Michael Held: Reforming culture and conduct in the financial services industry - how can lawyers help?

Remarks by Mr Michael Held, Executive Vice President of the Legal Group of the Federal Reserve Bank of New York, at Yale Law Schoo's Chirelstein Colloquium, New Haven, Connecticut, 8 March 2017.

* * *

Thank you, Nancy, for your invitation and for organizing this discussion. It is an honor to join this session of the Chirelstein Colloquium.

My topic today is culture in financial services. Reform of culture has been a priority for the Federal Reserve Bank of New York for several years. Many of the observations I will share today are based on that work. But, as always, what I have to say reflects my own views and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.[1]

My thesis is that lawyers should play important roles at financial firms as advisors not just on law —what is legal or illegal—but also on culture. As I see it, culture is distinct from both public law and private rules. That doesn't mean that culture is completely independent of either. Indeed, a group's culture often informs and is informed by its rules. But culture is a powerful force in its own right.

I do not mean to imply that a lawyer should rush headlong into areas best reserved for organizational psychologists. A lawyer's advice on culture should always be grounded in law, and lawyers should be cautious in venturing too far afield from their core expertise and fundamental role as advisors on the law.

That said, an in-house lawyer is well-suited to assess and help improve an organization's culture. A lawyer can supply a degree of both independence and insight that is required to understand an organization's culture without becoming captive to that culture. Independence comes, in part, from a lawyer's training, independent code of ethics, and reporting responsibilities that ultimately go up to the board of directors. Insight comes from building a trusted relationship with a client over time.

A lawyer's aim should be what Gillian Tett from the *Financial Times* has described as the viewpoint of the "insider-outsider," someone with both understanding and objectivity.[2] Ben Heineman, a recent speaker at this Colloquium and a former general counsel of General Electric, has another take on the same objective: A lawyer is both a partner and a guardian. There is some inherent tension between an insider's and an outsider's perspective, between being a partner and a guardian. But, as Heineman argues, "these potentially paradoxical ideas can co-exist and, indeed, can be complementary."[3]

Some might argue that this is an expansive view of a lawyer's role. I believe it is the appropriate view. A lawyer who is both a partner and a guardian—an insider and an outsider—can greatly benefit a financial services firm. You might apply the same thinking to any number of contexts and clients. But since my experience is largely with banks, I'll stick with what I know.[4]

Let me first explain what I mean by culture. I'll then address the relationship between culture and law, and how lawyers can contribute to a culture that respects law. Finally, I'll propose an idea for a new law to address a cultural problem, and ask for your input on how the idea might be refined. I promised Nancy I would wrap up with plenty of time for questions.

For the purposes of our discussion today, I will use the word "culture" to mean the shared norms within an organization that are evidenced through behavior. A strong culture is highly effective at transmitting norms within a group and helping newcomers assimilate to those norms. We each observe our environments. Often—sometimes too often—we conform our conduct to what we see around us. As one of the New York Fed's summer interns put it, "Culture is best understood as something that makes people feel safe and confident in their inherited understanding of the world."

This insight suggests why culture can sometimes cause trouble. An organization's culture may yield too high a degree of adherence—or a dangerous lack of questioning. Culture can sometimes lead to a conclusion that an action is right because it appears to be accepted or ordinary. After all, if conduct is accepted, it must be safe and alright—right?

This assumption, and others like it, are frequently at the core of enforcement investigations by the Federal Reserve. If you were to ask "Why do people commit financial crimes," it might be tempting to respond, simply, "They're greedy." Some people are greedy. And some of those people commit financial crimes. In my opinion, however, the reasons why bankers break the law are varied and complex. And, in many instances, misconduct is related to an organization's culture.

Let's face it: In figuring out how to behave on an everyday basis, people may not always refer to laws or rules or regulations or policies. They may not always consult their in-house counsel or their compliance department. I know that probably sounds terrible for me to say, particularly as a lawyer. Make no mistake, I place the highest value on our laws and regulations. When I first joined the Fed, a colleague passed along a saying that he learned while in law school: Laws are the wise restraints that keep us free. I firmly believe that. Looking at the role of culture is *not* the same thing as excusing personal responsibility. There is no "culture excuse" when people break the law. I want to be clear on this. Laws and regulations matter. As a supervisor, adherence to laws and regulations is my top priority.

But I'm also a realist.

I think of a new, junior banker—fresh out of school, or otherwise new to an organization. In my experience, junior bankers typically don't consult "the law" for guidance on a day-to-day basis. They take their cues from their peers and immediate supervisors. That's how they discover what is important—to gauge the difference between what is right and what is wrong, or between what is successful and unsuccessful. A newly-minted trader, for example, may not realize what's wrong with a particular activity, especially if the conduct has the appearance of an accepted, ordinary, or highly rewarded industry practice. More often than not, it's an organization's culture—the shared norms conveyed through conduct—that provides instruction.

Another noteworthy aspect of cultures at some banks—again, observed in hindsight through enforcement investigations—is that they do *not* tolerate failure. A banker with a track record of success (academically, athletically, or professionally) may feel pressure to misstate performance indicators to preserve a self-image of success or to keep a job. The employment structures within many a firm—for example, the tournament-style systems of job retention—may contribute to this. In any year, a bank may part ways with anyone in the bottom ten or twenty percent of a peer group, based on financial performance. These bankers operate in an environment that does not tolerate failure—even when failure is guaranteed by design for a large percentage of the workers. That's dangerous for several reasons: It can encourage cutting corners. And it discourages escalation of problems.[5]

In other cases, a misguided desire to help teammates may have contributed to misconduct. This is also a feature of culture. Teamwork and employee loyalty are, no doubt, worthy principles. But in the LIBOR and foreign exchange scandals, for example, loyalty to friends and teammates became a reason for manipulating market benchmarks. This behavior may indicate a culture in which the company or a team is somehow viewed as above the law, or at least apart from it, as long as you are a high performer. That's a dangerous mindset for a bank, which exists in part to provide the intermediation activities on which other participants in the economy depend.[6]

The rate-rigging scandals involving LIBOR and foreign exchange markets are further instructive about culture in two respects. *First*, cultures may exist within an industry in ways that are not firm-specific. In some instances, the allegiances of the traders involved in the LIBOR and FX scandals ran toward one another, almost as a guild of traders, rather than to their employers or customers. Loyalty to the guild may have provided a sense of security and belonging. *Second*, any organization may have multiple cultures or subcultures. Indeed, most people who worked at banks involved in benchmark manipulation did *not* participate in misconduct.

It can be tempting to define away problems like LIBOR and foreign exchange manipulation as isolated to a “rogue unit.” Anytime someone uses the term “rogue,” as in “rogue trading unit” or even “rogue trader,” the hairs on the back of my neck stand up. Yes, it is sometimes the case that one or more people simply “go rogue.” But it may be more likely that a firm has a more systemic problem on its hands. Branding a behavior as “rogue” does not explain why it occurred. Even if the scope of misconduct appears limited to a few people, an underlying reason—such misaligned incentives or loyalties—may apply more broadly within an organization, and may lead to problems elsewhere. Without an understanding of root causes, how can you know that a particular behavior is random, or that its breadth will remain limited? Or, to borrow a common metaphor—and we lawyers love to use metaphors—how can you know that you are dealing with a single bad apple or a bad barrel?

Let me make one final observation about culture. At the risk of stating the obvious, every organization has a culture. It may be embraced or eschewed, nurtured or ignored. I think an organization that ignores culture does so at its own peril. Or, more optimistically, culture can be a powerful tool for achieving the firm’s goals.

What, then, does law have to do with culture? And what role can lawyers play?

As I mentioned, having a law on the books does not mean people will follow it. And being a lawyer does not always mean clients will listen to you. Some believe the solution is more laws. (Only the enlightened few argue for more lawyers.) But as New York Fed President Bill Dudley has argued, rules are “necessary, but not sufficient."[7] It is impossible to create a rule for every situation. Gaps in a regulatory regime are inevitable. Groups will develop shared norms for filling those gaps. So, for that reason alone, we need to look to culture as well as laws for solutions.

In addition, the pace of rulemaking is not always commensurate with the pace of rule breaking. Focusing exclusively on rulemaking creates a risk of fighting last year’s scandal.

What’s more, laws are good at setting the outer limit of acceptable behavior—what is clearly prohibited. They are less frequently and less reliably used to define what is optimal or what is good.

Finally, a regime dependent on bright-line rules may, strangely, entice people to walk right up to the edge of a rule—or to find creative ways around the rules. A proliferation of technical rules prompts us to ask what we *can* do, not what we *should* do.

In short, law *can* shape culture and conduct—but not always as intended. I worry that lawyers in financial firms are too often asked by clients, in effect, “How close to the legal line can I get?” Or maybe they’re instructed, “Just tell me if this is legal or illegal, not what I should do.” Worse, I worry that lawyers, intentionally or not, enable this kind of thinking. Lawyers are certainly not immune from cultural influences.

And recall my observation earlier about culture: Repeated behavior becomes a shared norm. Preet Bharara, the United States Attorney for the Southern District of New York, has a few views about this. He has described two particularly pernicious forms of culture, based on cases handled by his office: the culture of *minimalism* and the culture of *formalism*. In a minimalist culture, an organization does the “least amount possible to be in some kind of compliance with rules."[8] In a formalist culture, technical requirements take precedence over principles. Either way, it’s only a matter of time before these cultures lead people to cross the line. When this happens, CEOs have to explain themselves to people like Preet Bharara—and, if you’re a banker, to me and my colleagues.

In my view, lawyers must push against minimalism and formalism. They must argue not just for what is legal, but for what is sound and right. Lawyers should play a role as a part of the conscience of the organization.

Now, this is not a new concept. I certainly didn’t invent it. And you’ve heard recently from a leading expert in the field—Ben Heineman. I state it here because it is so important to what we as lawyers do.

Good in-house counsel will combine traits of outsiders and insiders that can produce keen insights and contribute to successful results. As *outsiders*, lawyers are trained to spot issues and, in the common law tradition, to reason by analogy and common sense. We also learn *some* actual law—not necessarily a whole lot, but enough to be able to learn more as we go.

I also think that lawyers are natural questioners—a self-selecting bunch. Questioners tend *not* to be yes-men or yes-women, afraid of rocking the boat. One of my predecessors at New York Fed put it this way, writing to the Legal Department in 1964: Lawyers should be “neither obstreperous nor mousy."[9]

We also enjoy professional standards that help resolve difficult ethical questions. Indeed, the rules that govern our profession expressly permit advice on non-legal matters.[10]

Lawyers can also, and should, function as trusted *insiders* and advisors. We’re partners in addition to guardians. In-house counsel, in particular, are able to build longstanding relationships with their clients. We get to know their businesses. We have opportunities to build trust and confidence, which can make us that much more effective and credible when we raise questions.

Retained by the organization, we are invited to take an enterprise-wide view, not a narrow view of a particular business line.[11] At large financial firms, lawyers advise most divisions, if not all of them. Lawyers can leverage their broad insights across a financial services firm. They can discuss among themselves how the conduct they observe in one division compares with the conduct observed by colleagues in another division.

In this way, lawyers can identify and help combat troublesome silos of behavior—to help firm management identify whether they have an issue in an isolated “rogue” unit, or a more systemic problem. For a junior lawyer, this might mean escalating up when she spots issues. For a more senior lawyer, this might mean engaging with peers in management—including the chief risk officer or chief compliance officer—to help ensure that issues are identified and addressed.

All this is to say, lawyers should support their clients with a healthy skepticism. When a CEO chuckles over the ethical lapses at another firm, assuming that such a thing could never happen at her firm, that is precisely the moment to step in, and challenge, and ask how the CEO gains this comfort. Are her assumptions are well-founded? Supervisors at the Federal Reserve call this “effective challenge."[12] Lawyers can look out for effective challenge at all levels of an organization. They themselves should also be effective challengers.

In addition to challenging a CEO's schadenfreude when another firm experiences trouble, here are some categories of questions that, while not strictly legal, a good lawyer should ask. Each of these categories requires both the understanding of an insider and the independence of an outsider.

The first category is *structure*. Does a particular way of organizing a business run the risk of unacceptable conflicts of interest? Are roles within a group clearly defined? Are they over-defined, so that employees lose sight of the big picture? Are control functions participating in key decisions? Are lawyers themselves siloed within separate business units? Are they consulted early, or only at the last minute? To quote again from one of my predecessors at the New York Fed: "Please let us get in on the take-off, if you expect us to be in on the crash landing."[13]

The second category is *communication*. Are principles and tasks made clear? Are problems escalated early or belatedly? How is bad news relayed and received—both from employees to managers, and vice versa? Note that, in both directions, communications pass through a middle layer. So, you might also ask how intermediaries influence the content of communications. In addition, do control areas communicate and coordinate with each other? Do lawyers share with each other and with other control areas such as compliance and risk officers about what they are seeing?

The third category is *leadership*—in particular, what has been called "character at the top."[14] Do the messages from senior leaders match their actions? Do senior leaders set an example of encouraging questions? Do they seek out feedback and input? Do senior leaders ask questions themselves and demonstrate openness to alternative ideas? How do they handle the inevitable mistakes that will occur in large organizations? Do they learn from them?

A fourth category, which I think is particularly important, is how the firm treats employees who *escalate issues*. This is where I am focusing many of my efforts as general counsel at the New York Fed. For an institution with so many public responsibilities—and, indeed, for any institution that wants to be effective over the long run—it is mission-critical that employees feel comfortable escalating potential problems and challenging accepted points of view. Do we seek out a diversity of viewpoints? If not, how do we know it the best idea wins? This is not always easy or natural. I think human beings have a natural bias to seek out others who have similar views to our own. But this only results in group-think. So, I encourage you to pay close attention to how your organization encourages escalation and responds to dissenting or divergent views.

None of these questions are strictly, or even largely, legal. But, paying attention to these issues is good legal risk management—part of being both a partner and a guardian. In my view, organizations with good structures, communication, and leadership—and, perhaps above all, organizations that welcome divergent views and promote raising one's hand—will, in my opinion, have fewer legal problems."

Of course, lawyers have to be mindful of the possible consequences, however unintended, that the partner/guardian or insider/outsider model may create. Lawyers may be perceived as giving authoritative advice on issues for which they should be only one of many voices. While lawyers may have a monopoly on rendering legal advice, they do not have a monopoly on advising as to what is "right." "We are not priests or rabbis."[15] And as lawyers become more vocal on ethical issues, there is a risk that tough ethical questions may be routinely outsourced to the lawyers. I get nervous when I hear a client say, "I'm just doing this because the lawyers told me to." This would be the opposite of the result that I would like to see: that business lines feel more responsible and are held more accountable for their own ethics and conduct. Finally, the more lawyers engage on non-legal questions, the more doubtful the privileged nature of communications with them becomes—and, an uncertain privilege, is not much of a privilege at all.

I believe these risks are manageable. They require careful attention, but not anything extraordinary. On the question of privilege, for example, client confidences should be protected from discovery if lawyers ground their advice in legal matters. And, by the way, this is an important check against straying too far from our expertise. Our advice is more valuable and more credible when we speak from our training, knowledge, and experience.

Moreover, in my view, the benefits far outweigh any possible risks. Paying attention to structure, communication, leadership, and escalation in a firm provides opportunities to spot potential misconduct early and intervene before problems grow even larger. Lawyers can also serve as models in this regard, prompting non-lawyer colleagues to respond in kind. Remember, culture is contagious.

Beyond spotting issues, lawyers must be proactive in solving problems, even ones that are of their own making. I will give you an example that we are struggling with today. To extend the metaphor I introduced earlier, we often call this the “rolling bad apple problem."

When an employee moves from one bank to another, it is standard practice for an employer to provide the equivalent of name, rank, and serial number. You can blame lawyers for this. I mentioned earlier that lawyers are natural questioners. I think we’re also genetically averse to risk. Providing information about employees creates a risk. For example, if the information provided is incorrect, there is a risk of a lawsuit for defamation or tortious interference—to name just two possible causes of action. And, regardless of the merit of a claim, it is very difficult to get employment cases dismissed at the pleadings stage. Most suits go to discovery, which is expensive. So, lawyers advise clients that the best option is to say as little as possible.

Here’s the problem with that legal advice. It’s been observed since the financial crisis that some of the persons most directly responsible for misconduct were not first-time offenders. They had records of misconduct at previous employers. But their former employers did not share information about misconduct with their prospective employers. Thus, a banker with a record of misconduct could move from firm to firm, spreading bad practices. Remember what I said earlier: Culture is contagious. Bad behavior can travel with a banker across firms, but his official record does not travel with him. What’s legally advisable for one organization results in a collective action problem for all firms.

New York Fed President Bill Dudley spotted this problem a few years ago and proposed a database of banker misconduct to address the issue.[16] In theory, a change in the law could establish two duties for financial institutions: a duty to report misconduct and a duty to check the database before an employee begins work.

The duty to report should arise when a covered employee leaves a firm in connection with some misconduct, defined to include not only violations of law, but also bank policies that govern behavior. Banks must explain the circumstances of misconduct in reasonable detail, such that a prospective employer could understand what happened. Those records would be available to other financial institutions for some reasonable period of time—say, five years—and would then expire.

The duty to check the database should arise after a conditional offer is made, but before the individual begins work. An offer of employment would be contingent upon a database inquiry. The prospective employer could withdraw its offer if it were not satisfied with what it sees in the database.

To overcome the legal risk that inhibits disclosure, a federal statute could provide limited civil immunity for reporting—a safe harbor. Banks would not face suits for money damages by former employees. But their *reports* to the database *would* face judicial scrutiny. To guard against abuse by banks, the statute should entitle employees to prompt notice and two options to pursue redress in the event that they believe a report about them is false: a low-cost, fast-track ombudsman hearing, or a full judicial review in federal court. This is critical. Remember that most people who work in financial services firms are not millionaires. The official sector would also remain free to take action—criminal or civil—to combat abuse of the database and its safe harbor.

There are costs and benefits to this idea—again, I'm only dealing with a hypothetical law, not any statute on the books or pending before Congress. And the database idea is not a cure-all. It will not deter all bad conduct and will not, standing alone, restore the trustworthiness of banks. But, on balance, I think a database will *help* overcome a collective action problem in the financial services industry, which will benefit both banks and their customers.

The database idea would benefit from input by prosecutors and regulators, employment lawyers for plaintiffs and defendants, in-house counsel, and others with empirical insight on human behavior. It is, in short, a prime opportunity for collaboration and refinement through forums like this one. I welcome your comments and questions.

One final note before I open the floor for questions. Some of you may be saying to yourselves, "Well, that was a riveting and insightful speech. [You're welcome.] But since I'm never going to work in financial services, I don't really need to worry about any of this stuff."

There is an ongoing debate as to whether there is something intrinsic and idiosyncratic about financial services that creates especially egregious culture problems. I've tried to stay away from that discussion today. Instead, I've tried to frame my remarks about culture in a way that can be extended beyond financial services to a variety of industries—and, dare I say it, even to academic settings or public sector institutions like the New York Fed. I would respectfully suggest, though, that you should be concerned with culture in financial services even if you're planning a career in a very different field. That's because problems in financial services don't tend to stay in financial services. They involve clients of those firms, and often have consequences for other sectors of the economy.

What's more, cultural problems are everywhere. Think of the problems at GM with its faulty ignition keys, or problems in the pharma industry with inappropriate sales practices, or just recently the headlines about a ride sharing company that allegedly used software to evade local laws. In each of these instances, and in many others, I always wonder how the lawyers could let this happen. I'm not the only one. "Where were the lawyers?" is a question often attributed to Judge Stanley Sporkin following the collapse of Lincoln Savings and Loan.[17] A decade later, the post-mortem evaluation of Enron criticized lawyers who "saw their role in very narrow terms, as an implementer, not a counselor." [18] And, within the last year, Ben Heineman posed the question again regarding Wells Fargo.[19]

Culture is an issue that you, as lawyers—both starting out in your careers and as you become more seasoned—will need to work with, regardless of where you end up or who your client is. Hopefully, you will be positioned to help your clients think about these issues proactively to mitigate risk *ex ante*, rather than just reactively, after a firm experiences significant, even existential, problems.

Thank you again, Nancy, for your kind invitation, and thanks to all of you for your kind attention.

---

[1] Celine Hwang and Thomas Noone assisted in preparing these remarks. I am also grateful to Anne Thoma for her contributions through the New York Fed's summer intern program.

[2] Gillian Tett, *The Silo Effect* 50 (2015).

[3] Ben Heineman, *The Inside Counsel Revolution* 7 (2016).

[4] I use the terms "banks" and "bankers" informally, to mean any supervised financial institution or its employees.

[5] *Cf.* Wieke Scholten and Naomi Ellemers, "Bad apples or corrupting barrels? Preventing traders' misconduct," 24 *Journal of Financial Regulation and Compliance* 366, 336–67 (2016) (describing the case of Kweku Adoboli, who booked non-existent hedges to cover accumulated risk in his trading book).

[6] *See* Dan Awrey, William Blair, and David Kershaw, "Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?" 38 *Del. J. Corp. L.* 191, 217 (2013) (arguing for "a norm of 'other regarding' behavior within financial services firms, one which . . . attempts to induce firms to take into account the private and social costs of their decisions").

[7] William C. Dudley, Remarks at the Culture Imperative: An Interbank Symposium (Jan. 11, 2017).

[8] Preet Bharara, "Criminal Accountability and Culture," Remarks at the Federal Reserve Bank of New York's Conference: Reforming Culture and Behavior in the Financial Services Industry: Expanding the Dialogue (Oct. 20, 2016).

[9] John Clarke, "The Role of the Legal Department," 6 (June 10, 1964). I am grateful to Ernie Patrikis, another of my predecessors as General Counsel, for retaining and recirculating this memo.

[10] *See* Restatement (Third) of the Law Governing Lawyers § 94(3); Model Rules of Professional Conduct of the American Bar Association § 2.1.

[11] *Cf.* Association of the Bar of the City of New York, "Report of the Task Force on the Lawyer's Role in Corporate Governance" 3 (Nov. 2006) ("Lawyers are often in a position to influence or facilitate the conduct of their corporate clients.").

[12] *See, e.g.*, Supervision and Regulation Letter 15–18, "Federal Reserve Guidance on Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms," 10 n.12 (Dec. 8, 2015) ("The term 'effective challenge' means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results."); Supervision and Regulation Letter 11–7, "Supervisory Guidance on Model Risk Management," 4 (Apr. 4, 2011) ("Effective challenge depends on a combination of incentives, competence, and influence. . . . Such influence comes from a combination of explicit authority, stature within the organization, and commitment and support from higher levels of management.").

[13] Clarke, *supra* n.9, at 23.

[14] Thomas C. Baxter, Jr., "The Rewards of an Ethical Culture," Remarks at the Bank of England, (Jan. 20, 2015).

[15] *Id.*

[16] William C. Dudley, "Enhancing Financial Stability by Improving Culture in the Financial Services Industry," Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry (Oct. 20, 2014).

[17] *Lincoln Savings & Loan Ass'n v. Wall*, 743 F. Supp. 901, 920 (D.D.C. 1990) (Sporkin, J.) ("Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated? . . . Where also were the outside accountants and attorneys when these transactions were effectuated? . . . What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.")

[18] Final Report of Neal Batson, *In re Enron Corp.*, No. 01–16034 (S.D.N.Y. Bankr. Nov. 4, 2003), at 115.

[19] Ben Heineman, "Heineman on Wells Fargo: Where Were the Lawyers?," *Corporate Counsel* (Oct. 12, 2016).