

T&C and HR compliance for FCA regulated firms

Spotlight on Wholesale

Neil Herbert, April 2015



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Regulatory Conduct Reaches Wholesale and Institutional Sector – New Challenges for Compliance, Risk and HR.

In this quarter's newsletter we are focusing on the **wholesale sector** – both buy-side and sell-side institutions and some of the key challenges that FCA regulation presents.

Up close and personal

It's been a while coming but no one could say they were not warned. The FCA has long signalled its intention to focus its attention on the wholesale and institutional sector – both buy- and sell-side. For some time the primary conduct and associated T&C focus has been on the retail sector – mainly driven by the RDR shake up. As a result the wholesale sector has been lulled into a state of complacency.



The problem is that by its very nature, the primary FCA risks for the wholesale sector are **conduct based**, often relating to market abuse. The absence of clear guidelines on conduct for the sector (guidelines against which firms can set benchmarks) presents unique and considerable issues for senior management, Compliance, Risk and HR Professionals.

Criticisms

In the last month alone there has been extensive press coverage of the FCA's criticism of the funds industry and its failure to impose and manage adequate market abuse controls. This is the result of the most recent thematic review.

Ironically, there has also been criticism of the FCA for exceeding its regulatory remit in enforcement based on misconduct and whether it can justify enforcement against firms operating in unregulated wholesale markets.

Regulatory creep

The latter criticism came from the City of London Law Society (CLLS), which represents over 14,000 City Lawyers, to the Fair and Effective Markets Review. Singling out the FCA's enforcement actions against Citibank, HSBC, JPMorgan Chase, RBS and UBS in relation to attempted manipulation of the unregulated FX market, the CLLS claims that this represented a potential precedent for the FCA reaching beyond its formal 'regulatory perimeter'. This is a phenomenon known in the trade as **regulatory creep** (don't you just love that phrase!).

In particular the CLLS described as 'unsatisfactory' the FCA's reliance on the high level 'management and control' obligations of its Principle for Business 3, allowing such enforcement in unregulated markets. This they deemed to be something of a 'workaround'; allowing the requirement for firms to take 'reasonable care' to organise and control their affairs responsibly and effectively (and to have adequate risk management systems) to form the basis of enforcement in an unregulated market.

Guidelines

The argument (which is an oft heard one in the wholesale sector) is generally based around the lack of definition and the absence of clear guidelines. The wholesale sector complains that firms are currently at risk of enforcement even though the regulator itself has not issued or endorsed standards or guidance against which their conduct may be judged. The response pointed out that 'the FCA has authority to enforce standards but has no corresponding stewardship responsibility for setting and articulating the required standards'.

Principle 3

The justification to use Principle 3 is based on a 'macro threshold' of demonstrating adverse impact on the UK's financial system (an argument that could well have been made in reference to the widespread manipulation of the FX market?). Where conduct falls beneath

this threshold of impact (and that probably relates to most conduct shortfalls – even where individual conduct may be contrary to what is deemed as desirable - by this definition at least) it should be beneath the FCA’s remit.

These, however, are legal arguments. It is surely wishful thinking that the FCA is going to back away from enforcement wherever it finds conduct that is undesirable in any market. This enforcement will extend to anywhere that there may be perceived undesirable customer or market outcomes (and taking such misconduct to its end conclusion, there will always be such an undesirable outcome).

Enforcement and appeal

The FCA has always made it very clear that it will apply the same conduct and culture expectations to wholesale firms and to individuals operating in any financial markets (whether regulated or not). Yes, it will need to establish legal grounds for enforcement, but enforcement is not subject to the ‘innocent until proven guilty’ maxim. The FCA does not have to prove guilt to a jury or indeed anyone else: its view on misconduct is pretty much final.

There is limited recourse to appeal and the FCA of course enjoys statutory immunity. It is interesting to note that despite the lawyers’ sabre rattling contained within this response - and the fact that the actual banks enforced against no doubt had the most expensive teams of lawyers at their disposal, all of them have so far settled without appeal.

The arguments I often hear are broadly along the lines of ‘That doesn’t really apply to us’ or ‘Oh there aren’t any actual regulations in place that dictate we have to comply like they do in the retail sector.’ Admittedly, where activities are limited to unregulated markets there is a legal argument to be made over the FCA’s remit, but the principles remain the same for a regulated firm in that all of its activities are in many ways related – they have aggregate markets and client impact. In any case, most traders are authorised for very good reason, so their individual conduct remains up for scrutiny.

What will be the end result? Wholesale firms must take the issues of conduct risk and market abuse very seriously indeed. Any firms that do not will run significant regulatory risks at both corporate and individual levels.

Where will the FCA’s focus continue to be this year?

Culture

Last year’s FCA Business Plan and Risk Outlook clearly stated the intentions regarding

wholesale institutions, particularly highlighting areas of forthcoming thematic focus.

Continuing themes included, primarily, **Culture**. No surprise there then! The FCA will continue to expect to see firms embedding a culture that promotes clients' best interests and market integrity. The regulator will wish to observe demonstrable evidence that clients' interests are sufficiently prominent features of firms' business models and strategies. Many column inches have been devoted to the difficulties this presents in terms of the measurement and assessment of culture. Just because it is difficult, however, doesn't mean we don't have to deal with it.

It is important (and actually not that difficult) to develop a set of key cultural indicators that firms can benchmark against. The FCA has signalled very clearly its readiness to draw cultural conclusions from its observations of a firm.

So where should your focus be in terms of process, policy, monitoring and MI? What are the Key Culture Indicators the FCA may draw its conclusions from?

1) Complaints Handling

- *How seriously does the firm treat complaints: is there sufficient process and MI in place to support this?*

2) Performance Management

- *Are appropriate metrics used to assess individuals' performance – in terms of role performance, but more specifically in terms of competence and conduct?*
- *Are compliant behaviour / ethical conduct metrics being recognised and rewarded or is the focus revenue / profit orientated?*
- *Is there tracking and monitoring of key competence and mandatory compliance training KPIs – what are the consequences of not completing such KPIs?*
- *Are objective benchmarks in place by which to measure this?*

3) Response to Issues

- *How well does the firm manage and process issues / near misses – actions speak louder than words etc.?*
- *Are clear escalations and responsibilities set?*
- *Is there active encouragement to challenge issues – whistle blowing protection etc.?*
- *Where appropriate is the FCA notified – is there a remediation plan in place?*
- *How strong are internal risk / governance and audit functions, processes and controls?*

4) Remuneration / Incentivisation

- *Is variable remuneration linked to compliant and good compliant behaviours toward clients and markets?*
- *Is this measured objectively?*
- *Are there claw-back mechanisms in place?*

5) Quality and Commitment of Senior Management

- *Is this demonstrable and evidenced in policy and infrastructure investment?*
- *Has the CEO / Board articulated their cultural values and expectations and are people objectively measured against these?*
- *Does everyone understand these?*
- *Is the regular articulation and practice of the firm's cross-selling activities consistent with TCF and clients' best interests?*
- *What's the quality of the MI and does the Board actively engage in MI analysis (and act upon as well as commit to Compliance, Risk and HR initiatives)?*
- *Is meaningful MI provided to and acted upon by the right bodies within the firm's governance framework?*
- *How influential are these latter functions and what is the quality of the incumbents in position?*
- *What is the general attitude within the business to these functions?*

6) Training

- *Is there a robust T&C scheme / policy – is there buy-in?*
- *Has the firm determined what 'good' looks like across the key metrics?*
- *Does the firm have a demonstrable commitment to developing its staff in line with quality of advice, TCF, competence and integrity / conduct expectations?*
- *Do they measure outcomes and outputs from training?*
- *Are they dedicated to ensuring those in supervision, oversight and Significant Influence*

Functions are fully trained in latest FCA and general regulatory requirements and developments?

- *Is mandatory training actively monitored?*
- *Is there clear training around market abuse and how it manifests itself – are outcomes from this clearly assessed and monitored?*
- *How good is the training MI?*
- *Have they invested in suitable T&C systems?*
- *Are new joiners provided with sufficient induction training and is this recorded – are there sufficient initial competence assessment and identification of individual training needs?*

If you have answered no to one or more of these key indicators – we can help you.

Investment in a strong T&C and Performance management system will help protect your firm. Monitoring and assessing key metrics; keeping training and CPD / Compliance records on all authorised staff; creating meaningful MI; objectively assessing performance, competence and conduct against defined benchmarks and objectives (linking these to remuneration); these are all key features of our easy to use online software.

An examination of the 130-page 'Business Plan and Outlook' provides a good indication of where the FCA is heading with regard to your business and where they will focus. An examination of the stated forthcoming thematic reviews contained within that document is particularly illuminating.

Asset Management

Thematic Review

The first major thematic review by the FCA of 19 firms within the asset management sector has found that most of these firms did not have comprehensive risk management controls in place. These firms include long-only asset managers, hedge funds and one occupational pension scheme, with assets under management ranging from £200 million to over £100 billion.

There are many criteria to consider in determining whether there are comprehensive controls to prevent market abuse and insider trading. Key to delivering these controls and monitoring adherence is: training; policy distribution and attestation; testing of knowledge; and

assessment of adherence through key metrics and monitoring. The recording of all these indicators is also vital.

It is simply not enough to set the requisite e-learning and once completed assume that your responsibilities are met. You need to actively set benchmarks of conduct that the training is helping to achieve and then assess the outcomes of that training in the way conduct and market behaviours are improved as a result of that training. Assessment is key! This is what HRComplySoft is designed to do for you!

Those firms that do not heed this ‘warning shot across the bows’ and take appropriate action will almost inevitably face enforcement somewhere down the line.

Other planned reviews include:

- Agency responsibilities of Asset Managers
- Conflicts of interest in investment banks
- Controls over flows of information in investment banks
- Trader controls around benchmarks
- Visibility of resilience and risks at board level

Our Plug-In Package for smaller Asset Management Firms, Hedge Funds and boutique Advisory Firms

ENFORCEMENT ACTION ON ASSET MANAGEMENT FIRMS ‘ALMOST INEVITABLE’ FOLLOWING THEMATIC REVIEW, SAYS LEADING CITY LAWYER



Do you want a quick and comprehensive solution to manage your FCA conduct and Culture Risk? We offer:

- *Full software licence and online access to HRComplySoft's Assessment Module and CPD/Training Module*
- *Ready to use Job Descriptions and Competency sets for all your roles*
- *Defined benchmarks and KPI's against which conduct and competence should be measured in order to have a 'compliant culture'*
- *Key Assessments ready, designed and delivered*
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- *Policy distribution and attestation*
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- *All in fixed price for up to 30 staff of £800 per month (terms apply)*

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