McGriff

Internal Auditor Liability
Client Advisory

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Expanded Regulatory Exposure for Risk Officers & Internal Auditors

A recent decision by an Administrative Law Judge (ALJ) of the Office of Financial Institution Adjudication (OFIA) should be a concern to all internal auditors, risk officers, executives, and directors of financial institutions, and perhaps, all public companies.

In a ruling that affirmed and expanded civil penalties from the Office of the Comptroller of the Currency (OCC), the ALJ recommended a $7 million penalty for one internal auditor, a $1.5 million penalty for another internal auditor, and a $10 million penalty against a Group Risk Officer.

The ALJ, in an attempt to hold additional executives at the financial institution accountable, both **enforced and expanded the penalties** against the risk officer and internal auditors for their role in a 2016 fraud scandal (details below). The combined $18.5 million in penalties against the three individuals were assessed for failing to adequately perform their duties and for "failing to provide credible challenge," which contributed to the systemic problems at the financial institution.

Background:

The ALJ decision emanates from a 2016 fraud scandal in which sales incentives at a financial institution led to more than 1.5 million unauthorized deposit accounts and over 500,000 credit card accounts. The ensuing criminal and civil investigations by the Department of Justice (DOJ) and Securities and Exchange Commission (SEC) resulted in the financial institution entering into a Deferred Prosecution Agreement, agreeing to pay fines, penalties, consumer redress, and a distribution to investors of $3 billion. Separately, the Consumer Financial Protection Bureau (CFPB) assessed fines and penalties against the financial institution of $3.7 billion, noting that the institution had been a recidivist for over a decade.

In addition to the fines and penalties against the institution, fines and penalties related to the fake account fraud were levied against the former CEO by the OCC. Now, the OCC has accepted the recommendations of the OFIA and assessed the fines mentioned above against internal auditors and the company's Group Risk Officer totaling $18.5 million.

Regulatory Oversight:

The Office of Financial Institution Adjudication (OFIA) is an inter-agency group of administrative law judges established pursuant to the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) that presides over administrative enforcement proceedings brought by the Federal Deposit Insurance Corporation (FDIC), the OCC, the Board of Governors of the Federal Reserve System or the National Credit Union Administration. The OFIA issues recommendations to the relevant agency head. (www.ofia.gov/index.html)

The OCC is an independent branch of the U.S. Department of the Treasury and may take enforcement actions for violations of laws, rules or regulations, final orders or conditions imposed in writing; unsafe or unsound practices; and for breach of fiduciary duty by institution-affiliated parties (IAPs). The OCC is authorized to take enforcement actions against:

- National banks
- Federally chartered savings associations and their subsidiaries
- Federal branches and agencies of foreign banks
- IAPs, including officers, directors, employees, controlling stockholders, agents, and certain other individuals

Expanded Liability for Risk Officers and Internal Auditors:
In the fake account fraud matter, the OCC issued a Notice of Charges against three individuals: the Chief Auditor, the Group Risk Manager and the Executive Audit Director, a direct report of the Chief Auditor. The matter was referred to OFIA for findings of fact and recommendations, if any. Following the taking of testimony and presentation of documentary evidence, the ALJ issued his "Report and Recommendation – Executive Summary" in which he ruled against all three individuals.

One overarching theme in his 78-page report was the three former executives' **"failure to provide credible challenge,"** a phrase the ALJ used 14 times throughout his report. The "failure to provide credible challenge" means the former executives did not do enough to investigate, to question, and to properly escalate the issues they witnessed. This dereliction of duty is described further below:

- As to the **Chief Auditor**, the ALJ concluded that he served "as the head of the Bank's third line of defense, failed to timely identify the root cause of team member sales practices misconduct in the (financial institution), failed to provide credible challenge to (the financial institution's) risk control managers, failed to timely evaluate the effectiveness of (the financial institution's) risk management controls, and failed to timely identify, address, and escalate risk management control failures that threatened the safety, soundness, and reputation of (the financial institution.)"
- As to the **Group Risk Manager**, the ALJ concluded that she "failed to timely identify the root cause of team member sales practices misconduct in the (financial institution), failed to exercise credible challenge to (the financial institution's) head regarding risk management controls relating to sales practices, failed to timely and independently evaluate the effectiveness of risk management controls, and failed to identify, address, and escalate risk management control failures that threatened the safety, soundness, and reputation of (the financial institution)."

(continued)

- As to the **Executive Audit Director**, the ALJ concluded that he "failed to timely identify the root cause of team member sales practices misconduct in the (financial institution), failed to provide credible challenge when evaluating the effectiveness of (the financial institution's) risk management controls, and failed to identify, address, and escalate risk management control failures that threatened the safety, soundness, and reputation of the Bank."

The ALJ further found **as to all three defendants** that "each person separately and collectively engaged in unsafe and unsound banking practices by individually failing to identify and effectively address inadequate controls over known issues of risks related to sales goals pressure, knowingly and purposefully failing to escalate known issues related to those ineffective controls, misleading regulators regarding the efficacy of controls over risks related to sales goals pressure, thereby advancing their individual pecuniary interests over the safety, soundness, and reputational interests of (the financial institution and its holding company, … and breaching fiduciary duties each owed to the (institution). Further, (the Chief Risk Officer's) efforts to restrict material information from being disseminated among the (institution's) senior leaders, the … Board of Directors, and federal regulators violated federal statutes and regulations."

In addition to the monetary penalties recommended to and accepted by the OCC, the ALJ also determined that under the terms of Section 8(e) of the Federal Deposit Insurance Act, the entry of a *prohibition order* (or "bar order") barring their future participation in the conduct of affairs of any insured depository institution was appropriate for the Chief Auditor and the Chief Risk Officer. Finally, the Court recommended that the OCC also enter a cease-and-desist order against the Chief Auditor and the Executive Audit Director. In so recommending, the ALJ found that "(these individuals) separately and individually **engaged in conduct that was contrary to generally accepted standards of prudent operation**, the possible consequences of which, if continued, would be abnormal risk or loss or damage to the Bank, its holding company and the holding company's shareholders, or the agencies administering the insurance funds" (emphasis added).

Note that the three former executives can appeal the penalties in federal appeals court and all three have said that they plan to do so, so we may not have seen the end of this story yet.

Individual Accountability of Directors, Officers, and Other Employees:

Individual accountability is not a new concept to securities law. There are laws holding directors, officers and employees personally accountable, such as in the United States Bank Secrecy Act (1970), The Investment Company Act of 1940 and the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010). In 2015, the DOJ issued updated guidance on "Individual Accountability for Corporate Wrongdoing" based on a memo authored by then Deputy Attorney General Sally Yates. Known as "The Yates Memo," it says: "One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing. Such accountability is important for several reasons: it deters future illegal activity, it incentivizes changes in corporate behavior, it ensures that the proper parties are held responsible for their actions, and it promotes the public's confidence in our justice system." Memorandum for Assistant Attorney General (justice.gov) That accountability extends to internal auditors and Chief Risk Officers pursuant to the OCC holding referenced above.

Practical Guidance:

Considering this, companies – public and private – should take practical steps to protect the interests of their employees. These steps include:

- Review charter provisions or bylaws governing the election or appointment of directors
- Review charter provisions or bylaws governing the election or appointment of officers
- Ensure formal adherence to process for election or appointment of officers on all levels of management
- Review charter provisions or bylaws pertaining to indemnification obligations
- Review charter provisions or bylaws providing exculpatory clauses for directors and officers
- Review with your McGriff broker the details of your D&O policy, specifically the definition of Insured Person and scope of coverage for an Insured Person
- Speak with your McGriff broker to ensure expansive coverage for Insured Persons and, where available, coverage for fines and penalties

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