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CONDUCT RISK
Protecting your brand

This article is for Board members, senior executives, compliance, risk and legal professionals of wholesale firms, to help them further develop their understanding and management of conduct risk. In this brief article we set out a high-level definition of conduct risk, discuss a number of conduct risk "hot topics" and finally, pose questions designed to help firms benchmark their existing conduct risk arrangements against good practice.

Background

The financial services industry is slowly emerging from its most serious crisis in living memory. It is doing so against a hostile environment of public, political and regulatory mistrust, reduced buy-side demand, rising costs, significantly increased regulation, and high levels of risk and volatility. Few days pass without news of new, sometimes record fines, and new regulatory changes affecting the way firms do business today, and in the future. These changing demands are placing a great strain on firms and, in particular, on Board members, senior executives, and the compliance, risk and legal teams that work alongside them. Just as other industries that have gone through seismic structural and cultural change following serious risk failures – oil and gas, pharmaceuticals and aviation – the financial services industry is working hard to tackle the contributing factors that led to the crisis, including adjusting short-term incentives and tightening controls and processes.

In the UK, a meaningful outcome of the substantial reorganisation of the regulatory framework has been the creation of a regulatory body specifically tasked with the regulation and supervision of conduct – the Financial Conduct Authority (FCA). The FCA's work to date has focused primarily on the retail sector and on conduct relating to retail customers, but the FCA has made it very clear that it will not ignore the wholesale sector[1].

The final report from the Parliamentary Commission on Banking Standards (PCBS), published in June of this year, has drawn very similar conclusions as the FCA, regarding its focus on bankers' conduct and the related responsibilities of the Board and senior management. The PCBS proposes an overhaul of changes to the Approved Person Regime (APER) designed to reinforce individual responsibility, and recommends a more targeted and tougher penalties regime, at the same time encouraging shareholders to take a more active role in ensuring better behaviours in firms.

Boards should not be surprised that so much attention is being focussed on the requirement for them to have credible arrangements to manage conduct risk. Failing to do so creates the possibility of undetected future risks and damaging, expensive remedial action, both for individuals and firms.

What is conduct risk in wholesale markets?

The FCA continually refers to conduct risk, and while a simple, consistent definition hasn't been shared with the industry, there are enough indicators and examples of "poor" management of conduct risk for firms to grasp the concept, formulate their definition and, most importantly, translate it into a meaningful set of quantitative and qualitative internal business arrangements that positively impact customers and market integrity. One of the better definitions we have seen refers to conduct risk as "*the risk that detriment is caused to the firm, consumers and other market participants because of the inappropriate execution of business activities*".

Putting this into practice could mean determining what "good" looks like in terms of outcomes for particular markets, investors, business lines and products, then assessing whether the firm's existing processes, procedures and people are designed to meet that "good" standard. Many wholesale firms accept that their obligations now go beyond the "caveat emptor" principle previously relied upon and supported by legal precedent. This step-change has its origins in the now discredited view that, unlike retail firms which could directly impact consumers and cause detriment, wholesale firms couldn't do so, either individually or collectively. On the basis of the definition above, and the breadth and diversity of the wholesale markets, the challenge for wholesale firms is to define conduct risk on the basis of current business model, choice of distribution channels, future strategy, and known external factors (such as regulatory change).

[1] As Martin Wheatley, now CEO of the FCA, highlighted during his speech at the British Bankers Association (BBA) Annual Banking Conference in October 2012, the FCA will also have a renewed focus on conduct in wholesale markets. "This is because we realise there is a connection between what happens in retail and wholesale markets – and the risks caused by poor wholesale conduct can be passed between them." The most obvious market wholesale misconduct issue being LIBOR, which not only damaged the reputation of the entire banking industry but indirectly affects all mortgage holders and those with loans set by benchmarks.

Emerging conduct risk themes

When considering wholesale conduct risk, Boards and senior executives should consider areas beyond the "traditional" areas of market conduct, conflicts of interest, product design and manufacture, transparency, reporting, and financial crime. Conduct risk assessments need to also consider how a firm is addressing the following evolving issues, and their relevance to a firm's businesses and operations:

- **Imperfect markets** or "Information asymmetries" as the FCA is increasingly describing them. These are believed by the FCA to be more firmly entrenched in the wholesale market than in the retail market. There is no doubt that "professionals" are not all created equal, resulting in some less sophisticated investors unknowingly being misled; Interest Rate Hedging Products (IRHPs) and Credit Default Swaps (CDSs) being the latest example of "mis-selling" in the wholesale market. The European Commission is also attempting to address conduct issues under **MiFID II**, which will include increased reporting and disclosure requirements, and will introduce traditionally "retail" concepts such as acting honestly, fairly and professionally, and communicating in a way that is fair, clear and not misleading, into the wholesale markets.
- **Market-wide structural conflicts of interest** (as opposed to client verses client, or client verses firm conflicts) are seen as the root of much consumer disadvantage -payment for order flow being the most topical example. With the FCA's increased powers of intervention and its new competition objective, the regulators are more likely to investigate such uncompetitive practices. The question is, to what extent does your firm rely upon such structures and practices and what cost and impact would a past business review of such payments have on your firm?
- **Ownership of risk** seems to have developed to where it is now widely accepted that risk is primarily owned by the first line of defence. While wholesale firms have generally been very successful in doing this for market and credit risk, success in operational risk areas – including conduct – has been mixed. In order to accomplish this, many firms will need to redefine roles and responsibilities, provide additional education and introduce new management information systems for conduct risk areas.

> *"Boards will need to engage with and empower, senior management to take the lead in defining and managing a firm's conduct and conduct risk arrangements."*

- **The broad variety of wholesale products** has increased the likelihood of a dangerous "knowledge gap" developing between the Board and a firm's revenue generators. In retail firms, Board members can easily become familiar with the details of the firm's products – which are rarely customised. This is quite different for wholesale firms due to the complexity, risk characteristics and variety of wholesale products. Therefore wholesale firms have to work much harder than retail firms to meaningfully explain the breadth and diversity of products and associated risks to the Board.
- **Market Abuse Regime** the successor to the Market Abuse Directive, the new directive on criminal sanctions for insider dealing and market manipulation (CSMAD) proposes to broaden the scope of the regulatory framework to cover new trading venues, multilateral trading facilities and organised trading facilities (MTFs and OTFs) as well as to OTC-traded instruments. The proposals include new categories of inside information, an extension to the definition of market manipulation and, unsurprisingly, also capture benchmark manipulation. All wholesale firms will need to carefully and holistically review their operations and controls in relation to MiFID II, CSMAD, MiFIR and EMIR.
- **Arrangements between retail and wholesale firms regarding CASS** means that, ultimately, wholesale firms hold a portion of retail investors' client money and assets. Numerous failures in the wholesale markets (Lehman Brothers and MF Global) have resulted in retail customers' cash and assets being contested over and tied-up for years after catastrophic events. Wholesale firms affected by CASS and collateral arrangements will need to review their operations in light of new requirements and, more broadly, conduct risk.
- **Board and senior executive responsibility** is under renewed scrutiny as the new regulatory environment explicitly requires the Board and senior executives to set the "tone from the top". The expectation, including those noted by the PCBS, will not all be easy to implement, and will require time, patience and leadership, as well as additional or different resources. Certainly Boards need to be able to demonstrate their clear and unequivocal support for a more responsible, controlled approach to leading and managing the business. Boards will need to engage with, and empower, senior management to take the lead in defining and managing a firm's conduct and conduct risk arrangements. The old adage "you are only as strong as your weakest link" is worth heeding.

Questions Boards and senior executives may want to ask themselves

An integral part of a Board and senior executives level review of a firm and its performance should be asking themselves, individually and collectively, performance number of questions such as:

- Has "conduct risk" in your firm been defined, articulated and communicated to staff?
- How comfortable are you that all conduct risks related to the current business and future strategy of the firm been identified?
- How have conduct risk controls been assessed for effectiveness?
- Are you confident that the process used to complete this assessment is robust? And how comfortable are you with the outcomes?
- Can you be certain that you "know what you need to know" in relation to conduct risk in your firm?
- Are you confident that all business units have appropriate policies, procedures, systems and controls to manage conduct risk (including middle and back office) in place?
- How can you be sure that senior management, at group and business unit levels, have the necessary resources and influence to oversee and enforce adherence to relevant conduct risk policies and procedures?
- Is ownership and responsibility of conduct risk activities clearly defined and understood in all three lines of defence?
- Can you be certain that the firm's remuneration and incentive arrangements at all levels appropriately addresses conduct risk concerns?
- How do you know the firm's governance arrangements including reporting and escalation, support the firm's conduct risk arrangements?
- How willing would you be to "attest" to the FCA regarding your firm's conduct risk arrangements? If not, why not?

We know conduct risk exists throughout any business, therefore firms need to make sure they know what it is, where to find it and how best to manage it. We encourage you to take sensible and proportionate steps to prevent conduct risks crystallising and damaging the reputation of your firm – or the integrity of the market.

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