next level.

I commend Fordham for focusing this symposium on compliance and governance. They are related and intertwined. The four items discussed all relate to compliance. My last item touches on governance.

As I speak with chief ethics and compliance officers, a regular topic of conversation is conflict with the business leaders who own the risk. This is a little unsettling, because during the last twenty years we have been successful in establishing as a better practice the approval of the compliance program by the board of directors. One might think that, if the board of directors approves the compliance program, then it should not be difficult for the chief ethics and compliance officer to get the business owners to pay close attention.

The devil here, as in so many other places, lies in the details. It is usually the implementation of the compliance program that causes the conflict. It is usually related to the cost of compliance, because the cost ordinarily affects how the business owner measures success, which is the size of the business’ profit. The chief ethics and compliance officer will not be able to resolve the conflict easily, because compliance is a cost to the business which can make compliance the adversary of the business owner. The chief ethics and compliance officer will not want to bring a specific conflict issue to the attention of the board of directors. While this might be very effective in resolving the specific conflict, it could absolutely destroy her ability to function effectively thereafter. In a recent survey of chief ethics and compliance officers conducted by Price Waterhouse, the survey respondents identified as a problem their

“struggle to gain the attention of the board of directors.”<sup>51</sup> Two specific issues were identified. One related to fear on the part of the chief ethics and compliance officer to engage in action to resolve a conflict with a key business person—a fear of losing one’s job or her place in the corporate hierarchy. The other problem concerned access to the board of directors. It is one thing to go before the board of directors annually to have the compliance program approved. It is quite another to go before the board of directors to do battle with a senior executive who is probably before the board of directors on a regular basis.

One possible solution as we move to the next level is to embed ethics and compliance issues in the disciplines that are more typical of governance issues involving the board of directors. These would be issues like strategy, business goals, and risk management, all of which touch ethics and compliance. Another solution would be to create escalation pathways to the board of directors for resolving conflicts between the chief ethics and compliance officer and a senior business leader.

As I said at the outset, ethics and compliance have come a long way in a very short time. We have learned a great deal during the journey. As I look out over the road ahead, I believe we will continue to make significant progress in business organizations that deliver on their value proposition, not only to shareholders, but to the other constituents that these organizations serve, their customers, employees, and communities. Ethics and compliance will be an important part of that progress, provided that ethics and compliance is nurtured by a strong ethical culture, in a company following sound corporate governance, and employing the best and the brightest personnel. I am excited about the road ahead.

Thank you for listening.

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51. PWC, WHAT IT MEANS TO BE A ‘CHIEF’ COMPLIANCE OFFICER: TODAY’S CHALLENGES, TOMORROW’S OPPORTUNITIES 12 (2014), <http://www.pwc.com/mx/es/riesgos/archivo/2015-03-challenges.pdf> [<http://perma.cc/2YGX-6Y7E>].