Anchoring your compliance management system in today's regulatory environment

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WHO SHOULD READ THIS?

Executives, general counsel and compliance officers at financial services companies, particularly those looking to innovate and expand.

WHY READ THIS?

Federal regulators retain substantial enforcement authority despite the current administration's focus on reducing regulatory burdens.

This article explains why industry participants that stay the course on compliance risk management are best suited to thrive when closer regulatory scrutiny returns — as it surely will.

Financial services companies have welcomed recent efforts by the federal government to minimize regulatory burden on the industry and view this trend as opening the door to innovation, development, and expansion. Among the most pressing questions these companies face as they explore new opportunities is how to assess compliance risk and establish risk tolerances in the current regulatory environment. Increasing a company's risk threshold has the lure of reducing compliance expense and allowing a redirection of those resources to revenue generating activities, but this strategy may have consequences as political cycles ebb and flow.

As well-established and predictable as that pattern seems, some companies will inevitably be surprised when the regulatory tide comes in again. Industry participants that stay the course on compliance risk management and controls throughout the regulatory cycle are best suited to thrive when closer regulatory scrutiny and a more muscular enforcement posture are back in force.

THE EBBING TIDE OF FINANCIAL REGULATION

The current administration has been vocal about its desire to reduce unnecessary regulatory burdens imposed on the financial sector.[1] Over the past year, federal policymakers have rolled back restrictions put in place in response to the financial crisis. For example:

- Congress in May enacted the Economic Growth, Regulatory Relief, and Consumer Protection Act, which, among other things, presented relief from certain consumer lending and capital ratio requirements for banks with less than $10 billion in assets, and increased the asset threshold for enhanced prudential standards from $50 billion to $250 billion.[2]
- Federal banking regulators proposed modifications to the Volcker Rule to institute a tiered compliance structure that would (i) subject banking entities with "moderate" trading assets and liabilities of less than $10 billion to "reduced compliance requirements," and (ii) presume compliance with

1. *See, e.g.*, Department of the Treasury, *A Financial System that Creates Economic Opportunities: Banks and Credit Unions*, at *10 (June 2017) (summarizing the Treasury Department's recommendation that the banking sector regulatory framework should be reformed by "[r]educing regulatory burden by decreasing unnecessary complexity" and "[i]mproving regulatory efficiency and effectiveness by critically evaluating mandates and regulatory fragmentation, overlap, and duplication across regulatory agencies").
2. Pub. L. 115-174.

certain requirements by entities with "limited" trading assets and liabilities of less than $1 billion.[3]

- Congress passed a joint resolution disapproving the Consumer Financial Protection Bureau's bulletin regarding fair lending requirements applicable to indirect auto lenders.[4]
- Congress in November 2017 nullified a bureau rule prohibiting financial companies from including mandatory arbitration clauses in consumer contracts.[5]
- The bureau said it would reconsider (i) a 2015 final rule imposing additional requirements on financial institutions under the Home Mortgage Disclosure Act,[6] and (ii) its payday rule governing small-dollar lending.[7]
- The Department of Housing and Urban Development in June sought public comment on amending its disparate-impact standard under the Fair Housing Act.[8]

Most recently, the administration has recommended formalizing deregulation through the creation of a "regulatory sandbox" in which financial institutions would have the freedom to engage in "meaningful experimentation for innovative products, services, and processes." According to a Treasury Department report outlining this recommendation, the "regulatory environment should [be] flexible so that firms can experiment without the threat of enforcement actions that would imperil the existence of a firm."[9]

Despite these deregulatory steps, the statutory authority federal regulators and enforcement agencies rely upon to supervise financial institutions and take enforcement actions against them is largely unchanged. For example, the bureau and the federal banking agencies retain authority to litigate and pursue enforcement actions for violations of federal consumer financial protection laws, including prohibitions on unfair, deceptive, or abusive acts or practices.[10] Moreover, the federal banking agencies continue to supervise institutions for safety and soundness,[11] and are authorized under the Federal Deposit Insurance Act to take enforcement action if they find unsafe or unsound practices.[12] Notably, that includes banks with inadequate compliance management systems, which are subject to enforcement actions and civil money penalties. These agencies have wide latitude in determining when to pursue a supervisory or enforcement action; regulators that opt not to take such action may eventually be replaced by ones who will.

LESSONS FROM A PRIOR REGULATORY SEA CHANGE

This is not the first time the financial services industry has experienced a shift in regulatory oversight and enforcement. Indeed, prior to the financial crisis, regulatory oversight was comparatively limited, and the restrictions imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act[13] that have become entrenched in financial institutions' compliance frameworks largely did not exist.

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3. Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33437 (July 17, 2018).
4. Joint Resolution providing for congressional disapproval under chapter 8 of title 5, United States Code, of the rule submitted by the Consumer Financial Protection Bureau relating to ''Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act',' Pub. L. 115-172 (May 21, 2018).
5. Joint Resolution, Pub. L. 115-71 (Nov. 1, 2017).
6. Statement with respect to HMDA implementation (Dec. 21, 2017), *available at* https://files.consumerfinance.gov/f/documents/cfpb_statement-with-respect-to-hmda-implementation_122017.pdf.
7. CFPB Statement on Payday Rule (Jan. 16, 2018), available at https://www.consumerfinance.gov/about-us/newsroom/cfpb-statement-payday-rule/.
8. Reconsideration of HUD's Implementation of the Fair Housing Act's Disparate Impact Standard, 83 Fed. Reg. 28,560 (June 20, 2018).
9. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation*, at *167-68 (July 2018).
10. 12 U.S.C. § 1818; 15 U.S.C. § 45; 12 U.S.C. §§ 5531(a).
11. 12 U.S.C. § 1831p-1.
12. 12 U.S.C. § 1818.
13. Pub. L. 111–203 (July 21, 2010).

As the deregulatory tide ebbed following the crisis, some companies that had not kept an eye on compliance risk management found themselves in hot water. Many were forced to play catch up, scrambling to hire compliance professionals, develop more robust compliance programs, conduct extensive lookbacks, and engage in costly corrective action.

For example, in 2013 the bureau took an enforcement action against a large bank based on telemarketing practices that the bureau alleged were deceptive, despite the fact that the practices had been occurring since 2000 — well before the financial crisis and explosion of UDAP claims.[14] The same year, the bureau entered into a consent order with another large bank based on allegations that from 2005 through 2012, "the bank's compliance monitoring, service provider management and quality assurance failed to prevent, identify, or correct the [bank's] billing for [identity theft protection] services that were not provided" to consumers.[15] The fact that no other regulator had previously taken an enforcement action based on common industry practices did not prevent the bureau from pursuing public settlements and seeking penalties. In many cases involving practices dating back many years, the government has a multitude of options for expanding its reach, including tolling agreements — which are optional in theory only insofar as litigation is threatened absent consent — and assertion of the continuing violation theory. In other instances, there is no need to resort to tolling agreements where a statute of limitations is lengthy or where the limitations period only commences upon the issue's detection, rather than its occurrence.[16]

The post-Enron enactment of the Sarbanes-Oxley Act[17] provides another example of enforcement exposure's long tail and the risk of failing to maintain strong compliance risk management during a period of deregulation. In the year following Sarbanes-Oxley's enactment, the Securities and Exchange Commission filed 543 enforcement actions, of which 147 related to financial fraud or reporting violations.[18] The SEC targeted practices that were once widespread, and lapses that in the past had escaped attention. Regulatory interest in the compliance function may seem cyclical; companies that remained committed to it are at substantially lower risk when the next cycle approaches.

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MAINTAINING A STRONG COMPLIANCE ANCHOR

Business leaders should heed the hard lessons from prior periods of deregulation when institutions put compliance functions on the back burner, rather than put the enterprise at risk and face stiff penalties when the political tide shifts. Indeed, the risk remains even in periods of federal latency, which opens the door for state agencies to use their own supervisory and enforcement authority.

While appropriate compliance risk management is heavily dependent on an institution's specific circumstances, the following best practices may be helpful to keep regulated entities firmly anchored in managing their compliance risk management responsibilities:

- **Maintain all three lines of defense.** A rigorous compliance management system involves testing, monitoring, and reporting at each line: (i) the business

14. *In re American Express Centurion Bank*, 2013-CFPB-0011, at *19 (Dec. 24, 2013).
15. *In re JPMorgan Chase Bank, N.A. and Chase Bank USA, N.A.*, 2013-CFPB-0007 at *3, 5 (Sept. 18, 2013).
16. The general statute of limitations for laws that do not contain their own statutes of limitation is five years from the date of accrual. 28 U.S.C. § 2462. This is the statute of limitations generally used for enforcement actions brought by the primary federal banking regulators. *Proffitt v. FDIC*, 200 F.3d 855, 862 (D.C. Cir. 2000).
17. Pub. L. 107-204 (July 30, 2002).
18. William H. Donaldson, Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002, Senate Committee on Banking, Housing, and Urban Affairs (Sept. 9, 2003).

unit, (ii) compliance area and risk management, and (iii) audit. In a period of deregulation, it is common to see business-line priorities shift toward profit generation, with quality control, business line management reporting, and employee coaching and correction falling by the wayside. Failing to prioritize compliance-related activities at the business level leaves the enterprise susceptible to undetected issues that, if later identified, could result in a significant exposure, particularly if the problem has compounded over time.

- **Keep a centralized mechanism to track all consumer complaints, and perform trend and root-cause analysis.** Complaint management is too often delegated to business units trying new things — some of which may take complaints more seriously than others — and leave the entity without a centralized function that tracks complaints across all lines of business. Failure to do so prevents comprehensive, institutionwide trend and root-cause analysis. Future regulatory examination or investigation could subsequently detect ongoing errors that compliance staff does not know about and has not attempted to address.
- **Continue formal compliance training, particularly if business offerings change or hiring increases.** Developing products or expanding initiatives often requires additional staff, and in their zeal to pursue new opportunities, business units may forego formal compliance training designed to educate employees about regulatory risk. Short-term recapture of hours devoted to training risks long-term damage when regulatory priorities shift back to compliance and enforcement. Companies that have not maintained consistent and comprehensive training programs may find that some employees had limited understanding of their compliance responsibilities, or that certain higher-risk aspects of a particular products or services were never highlighted to the employees working with them. An ongoing, formal training regimen mitigates the chances that an institution will engage in conduct that could later subject it to liability.

By taking these and other steps to maintain strong compliance risk management programs, financial institutions will be able to take advantage of the benefits of a deregulated environment, while remaining prepared to withstand government scrutiny in the event that the tides shift again.

ABOUT THE AUTHORS

Andrea Mitchell advises financial services companies on enforcement and compliance matters regarding allegations of discriminatory lending, redlining, inaccurate credit reporting, unfair, deceptive, and abusive acts and practices, and safety and soundness violations.

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