The necessary shift to compliance outputs

Neil Herbert, HRComply, 22 May 2014

Without mentioning a single rule or regulatory principle and only one section of a statute, Neil Herbert of HR Comply offers up a very passable summary of what the UK's financial conduct regulator expects of the retail sector. Compliance officers at private wealth firms could do far worse than to circulate this among their front-line staff.

Keeping the wings on: what if your firm were an aeroplane?

The UK's Financial Conduct Authority has been very vocal about the fact that it is no longer looking at box-ticking and controls. The regulator is now more interested in ‘outputs’ in terms of how good compliance activity translates into 'market and client behaviour', in addition to the quality of advice that banks and wealth managers give their customers.

The wealth management sector recently had the relative ‘comfort’ of the Retail Distribution Review – a prescriptive and reassuring series of boxes to tick. They merely had to ensure that everybody eligible had done 35 hours of continuous professional development (CPD) and had an up-to-date Statement of Professional Standing (SPS) and that was that. It is very clear now that such box-ticking will no longer suffice.

Wholesale and investment banking firms have never had the comfort of such prescriptive guidelines regarding 'training and competence' (T&C) as the retail and private client sector. Firms in this sector may now find that they have even further to go to meet the FCA’s new expectations.

The FCA’s focus is now on the 'overall experience' that a firm gives its customers – in other words, results. This includes the way the compliance team, its T&C effort and the firm's broader compliance culture strive to make that experience a good one. The FCA, therefore, is looking at the quality of asset management and advice that the firm affords the customer, along with its 'market conduct'.

Keeping the wings on

An appropriate analogy here is with aircraft maintenance engineers and their routine inspection of the wings in circumstances where the air transport safety legislators have not bothered to specify the kind of checks that they want in detail. Instead of performing 100 legally mandatory checks on an aircraft wing, the engineer has to consider the actual 'customer experience'. He may have ticked all the boxes on his own self-compiled list, but if the wings fall off during a flight he will still be penalised for ruining the 'customer experience'. To take the analogy further, this is

in circumstances where the aviation authorities have provided only a sketchy impression of what they think might make the wings fall off - there is just a vague direction that the engineers must display appropriate conduct and the highest standards at all times!

To regulate the industry the FCA has launched a new supervisory model that is pre-emptive and judgement-based rather than reactive. This obliges firms to deal with underlying causes of trouble rather than mere symptoms and is focused more on firms 'doing the right thing' rather than merely complying with specific rules. The FCA says that firms do not usually 'go wrong' because they fail to comply with the rules but because there are fundamental flaws in their business models, cultures or business practices.

At a practical level, then, the FCA has made it clear that it is focusing on the 'outputs' and not the 'inputs'. What are those outputs? They include – let us lapse for a moment into regulator-speak for this – the achievement of appropriate customer outcomes and the highest ethical performance of all customer-facing staff, with those staff being technically competent to advise and provide the most suitable advice in any given scenario and with regard to each individual client.

Watching for changes in the regulator's facial expression

The FCA has often indicated that 'appropriate customer outcomes' depend heavily on firms having internal cultures that view the interests of their customers as paramount. Cultural leadership has to come from the top. The senior management of every firm must enshrine the right culture in clearly described business practices that ordinary people can understand easily and, once established, the culture must inspire every layer of management whenever someone has to make a judgement about what is acceptable and what is not.

The problem with all of this is that it is relatively arbitrary. Without clear rules or benchmarks, how can firms ensure that they are satisfying the expectations of the regulator? Increasingly it seems, the FCA is lashing out against both firms and individuals according ot its own subjective judgements and agenda rather than by black and white regulatory rules or guidelines.

For example in recent enforcements against 'market abuse' the FCA has relied upon *s118(5) Financial Services Act*, dealing with trading activity that gives a false impression of the supply, demand and price of investments. The FCA does not, however, impose comparative quantum caps concerning how much of a bond or stock can be held. This leaves the whole process of pricing bonds (particularly in relatively narrowly traded markets) open to claims of market abuse at the whim of the FCA. With careers and reputations at stake, who would be a market-maker in these circumstances?

Determining acceptable levels of conduct

The greatest challenge facing compliance and risk people is to try to determine the acceptable levels of conduct in the multiple market, investment and client sectors that the FCA regulates. There have been many recent references in FCA speeches or press releases about the need for senior management or compliance people to be aware of everything that happens on their watch. Much rhetoric and recent legislation has been directed at holding these senior individuals accountable for any of their staff's misconduct and shifting the burden of evidence to being one of 'unless you can prove you did something to stop it, you are as guilty as the perpetrators themselves'. Realistically speaking, in large organisations with huge trading floors and wealth management desks, this is simply impossible.

The recent response of the industry has been to recruit more and more compliance staff, and this has driven up both demand and salaries. There continues, however, to be little evidence that the issue of 'conduct risk' is being addressed at its root. Not enough boards are putting conduct risk at the top of their agenda, with the resultant absence of conduct and compliance strategies being imposed from the top down.

How to solve an undefined problem?

Regulators around the world are giving the management and mitigation of conduct risk a high priority, yet no universally agreed definition of conduct risk exists. In response therefore, compliance officers, risk managers, senior management – and, crucially in my view, human resources departments as well – need to establish what ‘good’ looks like for their organisation. They then need to put in place the systems, controls and infrastructure to effectively manage and attain that standard. What firms can do is implement the highest levels of scrutiny. They must 'benchmark' client and market behaviour along with conduct. They must then provide the means to monitor, assess and enforce such behaviour through appropriate policy, process and technological infrastructure.

A focus on conduct, quality and suitability of advice, and the maintenance of market integrity must influence behaviour. Yet in my experience, eight out of ten firms are focusing on compliance inputs (what they have done) instead of outputs (what the effect of those actions really is). If this situation persists, sooner or later the wings are bound to fall off.

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