Institution-Based Financial Regulation:  
A Third Paradigm

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This Article argues that in the ongoing trans-Atlantic discussion about principles-based and rules-based financial regulation, a new development has been largely overlooked. This is the rise, in the United States, of a new approach to financial regulation. The author names this new strategy “institution-based” financial regulation. In this strategy the regulators, to date the Securities and Exchange Commission and the Financial Industry Regulatory Authority, require firms to establish certain institutions. In the U.S. regulatory context these typically include: a Chief Compliance Officer, compliance policies and procedures, an annual self-assessment, access for the Chief Compliance Officer to the firm’s senior-level executives, and internal codes of ethics. The establishment of these institutions is required by rule, but the functioning of these institutions within each firm is generally left to the firms themselves, with the regulators providing interpretations, guidance, and personal statements. The author argues that institution-based regulation combines a mandatory institutional architecture with a customizable firm-specific functionality. This strategy provides regulatory solutions to a number of global issues, including: addressing firms’ competitive worries about rivals’ compliance free-riding, recognizing local regulatory choices, providing a model that is scalable to the size and resources of any firm or market, building continuous improvement into the regulatory model, and helping firms in newly emerging markets establish themselves in the international marketplace. The author concludes that the development of a global community of compliance institutions staffed by highly skilled compliance professionals holds great promise for the future, because it could enhance the mutual trust and confidence needed to forge a truly global marketplace out of the world’s current medley of regulatory regimes, while preserving local regulatory choices.

I. INTRODUCTION

In recent months, there has been a trans-Atlantic discussion about the optimal approach to financial regulation. This discussion has contrasted the relative virtues and vices of two paradigms: “principles-based” regulation and “rules-based” regulation. British financial regulation, it is said, is principles-based, while U.S. financial regulation is rules-based.1 In a principles-based system, the government establishes desired outcomes for regulated entities, and then provides guidance on how the entities can achieve those goals.2 In a rules-based system, on the other hand, the government imposes bright-line requirements on regulated entities, and then uses the power of the state to enforce those requirements.3 This discussion raises important

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1. See infra Part II.
2. Id.
3. Id.
issues of regulatory strategy and has drawn considerable attention. How-
however, the binary choice it presents—principles versus rules—does not ac-
count for one of the most interesting recent developments in financial
regulation. This is the rise, in the United States, of an approach to regula-
tion that contains both principles and rules, but is fundamentally based on a
different regulatory strategy. To give it a name, it could be called "institu-
tion-based" regulation.

In an institution-based system, the government or industry self-regulator
requires regulated entities to create certain internal institutions. In the U.S.
regulatory context, these typically include a chief compliance officer
("CCO"), written compliance policies and procedures, annual self-assess-
ments, mandatory access for the CCO to the entity’s senior executives, and
written codes of ethics. The regulator does not, however, dictate how these
institutions shall function. Rather, it communicates its expectations through
interpretations, guidance, and personal statements. Similarly, in the U.S.
regulatory context, the regulators have brought a small number of public
actions to enforce the mandatory institutional requirements, and have uti-
лизирована большая часть неформальных проверок, чтобы убедиться, что
институты функционируют в рамках каждой отдельной фирмы. In other words, to a surpris-
ing degree—at least to those who consider the United States a rules-based
financial regulator—once regulated entities have established the mandatory
institutions, they have considerable discretion in determining how those in-
stitutions will actually function within the context of each particular firm.

This Article argues that institution-based financial regulation requires
regulated firms to establish a mandatory institutional architecture, but then
allows the firms to give those institutions a customizable firm-specific func-
tionality. This Article both describes institution-based financial regulation,
as illustrated by the approach in the United States, and demonstrates its
promise as a global regulatory paradigm. Following this introduction, Part
II presents the idea that the current regulatory debate suggests a paradigm-
atic choice between principles-based regulation and rules-based regula-
tion, a choice that is, however, neither simple nor binary in practice. Part III
explores examples of this new potential third paradigm, institution-based
financial regulation, using as a model recent trends in financial regulation in

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4. Id.
5. See infra Part III.
6. Id. at Part III.A.
7. Id. at Part III.B.
8. Id. at Part III.C.
9. Id. at Part III.D.
10. Id. at Part III.E.
11. See infra Part III.
12. See infra Part IV.
the United States for investment companies ("funds"), investment advisers ("advisers"), and broker-dealers. Part IV addresses several practical issues arising from the implementation of an institution-based regime, with a particular emphasis on how U.S. financial regulatory authorities, the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"), have dealt with them in the context of their enforcement and examination programs. Part V argues that the time has come to recognize that institution-based regulation’s combination of a mandatory institutional architecture with a customizable firm-specific functionality provides a paradigm-like strategy for financial regulation. Finally, Part VI argues that the use of institution-based financial regulation on a global scale could provide beneficial solutions to a number of regulatory issues. The Article concludes that institution-based financial regulation holds great promise for the future. The rise of a global community of compliance institutions staffed by compliance professionals could enhance the mutual trust and confidence needed to forge a truly global marketplace out of the world’s current medley of differing regulatory regimes, while preserving local regulatory choices.

II. Principles-Based Versus Rules-Based Regulation

A perusal of the current literature on financial regulation could easily lead one to believe that contemporary policymakers have two paradigmatic models from which to choose: principles-based regulation and rules-based regulation. In general, it is said, British financial regulation is principles-based and U.S. financial regulation is rules-based. Nonetheless, principles-based

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regulation has received much recent attention in the United States. Greater use of principles has been recommended in two major reports on sustaining the competitiveness of the financial services business in the United States, one by the Committee on Capital Markets Regulation, and another by New York Senator Charles Schumer and New York City Mayor Michael Bloomberg. In addition, several individuals have indicated interest in principles-based regulation, including Secretary of the Treasury Henry Paulson and Federal Reserve Chairman Ben Bernanke. Industry groups, including the Securities Industry and Financial Markets Association ("SIFMA"), have also expressed interest and support.

In a principles-based system, the government defines desired outcomes for regulated entities and then provides guidance on how the entities can meet those goals. The best known financial regulator to adopt a principles-based approach is the Financial Services Authority ("FSA") in the United Kingdom. The FSA describes principles-based regulation as, "where possible, moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their business." Instead, firms should have "the responsibility to decide how best to align their business objectives and processes with the . . . outcomes" specified by the regulator.

As a regulator, the FSA focuses on "setting out desirable regulatory outcomes in principles and outcome-focused rules." In this regard it has established eleven "Principles for Business" that "set overarching requirements for all financial securities firms." It also provides various forms of guidance to regulated firms on how they can meet those goals. Critically, a senior FSA official has explained, the principles "focus on what

20. BLOOMBERG & SCHUMER REPORT, supra note 18, at 104–06.
26. Id.
27. Id.
28. Id. at 8.
29. See id. at 8–16 (describing types of guidance and other regulatory actions).
2008 / Institution-Based Financial Regulation: A Third Paradigm 385

the regulations are trying to achieve and so are expressed in terms of outcomes rather than processes or procedures.”

The FSA has led in developing a principles-based approach, but others are now following. In November 2007, the superintendent of insurance for the State of New York released a draft regulation that would make the New York Insurance Department the first in the United States to establish principles-based regulation. Much like the FSA, the New York Insurance Department sets out a short list of principles, in this case ten for the industry and ten for the regulator. Moreover, again like the FSA, the New York Insurance Department emphasizes that its essential goal is “ensuring appropriate outcomes.” According to the New York Insurance Department, the principles are “a code of conduct” that can be “incorporated into the business philosophy and operations of regulated parties.”

Principles-based regulation is not without its critics. The Regulatory Law Committee of the City of London Law Society has expressed apprehension about the “unacceptable vagueness for firms as to how to satisfy” a financial regulator applying this approach. One commentator has noted that the Law Society’s public criticism of the principles-based approach made something of a “splash.” Others have made the same point, some by worrying that once the detailed rules are gone, regulators may find it difficult to judge firms, leading to the possibility of inconsistencies and the development of unpublished regulatory standards; and others by suggesting that since the principles-based regulator monitors “what” is being delivered, as opposed to “how” the firm is complying with specific rules, “there is a likelihood that enforcement action will become one of the more significant tools in influencing industry behaviour.” Others still have argued that this uncertainty will also work against the regulator, making it difficult for a regulator to punish on the basis of principles that can be interpreted in so

32. Id.
33. Id.
34. Id.
many different ways. This may give the industry an opportunity to become “a-compliant.” Finally, there is concern about how principles-based guidance would work in the hands of the unprincipled. If, for example, unprincipled auditors were able to manipulate the rules to allow public companies to misrepresent themselves, the results could be troubling: “Imagine how much more creative one can be when one has only a principle defining the boundaries!”

While principles-based regulation has its advocates and critics, the same could be said for rules-based regulation. In a rules-based system, the government establishes binding rules that regulated firms must obey and then uses the power of the state to enforce those rules. At the threshold, much of the commentary on rules-based regulation today is from those who criticize it and hope to replace it with a principles-based approach. For example, the head of the FSA has said that reliance on rules to address market misconduct “sets us firmly on the path to an ever burgeoning handbook, full of detailed rules to prevent further misdemeanor.” Indeed, such an approach “would suggest that we are only treating the symptoms of market failure and perhaps neglecting the root causes.” Similarly, the New York Insurance Department has noted, “[i]t is clear that detailed rules alone have not prevented misconduct.” Beyond these claims that rules are ineffective or treat symptoms rather than causes, advocates for principles-based regulation argue that rules are misguided because they require the regulated entity to focus on “technical requirements,” or “divert attention towards adhering to the letter, rather than the purpose of . . . regulatory standards.” Perhaps most damning of all, some assert, the “essential goal of regulation is not rote compliance with a long list of rules . . . .”

While those advocating principles criticize rules-based regulation, it is not without supporters. Peter J. Wallison, the Arthur F. Burns Fellow in Financial Market Studies at the American Enterprise Institute, has noted that the more detailed a rule, the more discretion is taken away from the

39. Samuel, supra note 56.
40. Id. (meaning that the industry could have an opportunity to work in an environment in which compliance is absent or irrelevant).
41. Paul F. Williams, Commentary on “Principles Versus Rules-Based Accounting Standards and the Concept of Substance over Form,” C. Richard Baker and Rick Hayes, Remarks at the Universidad Carlos III de Madrid 7th Interdisciplinary Perspectives on Accounting Conference (July 13, 2003), available at http://turan.uc3m.es/uc3m/dpto/EMP/noved/williams%20on%20baker%282%29.pdf.
42. Id. (referring to misrepresentations of Enron Corporation).
43. Tiner, Principles-Based Regulation, supra note 50.
44. Id.
46. Id.
47. FSA, PRINCIPLES-BASED REGULATION, supra note 25, at 6.
2008 / Institution-Based Financial Regulation: A Third Paradigm 387

government and given to the person subject to the rule.49 “[T]he rules-based regulatory system takes a great deal of discretion away from government officials, and thus reflects the traditional American suspicion of unfeathered government power.”50 Indeed, according to Wallison, “Americans simply feel more comfortable when they can exercise the discretionary judgments that affect their lives and livelihoods. When they must function under regulation, they want to understand the precise scope of that regime.”51 Moreover, he asserts, a rules-based system helps increase market competition by improving transparency and reducing barriers to market entry.52 A principles-based system will make it easy for regulators to make up “supposed policy reasons to protect favored industries from competition . . . .”53

Based on even the brief review above, it is fair to say that both approaches, at least at the level of paradigm, have their strengths and weaknesses. Moreover, actual regulatory systems are unlikely to achieve paradigmatic purity. The FSA has indicated that it intends to use rules in certain specific settings, such as to ensure adequate customer protection or sufficient consistency and comparability between regulated entities.54 In the other direction, a then-commissioner of the SEC indicated that certain elements of its regulations are already principles-based, such as its major antifraud rule, which is a short statement of prohibited frauds.55 Perhaps the optimal regulatory regime would deploy both principles and rules, utilizing whatever works best in resolving the regulatory problem presented.

It is not the purpose of this Article, however, to contrast and weigh the relative virtues and vices of principles-based and rules-based regulation. Rather, the purpose of this quick review has been to highlight the supposed paradigmatic choices currently available to a financial policymaker. In the principles-favoring language that has come to dominate such discussions, the choices are either guiding regulated entities to appropriate outcomes or dictating compliance with long lists of rules. But this simple binary choice is misleading. Guided outcomes and long lists of rules are not the only strategies now available to a financial regulator.

50. Id.
51. Id. at 6.
52. Id. at 4.
53. Id.
54. FSA, PRINCIPLES-BASED REGULATION, supra note 25, at 6.
Largely unnoticed in this debate over principles and rules is the advent in the United States of an interesting new institution-based approach to financial regulation. The strategy focuses on the construction and empowerment of certain compliance institutions within securities firms. To date, this institutional effort has unfolded in piecemeal fashion. Differing institutional requirements have been established for different types of regulated entities: funds, advisers, and broker-dealers. Nonetheless, viewing the last several years of regulatory efforts as a whole and as they apply across the regulated community, a fundamentally consistent approach can be detected. To understand this institution-based strategy, one must consider both the institutions and what they are expected to do.

The starting point for institution-based financial regulation can be found in certain specific rules of the SEC and FINRA. In December 2003, the SEC adopted rules requiring the establishment of compliance institutions at funds and investment advisers. In June and September 2004, the SEC approved rules of the National Association of Securities Dealers, a predecessor organization to FINRA, requiring the establishment of enhanced compliance institutions at broker-dealers. Finally, the SEC adopted rules

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388 Harvard International Law Journal / Vol. 49

III. INSTITUTION-BASED REGULATION

56. This piecemeal approach may be attributable to the fact that different regulators, the SEC and FINRA, are responsible for the regulations, and to the fact that even within the SEC, different operational divisions are responsible for drafting rules for funds and advisers and for broker-dealers.

57. The author wishes to note that he serves in the office within the SEC that is responsible for providing examination oversight of all of these types of entities. His observations about the consistencies across these multiple regulatory regimes are based on the perspective enabled by that consolidated oversight.


59. 17 C.F.R. § 270.38a-1 (2005) [hereinafter Rule 38a-1].

60. 17 C.F.R. § 275.206(4)-7 (2005) [hereinafter Rule 206(4)-7].


64. In 2007, the National Association of Securities Dealers and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange were merged to form FINRA. See July 26, 2007 FINRA Release, supra note 17; see also FINRA, About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/CorporateInformation/index.htm (last visited Mar. 17, 2008) (overview of FINRA functions).

65. NASD Manual §§ 3012(a)(1), 3013 (2006) [hereinafter FINRA Rule 3012(a)(1) or FINRA Rule 3013]. As discussed below, these rules enhanced certain longstanding requirements of the NASD. See infra text accompanying note 115.
requiring the establishment of codes of ethics by funds and advisers, in October 1980 and July 2004, respectively.

These rules establish the mandatory compliance structures for institution-based regulation. They require all three types of regulated entities—funds, advisers, and broker-dealers—to have a CCO, written compliance policies and procedures, and an annual self-assessment. They also require that funds and broker-dealers give the CCO access to the firm’s senior-level executives and that funds and advisers have a written code of ethics. If one were to consider only the rules-based elements of this type of regulation, these requirements would be its sum and substance. However, requiring the establishment of these institutions is only the start.

The SEC and FINRA also address how these institutions should function. Moving away from the bright-line, rules-based requirements that characterize their approach to the institutions themselves, they have stated their expectations in the form of interpretations, guidance, and personal statements. The primary sources of interpretations and guidance have been the releases that the SEC issues when adopting its rules, the Interpretative Materials that FINRA sets out with its rules, and guidance published by FINRA and its predecessor. The SEC has argued that the statements in its releases are not “legislative rules” that establish new legal obligations. Rather, they are interpretative rules that inform the public about the stan-

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67. 17 C.F.R. § 275.204a-1 (2005) [hereinafter Rule 204a-1].
70. Rule 38a-1(a)(4), supra note 59; Rule 206(4)-7(c), supra note 60; FINRA Rule 3013(a), supra note 65.
71. Rule 38a-1(a)(1), supra note 59; Rule 206(4)-7(a), supra note 60; FINRA Rule 3012(a)(1), supra note 65.
72. Rule 38a-1(a)(5), supra note 59; Rule 206(4)-7(b), supra note 60; FINRA Rule 3012(a)(1), supra note 65; see also Annual Compliance and Supervision Certification IM-3013, NASD Manual (CCH) (2006) [hereinafter FINRA, IM-3013].
73. Rule 38a-1(a)(4)(iv), supra note 59; FINRA Rule 3013(b), supra note 65.
74. Rule 17j-1, supra note 66; Rule 204a-1(a), supra note 67.
75. As a matter of policy, the SEC requires its members and staff to accompany personal statements about the work of the agency with a statement that the views expressed are those of the speaker and do not necessarily reflect those of the Commission, the Commissioners, or, when appropriate, the speaker’s colleagues on the staff.
76. See, e.g., Investment Adviser Codes of Ethics, supra note 69.
77. See, e.g., FINRA, IM-3013, supra note 72.
standards that the agency intends to apply when exercising its discretion. In other words, the statements are in the nature of "advice" from the agency, not rules with "the force of law." Of course, persons subject to agency regulation ignore its advice "at their peril." Similarly, when FINRA's Interpretative Materials have been approved by the SEC, they are "generally considered part of the rules" they interpret, while the publications that provide "guidance" are labeled as such. Finally, regulatory officials' personal statements about their hopes for compliance institutions are useful in understanding the regulators' vision for the new institutions, but as a matter of law they are merely hortatory. Taking all of these materials together, it is possible to describe in some detail both the institutional arrangements specifically required by the rules as well as the regulatory expectations for how these institutions would operate.

A. Chief Compliance Officer

All three types of regulated entities—funds, advisers, and broker-dealers—must have a CCO. In all cases the entity must "designate" someone to serve in this capacity. Beyond that, the rules contain certain variations. Funds and advisers must designate a single person to serve, while broker-dealers may designate more than one. Broker-dealer CCOs must be "principals," a defined status requiring, among other things, the completion of an appropriate qualification examination. Fund and adviser CCOs have no such qualification requirement. The designation, compensation, and removal of fund CCOs must, however, be approved by the fund's board of directors, including a majority of the independent directors. Finally, ad-

80. Id. at 37–38.
81. Id. at 59.
82. Id. at 42.
84. See, e.g., FINRA, NTM 05-29, supra note 78.
85. See, e.g., F.X.C. Investors Corp. and Francis X. Curzio, Initial Decision Release No. 218, 2002 SEC LEXIS 3168 (Dec. 9, 2002), available at http://www.sec.gov/litigation/aljdec/id218jtk.htm (rejecting binding authority of such personal statements, including, inter alia, a speech by a member of the Commission). That initial decision became final in 2003. F.X.C Investors Corp. and Francis X. Curzio, Investment Advisers Act Release No. 2097, 79 SEC Docket 276 (Jan. 9, 2003), available at http://www.sec.gov/litigation/aljdec/id218jtkfo.htm. As previously noted, as a matter of policy, the SEC requires its members and staff to accompany personal statements about the work of the agency with a statement that the views expressed are those of the speaker and do not necessarily reflect those of the Commission, the Commissioners, or, when appropriate, the speaker’s colleagues on the staff.
86. Rule 38a-1(a)(4), supra note 59; Rule 206(4)-7(c), supra note 60; FINRA Rule 3013(a), supra note 65.
87. Id.
88. Rule 38a-1(a)(4), supra note 59 ("one individual"); Rule 206(4)-7(c), supra note 60 ("an individual").
89. FINRA Rule 3013(a), supra note 65 ("one or more").
90. Id.
92. Id. §§ 1021–22.
viser CCOs must be "supervised" persons of the adviser, which means that the adviser could be liable if a CCO commits a violation and the adviser "failed reasonably to supervise" him or her with a view to preventing such violations.

Beyond these rules-based requirements, the CCO has received considerable interpretative attention from the SEC, both in regards to the nature of the position and the characteristics of the individuals who should fill it. The SEC has indicated that it expects the CCO to have a strong role in the firm, with "sufficient seniority and authority within the organization to compel others to adhere to compliance policies and procedures." The SEC also has said that the CCO "should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm." In regards to a CCO's individual characteristics, the SEC has stated that he or she should be "competent and knowledgeable."

FINRA's Interpretative Materials have less to say about CCOs, perhaps because requiring broker-dealers to designate a CCO was "not seen as much of a new requirement." The vast majority of broker-dealers, it was reported in the press, had already made such a designation. Nonetheless, FINRA states that the new requirements are intended to "indicate the unique and integral role" of the CCO. The CCO is the firm's "primary advisor" on "its overall compliance scheme and the particularized rules, policies and procedures" that the firm adopts. What distinguishes the CCO, FINRA says, is his or her "expertise in the process of compliance." This makes the CCO "an indispensable party" in complying with the new rule.

The most detailed overview of the role of the CCO has been offered in a personal statement by a member of the SEC staff, an associate director of the SEC office that examines regulated firms for compliance with these rules. In a speech given in the spring of 2005, he proposed a list of duties or functions that CCOs should consider performing. They include advising senior management on the fundamental importance of compliance, conferring with senior management on significant compliance issues, serving as a compliance "consultant" to businesspeople throughout the firm, analyzing and

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94. Rule 206(4)-7(c), supra note 60.
96. SEC, Compliance Programs, supra note 58, at 74,720.
97. Id.
98. Id.
100. Id.
101. FINRA, IM-3013, supra note 72.
102. Id.
103. Id.
104. Id.
resolving significant compliance issues as they arise, ensuring that the firm’s compliance processes are appropriate and timely carried out by responsible staff, ensuring that employees are appropriately trained in compliance-related matters, serving as the firm’s point of contact during regulatory oversight, and being active in industry efforts to develop good compliance practices.  

The regulatory vision for the CCO encompasses expectations far beyond the simple designation required by the rules. As a former member of the SEC staff, the then-director of the SEC division that drafted the rules for funds and advisers, put it, CCOs should be “principled, responsible, firm and determined.” Moreover, this vision contemplates that CCOs would have a real impact within their firms. The same former division director articulated this point colorfully when he likened the CCO to a hammer. The CCO “must ‘hammer’ home the importance of complying with policies, procedures and regulations and also ‘hammer’ down on those persons who are not meeting their compliance obligations.”

### B. Written Policies and Procedures

All three types of regulated entities must have written compliance policies and procedures. Funds and advisers must “adopt and implement” written policies and procedures “reasonably designed” to prevent violations of the federal securities laws in the case of funds, and of the Investment Advisers Act and rules thereunder in the case of advisers. In addition, funds’ policies and procedures must provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund. Broker-dealers have been subject to a longstanding requirement that they “establish, maintain, and enforce” writ-

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106. Id. Other CCO duties or responsibilities could include ensuring that policies and procedures are comprehensive, robust, current, and reflect the firm’s business and conflicts of interest; ensuring that appropriate principles of management and control are observed in the implementation of policies and procedures; ensuring that staff responsible for compliance functions are competently and fully performing their functions; ensuring that quality-control testing is conducted to detect deviations of transactions from policies and standards; establishing a compliance calendar that identifies all important deadlines for regulatory and compliance matters; reporting the results of self-assessments to management; strongly advocating that the compliance function receive appropriate resources; remaining current on regulatory and compliance issues; and participating in continuing education programs. Id.


109. Id.

110. Rule 38a-1(a)(1), supra note 59; Rule 206(4)-7(a), supra note 60; FINRA Rule 3012(a)(1), supra note 65.

111. Rule 38a-1(a)(1), supra note 59; Rule 206(4)-7(a), supra note 60.

112. Rule 38a-1(a)(1), supra note 59.

113. Rule 206(4)-7(a), supra note 60.

114. Rule 38a-1(a)(1), supra note 59.
ten supervisory procedures “reasonably designed” to achieve compliance with applicable securities laws, regulations, and rules of their self-regulatory organization.115 In the more recent rulemaking discussed in this Article, broker-dealers have also been required to establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the firm’s supervisory procedures are reasonably designed to achieve compliance with those laws, regulations, and rules, and that create and amend procedures as needed.116

As with the CCO guidelines, beyond these rules-based requirements, compliance policies and procedures have received considerable interpretative attention from the SEC. Most importantly for the compliance professionals responsible for designing and writing such policies and procedures, the SEC has clearly articulated the purpose that these policies and procedures were intended to serve. In the course of its rulemaking, the SEC had been urged to limit the application of these policies and procedures to promoting compliance with the securities laws.117 The SEC did not adopt this view. Rather, it said policies and procedures should do more than merely promote compliance; they should be designed to “prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.”118 While the SEC recognized that compliance policies and procedures will not prevent every violation of the securities laws, it took the position that “prevention should be a key objective of all firms’ compliance policies and procedures.”119

The SEC also noted that to create these policies and procedures, firms “should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm’s particular operations, and then design policies and procedures that address those risks.”120 In the months after the rule was adopted, a shorthand language grew up around this statement. Firms said they were conducting “risk assessments” by creating “inventories of risks.”121 In its release the SEC also identified certain areas that it expected would be covered by advisers’ and funds’ policies and procedures, at least to the extent, in the case of advisers, that they are relevant to the firm.122 Finally, the SEC noted that where appropriate,

115. NASD Manual § 3010(b) (2006). This requirement has been in place for decades. See, e.g., In re Transmittal Sec. Corp., 44 S.E.C. 805 (1972) (upholding NASD discipline based on Article III, Section 27(a), predecessor to Rule 3010, against a firm that had failed to establish and maintain written supervisory procedures).
116. FINRA Rule 3012(a)(1), supra note 65.
117. SEC, Compliance Programs, supra note 58, at 74,716 n.16.
118. Id. at 74,716 (footnotes omitted).
119. Id. at 74,716 n.16.
120. Id. at 74,716.
122. SEC, Compliance Programs, supra note 58, at 74,716–20 (listing portfolio management processes, trading practices, proprietary trading of the adviser and personal trading of supervised persons,
advisers’ policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns. In short, “funds and advisers are too varied in their operations for the rules to impose a single set of universally applicable required elements.”

Instead, through this process of conducting a risk assessment, designing responsive policies and procedures, and following up with compliance tests, firms should be able to prevent, detect, and correct compliance problems, with an emphasis on prevention.

FINRA’s guidance on broker-dealers’ policies and procedures has contained many similar points. In April 2005, FINRA’s predecessor issued guidance that contained a six-point plan for “designing a system of supervisory control policies and procedures that will test and verify that their supervisory procedures are reasonably designed to achieve compliance with the applicable” laws, regulations, and self-regulatory rules. This plan was similar to the plan the SEC set out for advisers.

In its plan, FINRA stated that a broker-dealer should first conduct an inventory of all of its businesses and the laws, regulations, and self-regulatory rules applicable to those businesses. Second, the firm should analyze the applicable requirements by asking, “what questions do the requirements raise that must be answered?” In other words, what conduct is “prohibited, compelled, limited or conditioned;” how will the firm assure compliance with those requirements; who at the firm is responsible for supervising the conduct; and what are the “methods and parameters” of that supervision? Third, the broker-dealer should analyze its own supplementary internal requirements and consider whether it will restrict conduct beyond the specific requirements of the regulatory regime. Fourth, in the portion of this guidance that has received the greatest attention, the firm “should next compare the answers that result from the analysis conducted above to its current supervisory procedures and use that comparison to determine if any gaps or deficiencies in those procedures are evident.” The firm should determine what “gaps” exist between the requirements of the regulatory regime and the firm’s own supplementary requirements and the policies and procedures it has adopted to implement them. Finally, in steps five and six,
the firm should “analyze how to address any identified gaps,” and prepare new or amended procedures to “resolve the identified gaps or deficiencies.”132

The regulatory vision for compliance policies and procedures has focused on making them relevant and effective within the context of each individual firm. Both the SEC and FINRA’s predecessor have emphasized that these policies and procedures should be based on a process within each firm for identifying risk exposures or gaps in coverage and then creating appropriately tailored responses. An SEC commissioner summed up this vision and what it sought to avoid when he said that compliance is no “rote organizational matter.”133 Rather, it is “a matter of ethics and a way of thinking.”134 Too often, companies want policies and procedures to fulfill a regulatory requirement, but with “no connection to reality or how the company is conducting its business.”135

C. Annual Self-Assessment

All three types of regulated entities must conduct an annual compliance self-assessment.136 Funds and advisers must review, “no less frequently than annually,” the “adequacy” of their compliance policies and procedures and the “effectiveness of their implementation.”137 Funds must also review the adequacy and effectiveness of the policies and procedures of each investment adviser, principal underwriter, administrator, and transfer agent of the fund.138 At least once per year, broker-dealers must prepare a report specifying the system of supervisory controls employed by the firm that includes a summary of the results of the tests conducted to verify those controls, significant exceptions, and any additional or amended procedures created in response to the tests.139 Finally, broker-dealer CEOs must certify that the firm has in place “processes to establish, maintain, review, test, and modify” its compliance and supervisory policies and procedures,140 and the processes about which the CEO makes his or her certification must be evidenced in a report.141

By their terms, reviews under the fund and adviser rules both require two different lines of inquiry. Funds and advisers must review both the adequacy

132. Id. at 3.
134. Id.
135. Id.
136. Rule 38a-1(a)(3), supra note 59; Rule 206(4)-7(b), supra note 60; FINRA Rule 3012(a)(1), supra note 65; FINRA IM-3013, supra note 72.
137. Rule 38a-1(a)(3), supra note 59; Rule 206(4)-7(b), supra note 60.
139. FINRA Rule 3012(a)(1), supra note 65.
140. FINRA Rule 3013(b), supra note 65.
141. FINRA, IM-3013, supra note 72.
of their compliance policies and procedures, and the effectiveness of their implementation. While related, these lines of inquiry raise different issues. "Adequacy" refers to something as being sufficient for its purpose, while "effectiveness" entails its actual production of or its power to produce an effect. Hence, presumably, the review should cover both the sufficiency of the policies and procedures and the effects they produce.

Beyond the text of the rules, the SEC suggested in its adopting release that the review should be "systematic," or at least more systematic than the type of periodic reviews some advisers had previously conducted. The annual review should also consider "any compliance matters that arose during the previous year, and any changes in the business activities of the firm or its affiliates, and any changes in . . . applicable regulations that might suggest a need to revise the policies or procedures." As a specific example, the SEC noted that an adviser should consider whether its policies and procedures are adequate to cover the new conflicts created when it is acquired by a broker-dealer (or its corporate parent), such as the broker-dealer executing client transactions or the adviser investing client funds or assets in securities distributed or underwritten by the broker-dealer. Funds should additionally consider recent revelations of wrongdoing in the industry at large (as well as at the firm conducting the review). At the time the SEC adopted the rule, there had been multiple "revelations of unlawful practices involving [fund] market timing, late trading, and improper disclosures of nonpublic portfolio information." In the future, there likely will be other issues that should be considered.

The intended scope of the self-assessment is also reflected in the documentation that the reviewing firm must produce. While these record requirements do not dictate how one should conduct the review, they do establish the minimal work-product that one must produce at its conclusion.

First, fund CCOs, no less frequently than annually, must provide a written report to the fund’s board of directors addressing the operation of the fund’s compliance policies and procedures. The report must also address the operation of the compliance policies and procedures of any investment

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142. Rule 38a-1(a)(3), supra note 59; Rule 206(4)-7(b), supra note 60.
143. Id.
144. See WEBSTER’S NEW WORLD COLLEGE DICTIONARY 16 (4th ed. 2001) (defining the term to mean the quality or state of being adequate).
145. Id. at 454.
146. SEC, Compliance Programs, supra note 58, at 74,725.
147. Id.
148. Id. at 74,720.
149. See id.
150. Id.
151. Id.
152. Rules 38a-1(a)(4) and 38a-1(a)(4)(iii), supra note 59.
adviser, principal underwriter, administrator, and transfer agent of the fund, as well as various other more specific matters. Second, while advisers are not required to prepare a report on their annual compliance review, they must make and keep records documenting the annual review. One can explain this different approach by the small institutional size of most advisers. More than ninety percent have fifty or fewer employees and more than sixty-eight percent have ten or fewer employees. In an institution of such small size, one might question the need for a formal written report.

FINRA has also provided guidance on what a broker-dealer’s review should cover. The two required reports, one detailing the system of supervisory controls and related tests and procedures and the other supporting the CEO’s certification, may be combined into a single report. As with the SEC, FINRA does not dictate how the review underlying the consolidated report should be conducted. Nonetheless, like the SEC, FINRA has made several statements that illuminate its expectations of how the self-assessments would be conducted.

Regarding the report on supervisory controls, an official of FINRA’s predecessor discussed the review in a telephone workshop held shortly after the rule was approved. The official declined to opine on the specific processes a firm could use to conduct the review. This was because the processes a firm should use to test and verify its supervisory procedures are so dependent on the activities the firm conducts, the structure of the firm, and its existing supervisory procedures, that the firm’s CCO would need to determine what processes would be adequate testing vehicles. However, the official went on to suggest that before the CCO decides to use a process, such as a firm’s internal audits or inspections, or some other pre-existing

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153. Rule 38a-1(a)(iii), supra note 59.
154. Id. (material changes to the policies and procedures, material changes recommended as a result of the annual review, and material compliance matters occurring since the date of the last report).
157. See FINRA Rule 3012(a)(1), supra note 65.
158. See FINRA Rule 3013(b), supra note 65; FINRA, IM-3013, supra note 72.
160. FINRA Rule 3012(a)(1), supra note 65.
162. Id.
163. Id.
self-assessment process, the CCO "will need to first determine the sufficiency of that process’s methodology and conclusions." 164

As to the report supporting the CEO certification, FINRA provides a form of certification for CEOs to use.165 This form provides considerable direction on the work product that will result from the review. It requires the CEO to certify that the firm has in place processes to: “establish, maintain and review policies and procedures reasonably designed to achieve compliance” with applicable rules and securities laws; to "modify such policies and procedures as business, regulatory and legislative changes and events dictate"; and to “test the effectiveness of such policies and procedures on a periodic basis” so as to ensure continuing compliance.166 FINRA’s materials also state that the report supporting the certification must document the processes and should include "the manner and frequency with which which the processes are administered, as well as the identification of officers and supervisors" responsible for their administration.167 The report must be completed before the CEO makes his or her certification.168 The report is then delivered to the board of directors and its audit committee.169 However, while the Interpretative Material provides extensive direction on the final work-product of a review, FINRA, much like the SEC, leaves open how the review should be conducted. An official of FINRA’s predecessor indicated that this “open-ended” approach was “purposeful.”170 The rule is not prescriptive.171 It is intended to leave firms with "a lot of discretion."172

The regulatory vision for self-assessments encompasses at least two expectations. First, the self-assessments are expected to keep compliance systems current. The SEC summed this up by stating that FINRA’s annual CEO certification requirement would help motivate firms to keep their compliance programs current with business and regulatory needs.173 The same expectation can be seen in the SEC’s statements about how funds and advisers should take account of changes in their business, the regulatory environment, and any recent revelations of new types of wrongdoing.174 Additionally, the self-assessments are also expected to help integrate compliance and business. As an SEC commissioner noted, policies and procedures can be worthless if they do not have the "buy-in" of the rest of the company, are

164. Id.
165. FINRA, IM-3013, supra note 72.
166. Id.
167. Id.
168. Id.
169. Id. The CEO may certify either that the report has been delivered or that it will be at the board’s next regularly scheduled meeting. Id.
171. Id.
172. Id.
174. See supra text accompanying notes 148–51.
not followed, or are not effective. Self-assessments were expected to help in this endeavor by enhancing the attention senior managers would give to the effectiveness of their compliance efforts, and by bolstering the attention given to compliance programs through the "substantial and purposeful interaction between business and compliance officers throughout the firm." At the time the CEO certification requirement was approved, a senior official of FINRA's predecessor said compliance "starts with a clear commitment from . . . the CEO and requires purposeful discussions between business and compliance officers throughout the firm." As an SEC commissioner said about funds and advisers, the annual review should not be just a "check the box" review on a regulatory form. Instead, it should be an integral part of the company's business.

D. Access to Senior Executives

Two of the three types of regulated entities must implement certain measures to ensure that their CCOs have access to the top executive levels of the firm. Fund CCOs must meet separately, no less frequently than annually, with the fund's independent directors. Broker-dealer CCOs must have at least one annual meeting conducted by the firm's CEO to discuss the processes underlying the CEO's certification discussed above. While no such mandatory access to executives is provided for adviser CCOs, the small institutional size of most advisers, noted above, often makes such a requirement unnecessary. The SEC has also prohibited any "officer, director or employee of the fund, its investment adviser, principal underwriter, or any person acting under such person's direction," from taking "any action, directly or indirectly, to coerce, manipulate, mislead, or fraudulently influence" a fund CCO in the performance of his or her duties.

175. Atkins, Statement at Open Meeting, supra note 133 (statement will be found at 1 hour, 12 minutes).
179. Atkins, Statement at Open Meeting, supra note 133 (statement will be found at 1 hour, 13–14 minutes).
180. Id.
181. Rule 38a-1(a)(4)(iv), supra note 59; FINRA Rule 3013(b), supra note 65.
183. FINRA Rule 3013(b), supra note 65.
184. See supra text accompanying notes 135–156.
185. Rule 38a-1(c), supra note 59.
Beyond the requirements of the rule, the SEC described the fund CCO’s annual meeting with the independent directors as an “executive session” that is intended to exclude fund management and interested directors. This setting creates an opportunity for the CCO and the independent directors to “speak freely” and gives them an opportunity to discuss “any reservations about the cooperativeness or compliance practices of fund management.”

Similarly, FINRA’s Interpretative Materials state that the annual meeting between the CCO and the CEO will “foster regular and significant interaction between senior management and the chief compliance officer regarding the [firm’s] comprehensive compliance program.” Moreover, guidance has suggested that the “size, nature, and complexity” of a firm’s business may warrant more frequent meetings between the CCO and the CEO than the annual meeting required by the rule. FINRA’s predecessor stated that through these processes, senior management should focus the same attention on compliance and supervisory policies and procedures as on revenue-producing businesses and such fundamental operational prerequisites as capital requirements.

The regulatory vision for these measures focused on bringing compliance into the executive suite. Of course, at a certain level, this was accomplished by making the CCO, compliance policies and procedures, and self-assessments mandatory. Backed by a regulatory mandate, all of these institutions should have appreciable authority within a firm and receive more attention from executives. Nonetheless, the more specific measures included in the rules for funds and broker-dealers go beyond this general enhancement in authority. They ensure that the CCO interacts directly with the highest levels of the firm. As a former member of the SEC staff, the then-director of the SEC division that drafted the compliance rules for funds and advisers, has described, these measures were designed to promote the CCO’s independence. Moreover, this is a very purposeful independence. As a then-SEC commissioner explained, it is a basic theme of corporate governance to get information up the chain of command to boards, directors, and especially to independent directors. Too often, the former commissioner said, boards

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186. Id. at 38a-1(a)(4)(iv).
187. SEC, Compliance Programs, supra note 58, at 74,721.
188. Id.
189. FINRA, IM-3013, supra note 72.
190. FINRA, NTM 04-79, supra note 177, at 974.
have been shielded from wrongdoing. The CCO’s independence would allow compliance information to flow upward to the top of the organization and not be blocked by self-interested managers.

E. Written Codes of Ethics

Two of the three types of regulated entities must have written codes of ethics. Funds must adopt a written code of ethics containing provisions reasonably necessary to prevent advisory persons and others defined in the rule from engaging in fraudulent and other defined misconduct in connection with the purchase or sale of securities held or to be acquired by the fund. Investment advisers must establish, maintain, and enforce a written code of ethics that includes, at a minimum:

1. A standard (or standards) of business conduct that require[s] of its supervised persons that must reflect [its] fiduciary obligations and those of its supervised persons;
2. Provisions requiring its supervised persons to comply with applicable federal securities laws;
3. Provisions that require all of its access persons to report, and [it] to review, their personal securities transactions and holdings periodically;
4. Provisions requiring supervised persons to report any violations of [the] code of ethics promptly to [its] CCO, or, provided [the] CCO also receives reports of all violations, to other persons [it] designates in the code of ethics; and,
5. Provisions requiring [it] to provide each of its supervised persons with a copy of the code of ethics and any amendments, and requiring [it] to provide . . . a written acknowledgment of their receipt of the code and any amendments.

Beyond the requirements of the rules, the SEC has also provided guidance on codes of ethics. In 1980, when adopting the code of ethics rule for funds, the SEC expressed that a rule covering “all conceivable possibilities” was impracticable, and therefore it imposed the obligation on funds and their advisers and underwriters to prescribe their own standards and procedures. In 2004, when adopting the code of ethics rule for advisers, the

194. Id.
195. Id.
196. Rule 17j-1(c), supra note 66; Rule 204A-1(a), supra note 67.
197. Rule 17j-1(c), supra note 66.
198. Id. at 17j-1(a)(ii) (The rule also covers certain officials of the fund’s principal underwriter.).
199. Id. at 17j-1(b).
200. Rule 204a-1(a), supra note 67.
201. Id. at 204a-1(a)(1)–(5).
202. Rule 17j-1 Adopting Release, supra note 68, at 73,916.
SEC stated that the code should be more than a compliance manual. Rather, the SEC said, "a code of ethics should set out ideals for ethical conduct premised on fundamental principals [sic] of openness, integrity, honesty, and trust." According to the SEC, a "good code of ethics should effectively convey to employees the value the advisory firm places on ethical conduct, and should challenge employees to live up not only to the letter of the law, but also to the ideals of the organization."

The SEC also noted that while the mandatory requirements it established for advisers' codes of ethics did not include the sort of detailed prophylactic measures common to many codes, it identified several provisions that advisers could consider and pointed to the codes of ethics or model codes of several private professional and trade groups.

The regulatory vision for codes of ethics can be found in contemporary remarks of the then-chairman of the SEC. Firms need a "company-wide environment that fosters ethical behavior and decision-making." This environment should be a "moral compass" guiding hiring decisions, operating practices, and internal policies and procedures. Moreover, during the meeting in which the SEC adopted the adviser code of ethics rule, the SEC staff emphasized how codes of ethics would relate to compliance. Under a conforming code, employees will be required both to obey the federal securities laws and to report violations to the CCO. This will help ensure that violations of the securities laws are promptly reported to the adviser, and for funds, to the fund's board.

At the level of paradigm, institution-based financial regulation presents a short list of mandatory institutions—CCOs, written policies and procedures, annual self-assessments, access to senior executives, and codes of ethics—and a larger body of interpretations, guidance, and aspirations about how these institutions should function. However, no regulatory regime functions at the level of paradigm. The actual implementation of the regime is crucial.

203. Investment Adviser Codes of Ethics, supra note 69, at 41,697.
204. Id.
205. Id.
206. See supra text accompanying note 69.
207. Investment Adviser Codes of Ethics, supra note 69, at 41,697–98 & n.17 (citing to, inter alia, limitations on acceptance of gifts and limitations on circumstances for serving as a director of a public company).
208. Id. at 41,697 & n.6.
210. Id.
212. Id.
IV. Practical Issues in the Implementation of an Institution-Based Regime

Regulators confront a number of practical challenges in the implementation of an institution-based regime, but they have successfully been able to address these problems through the two primary regulatory tools of public enforcement actions and nonpublic examinations. Most fundamentally, just as firms differ in their compliance risks or gaps in compliance coverage, they also differ in their responses to regulation. Regulators must deal with firms that reject regulation and even some that do so, perhaps most insidiously, while feigning compliance. This danger is real. For example, Enron Corporation, an entity whose operations were tainted to an extraordinary degree with fraud and many of whose senior executives were eventually convicted of criminal fraud, had a model code of ethics that was held out for years as a leading example of the form. At the same time, regulators must also deal with firms that are making a good-faith effort to comply with the regulatory regime, even if they are doing so at a pace, or in a manner, with which the regulator disagrees. How the regulator responds to these challenges will largely determine the paradigm’s success.

The first regulatory tool used by the SEC and FINRA to implement the institution-based regime has been their authority to bring public actions against regulated firms. Both the SEC and FINRA have authority to bring public actions—known at the SEC as enforcement actions and at FINRA as disciplinary actions—against firms and individuals that violate applicable laws, regulations, or rules. These actions can compel compliance, impose remedial actions, and require the payment of fines or penalties. Both have used this authority to enforce the rules requiring the establishment of compliance institutions. The circumstances in which they have used this authority illustrate some of the challenges a regulator may face in implementing an institution-based regime.

Some firms or individuals may fail to implement their basic regulatory obligations. For example, in one case the SEC found that an adviser had failed to implement compliance policies and procedures reasonably designed

216. Id.
for its business. The firm had policies and procedures, but they consisted of a pre-packaged electronic template that the firm had purchased. The template related to the business of a discretionary money manager, but the firm worked primarily as a pension consultant. The firm had never taken any steps to modify the pre-packaged policies and procedures to address its actual business. As a result, the firm lacked policies and procedures reasonably designed to prevent the types of conflicts of interest that could arise, and in fact did arise, in its business. The SEC brought an enforcement action against the firm and its CCO based, among other things, on their violations of the relevant compliance rule. FINRA has also brought an enforcement action against an individual who failed to carry out the basic requirements of these rules, including to establish, maintain, and enforce written supervisory control policies and procedures and to ensure that the firm completed an annual certification.

Some firms or individuals may disregard the regulator’s warnings. For example, in one case SEC staff informed the CCO of false statements the firm had made in several of its responses to requests for proposals. Nevertheless, despite the CCO’s knowledge of the staff’s concerns, the firm failed to develop any remedial policies and procedures, and a few months later, the firm repeated the same misrepresentation. The SEC brought an enforcement action against the firm and its CCO based on, among other things, their violation of the relevant compliance rule.

Some firms or individuals may feign compliance. For example, in one case, the SEC staff reminded a firm about the new code of ethics rule for advisers and of the firm’s obligation to be in compliance by a certain date. The firm had not brought itself into compliance on time. Instead, the CCO instructed employees to backdate documents to make it appear that the firm had been compliant. Moreover, some months later, when the SEC staff asked the firm to evidence its compliance, the CCO collected additional

218. Id.
219. Id.
220. Id.
221. Id.
222. Id. (finding violations of Rule 206(4)-7).
225. Id.
226. Id. (finding violations of Rule 206(4)-7).
227. Consulting Services Group, supra note 217.
228. Id.
229. Id.
backdated documents to give to the staff.\textsuperscript{230} The SEC brought an enforcement action against the firm and its CCO based on, among other things, their violation of the relevant code of ethics rule.\textsuperscript{231}

Finally, some firms or individuals may be egregious in their repeated violations of preventive compliance requirements. For example, the codes of ethics rules require self-reporting by certain employees of funds and advisers of their securities holdings and transactions.\textsuperscript{232} In one case, a portfolio manager failed to file transaction reports with his employer thousands of times over several years.\textsuperscript{233} The SEC brought an enforcement action against him based on his violation of the fund code of ethics rule.\textsuperscript{234} Commentary in the press noted that while it is a fact of life that from time to time employees forget to file their reports, it is “an entirely different story” when an employee “deliberately fails to report thousands of trades for years and years and affirmatively represents along the way that he made no personal trades and had no personal securities holdings.”\textsuperscript{235}

In addition to patrolling for noncompliance, the SEC has used its enforcement authority to maintain the integrity of the compliance profession. This can be seen in the case of the CCO, mentioned above, who falsified records to feign compliance.\textsuperscript{236} As a remedy in the enforcement action it brought against him, the SEC barred him from service as a compliance professional. Specifically, the SEC said, he was “barred from association in a compliance capacity with any broker, dealer, or investment adviser.”\textsuperscript{237} This compliance bar, to the author’s knowledge the first of its kind, preserves the integrity of compliance and the professionalism of its practitioners.

Nonetheless, while enforcement activity has played a role in shaping the implementation of the institution-based regime in the United States, it is remarkable how rarely regulators have resorted to their enforcement tools in this regard. To put in context the small number of actions discussed above,\textsuperscript{238} over the four years from 2004 to 2007, the SEC brought 2499 enforcement actions,\textsuperscript{239} and FINRA and its predecessor brought more than
4000 disciplinary actions. One could expand the list of cases to include any action against a CCO acting as such for any type of misconduct, a list that would include an action against a CCO who forged checks, misappropriated client assets, and used her role as a compliance professional to hide the misconduct, another against a compliance lawyer who has been convicted of tipping inside information she was supposed to be protecting in return for a share in the illicit trading profits, and a third against a CCO who was aware of, and had in fact reviewed, documents responsive to a request for records from SEC staff, but failed to provide the documents or any responsive information. Even so, the list would remain short. This restraint is remarkable, at least if one assumes that the SEC is solely a rules-based regulator.

The second regulatory tool used by the SEC and FINRA to implement the institution-based regime has been their authority to conduct examinations of regulated firms. The purpose of examinations is to detect fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the Commission is continually made aware of developments and areas of potential risk in the securities industry. These exami-
nations do not result in penalties, but they generally conclude with the staff of the regulator providing the firm with a letter—known as a deficiency letter—that describes the problems identified during the examination and requests the firm to take corrective action.\textsuperscript{248} Of course, examiners refer serious misconduct to the enforcement staff for possible investigation. Ideally, an examination is a nonpublic dialogue between the regulator and the firm about how the firm can improve its compliance.\textsuperscript{249}

In 2004, officials of both the SEC and FINRA’s predecessor announced that they intended to examine for compliance with the new rules.\textsuperscript{250} While examinations are nonpublic, some sense of the extent of the regulators’ activity can be seen in later statements. In May 2006, FINRA’s predecessor identified the new compliance requirements as elements in its routine examinations,\textsuperscript{251} as priorities, and even as frequently found violations.\textsuperscript{252} In December 2006, the Director of the SEC office that conducts examinations provided some specific numbers from the examinations.\textsuperscript{253} She indicated that during a three-month period, the SEC’s staff had examined 158 advisers and twenty-four fund groups in this regard.\textsuperscript{254} A year later, another member of the SEC staff serving in the same office reported similar numbers for a three-month period in 2007.\textsuperscript{255} In short, as opposed to a handful of enforcement actions,\textsuperscript{256} hundreds of examinations have been conducted.

While specific examinations are nonpublic, SEC officials have also made several public statements about how they are reviewing the new compliance institutions. For example, members of the SEC staff serving in the SEC’s examination program have described the tests that could be used to evaluate

\begin{footnotesize}
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\item \textsuperscript{248} See generally John H. Walsh, \textit{Regulatory Supervision by the Securities and Exchange Commission: Examinations in a Disclosure-Enforcement Agency}, 51 \textit{Admin. L. Rev.} 1229 (1999) (discussing the differences between examinations and enforcement).
\item \textsuperscript{249} See id. at 1240.
\item \textsuperscript{251} Letter from Robert C. Errico, Executive Vice President, NASD, Member Regulation, to NASD Members (May 17, 2006), available at http://www.finra.org/web/groups/corp_comm/documents/home_page/p016638.pdf (highlighting exam priorities).
\item \textsuperscript{252} FINRA, Improving Examination Results (May 2006), http://www.finra.org/RulesRegulation/ComplianceTools/ImprovingExamResults/p016382 (citing to Rule 3012).
\item \textsuperscript{254} Id.
\item \textsuperscript{256} See, e.g., supra cases described in notes 217, 223, 224 & 233.
\end{itemize}
\end{footnotesize}
the effectiveness of compliance policies and procedures, how they review a firm's self-assessment, and in some cases, the aggregated results of their examinations. With regards to the last item, the officials have indicated that they have given deficiency letters to funds and advisers identifying the need for improvements in annual reviews in approximately forty percent to forty-nine percent of the examinations on that topic. However, the member of the staff serving as director of the office that conducts examinations gave the most revealing information about their regulatory approach. When reviewing a firm's self-assessment, she said, examiners seek to determine whether a "solid" review had been performed; that is, a review "in which the planning and execution appeared to provide a reasonable or a high degree of assurance that its compliance program will deter, detect and correct problems." To make this determination, examiners ask a number of questions, all aimed at the institutional organization and operation of this function. It is worth quoting these questions in full:

- Who conducted the annual review? (e.g., the CCO, with other compliance staff, with business-line staff, internal auditors, external counsel or compliance consultant)
- What was the scope of the review, and how was the scope determined (i.e., was a risk-assessment completed, did the scope include existing compliance policies and procedures, did it review the firm’s process for identifying gaps)
- When was it performed?
- How was it performed? (e.g., using a checklist, forensic tests, review of past exceptions)
- What were the findings? (we would expect that thorough reviews would be likely to have findings and/or areas where the firm’s compliance programs could be proactively improved)
- What recommendations were made by the staff who conducted the review? (do they appear to adequately address the findings)
- What is the current status of those recommendations—have they been implemented?
- What documentation was created and retained by the firm to reflect the work done?
- What, if any, was the involvement of senior management in the review?

259. Id. (reporting findings for 2006).
260. Id. (reporting forty percent in three-month period in 2006); COMPLINET, Need to Improve Advisers’ Annual Compliance Reviews, supra note 255 (reporting forty-nine percent in three-month period during 2007).
262. Id.
In sum, in their implementation of the institution-based regime, the SEC and FINRA have played two roles. First, through enforcement actions, they “hold the ring” among regulated firms. Enforcement of the mandatory institutions has imposed a uniform, or at least, given the piecemeal regulatory structure, a relatively uniform minimum obligation on all competitors. All must create and maintain the same basic institutions with the associated financial and competitive costs. Moreover, selective and few as the enforcement actions have been, firms investing in these compliance institutions can have some degree of confidence that free-riders will eventually be held to their responsibilities. Second, through examinations, the SEC and FINRA have worked with firms in a nonpublic dialogue to comment on the adequacy and effectiveness of the firms’ compliance institutions. This is not a prescriptive approach. Instead, as shown by the questions that SEC examiners ask about the self-assessment, this is an open-ended dialogue in which the regulator essentially inquires as to how the institutions are actually functioning within each specific firm. One could readily characterize this approach as a combination of public enforcement of the mandatory institutional architecture and nonpublic examination of the customized functionality within each firm.

V. An Argument for Recognizing Institution-Based Regulation as a New Paradigm

One finds several important consistencies in how the SEC and FINRA have dealt with compliance institutions. First, consistencies exist in the requirements that the rules set forth. Despite the piecemeal nature of the recent regulatory actions across multiple regulatory regimes, at the end of the day, funds, advisers, and broker-dealers must establish certain common core compliance institutions: CCOs, policies and procedures, and annual self-assessments. In addition, certain other institutions have an important presence, even though the regulatory regimes do not uniformly require access to executives or written codes of ethics. Second, one sees consistencies in the structure of the regulatory regimes. For all three types of entities, the regulators have used rules-based requirements only to provide a minimal architecture, specifically to identify the institutions that must be created. How those institutions should function within each firm, however, has been addressed through interpretations, guidance, and supportive personal statements. Third, there are consistencies in the actual implementation of the institutional regimes. Both the SEC and FINRA have made limited use of enforcement and disciplinary actions, while conducting hundreds of nonpublic examinations to accomplish their goals.

Having identified these consistencies, however, a question remains: is this a paradigm? Several factors suggest a negative response. The most important are the piecemeal nature of the regulatory actions giving rise to institution-
based financial regulation in the United States and the level of assembly needed just to observe the identified consistencies across multiple regulatory regimes.

On the other hand, if institution-based regulation is not a paradigm, perhaps it should be. The combination of mandatory institutional architecture and firm-specific customizable functionality provides a paradigm-like regulatory strategy. Perhaps the time has come to take these piecemeal actions, give them a name, and treat them as a recognizable strategy.

VI. BENEFITS OF USING INSTITUTION-BASED FINANCIAL REGULATION ON A GLOBAL SCALE

Recognizing institution-based regulation as a new paradigm, and using it in financial regulation on a global scale, could confer several significant benefits. Its combination of mandatory architecture and customizable functionality provides solutions to several regulatory issues. As previously noted, it could help address firms’ competitive worries about rivals’ compliance free-riding. At least five other benefits deserve special note.

First, institution-based regulation is content-neutral. In the United States, regulators have already deployed it to address compliance risks ranging from the generalized fiduciary duties of advisers to the specific financial responsibilities of broker-dealers. As a global paradigm, this open-ended nature could be of crucial importance. Many regulatory regimes contain distinct features. Some of these features are matters of regulatory strategy, such as the differences between principles-based and rules-based regulation that were discussed above. Others are matters of religion, such as the special compliance needs of shari’a law in Islamic finance. In all cases, however, regulators can deploy the institutional structure to achieve compliance goals that are consistent with the local regulatory choices. Indeed, in at least one area—anti-money laundering compliance—an institutional strategy of managerial responsibility, written policies and procedures, and annual self-assessments already seems to be taking hold on a global scale.

Second, institution-based regulation is scalable to the size of any market or firm. In the United States, it has functioned in firms ranging in size from large broker-dealers with tens of thousands of employees to small advisers employing less than ten. As a global paradigm, this scalability could allow great flexibility. Vibrant securities markets are emerging in East Asia, South Asia, the Middle East, Africa, and the Caribbean. These markets, their par-

263. See supra Part II.
participants, and their regulators vary dramatically in their size and in the resources they have available for oversight and compliance. The scalable nature of institution-based regulation could prove very useful in these settings.

Third, institution-based regulation is self-sustaining. In the United States, many funds and advisers have used their annual self-assessment to develop recommendations on how they can improve their own compliance. Recommendations have included improving, changing, or strengthening the firm’s policies and procedures; committing additional resources to compliance; improving disclosures; improving documentation; improving oversight of service providers; implementing or improving compliance testing; and improving the risk assessment process.\footnote{266} As a global paradigm, this type of continuous improvement could help firms and regulators stay current, especially in the fastest-growing securities markets. Change is coming quickly to many securities markets, but in some of the youngest and most rapidly growing markets the rate of transformation is staggering. Institutionalized self-improvement, by the regulated firms themselves, could help compliance keep pace.

Fourth, institution-based regulation is conducive to enhancing the professionalism and expertise of compliance practitioners. In the United States, it provides certain basic institutional consistencies in the practice of compliance. The compliance community has responded with a greater sense of shared purpose and a heightened sense of professionalism and expertise. A professional association has issued a code of ethics for compliance practitioners,\footnote{267} several certification programs are now available for demonstrating practitioners’ professionalism and expertise,\footnote{268} and multiple compliance conferences provide continuing education and training.\footnote{269} As a global paradigm, this dynamic process of self-improvement could help address a pressing need. In some cases, members of the international regulatory com-

\footnote{266. Richards, 2006 Securities Law Developments Conference, supra note 253.}


\footnote{269. The author does not wish to cite to any conferences, as a comprehensive listing would be impossible, and any selection could appear to be an inappropriate recommendation or endorsement. However, a simple web search will quickly reveal the names and schedules of multiple compliance conferences.}
munity are not just creating new markets; they are also creating new compliance communities. The dynamic growth in certified professionalism and expertise could prove a valuable resource in this effort.

Fifth and finally, institution-based regulation can address some of the problems confronting the global regulatory community. One of the most serious current problems is the rise of securities frauds conducted on a global scale. For example, in one case, an entity claimed to be an “international financial consulting firm” based in Uruguay with offices in several foreign countries. In fact, the SEC alleged, it had no such offices and was only a boiler room in Spain that used false and misleading claims about securities to raise millions of dollars from investors in twenty countries over four continents. In other cases, the allegations of misconduct have included that misleading sales materials were prepared in multiple languages, sales efforts targeted specific linguistic groups in several countries, or a scheme was executed by a boiler room located in a city not previously recognized as a financial center, such as Vientiane, Laos. As a global paradigm, institution-based regulation could help regulators and market participants distinguish legitimate firms from boiler rooms. This may be especially helpful in the newer markets, where market participants are less well-known outside of their hitherto local communities. As these markets and their participants enter the global community, establishing solid compliance institutions that can interact with regulators and the compliance institutions of other firms may be one way for them to establish their credibility on a global scale.

Institution-based financial regulation holds great promise for the future. As a global paradigm it could play a valuable role in several settings and in addressing several pressing issues. Perhaps most importantly, it could enhance trust and confidence among securities markets. Indeed, this is the true promise of institution-based financial regulation: a global community of compliance institutions staffed by compliance professionals who share a common professionalism and expertise. Such a community could also help forge a global marketplace out of the current medley of differing regulatory regimes while preserving local regulatory choices. The time has come to give institution-based regulation a name, and to treat it as a third paradigm for financial regulation.

271. Id.