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THE RISING COSTS OF NON-COMPLIANCE: FROM THE END OF A CAREER TO THE END OF A FIRM

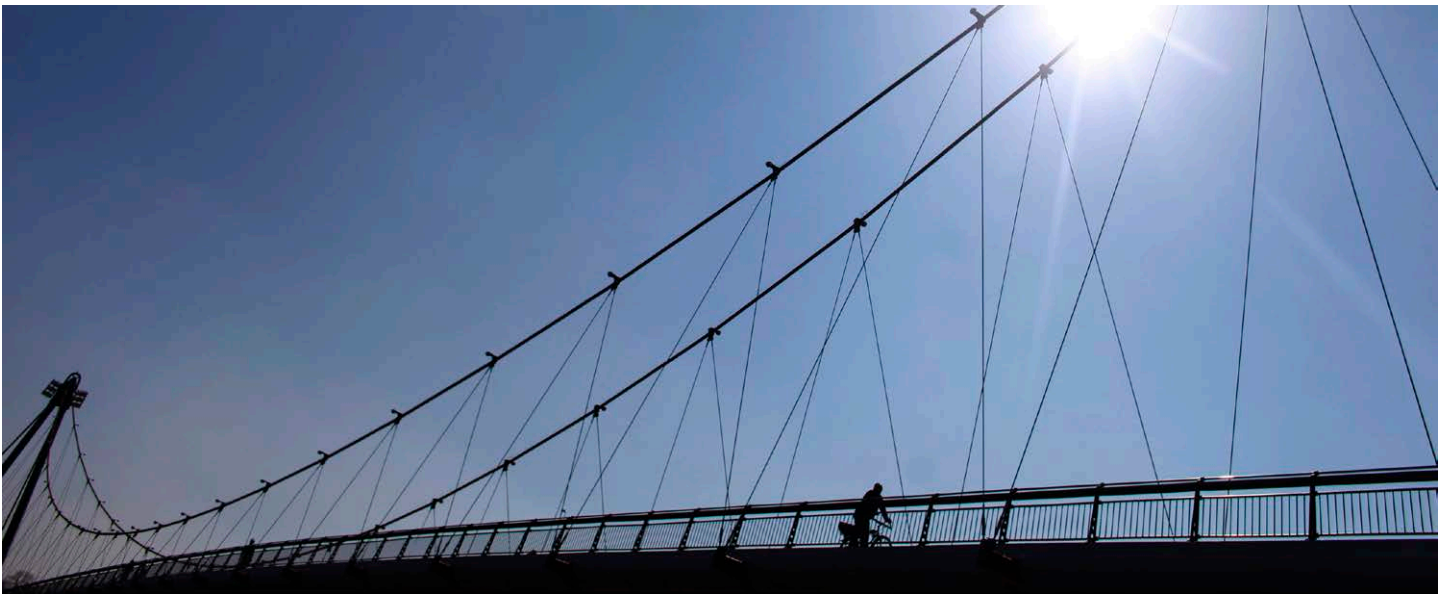
Stacey English & Susannah Hammond



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EXECUTIVE SUMMARY

The costs and consequences of non-compliance within financial services firms are greater than ever before. The cost for firms of endeavoring to be compliant has been growing in line with the rapid rate of regulatory change but it is the widespread and myriad costs of failing to be compliant which are now taking center stage. Regulators have lost patience and in a world where super-size fines no longer either shock or deter have moved on to using a wider range of measures to ensure compliant behavior. The wider impact can result in the firm or the individual suffering multiples of the cost and pain of the penalty itself. The ramifications of which will be felt by all stakeholders.

- Monetary fines, while huge and still growing, can be the least of the "costs" imposed on a firm or individual. Financial implications are much wider than the actual fine levied. They can include the end of a business line, the curtailment of the ability to sell specific products or ultimately the end of the business itself. Regulatory action can have a negative impact on the share price of a firm and damage its relationship with investors. Additional regulatory powers could also now result in firms being required to increase liquidity or capital, putting them at a disadvantage to their more compliant peers.

- Senior managers are in the regulatory firing line. As a deliberate international regulatory approach senior managers are increasingly being held to account for their own behavior, with the potential for claw-backs on bonuses and a career-ending criminal conviction. All of which is in addition to being significantly distracted by having to spend increasing amounts of time on remedial actions rather than focusing on the business itself.
- Expensive and disruptive operational consequences of non-compliance include the increased cost of recruiting and retaining high-quality compliance resources and implementing past business reviews and customer redress programs through to needing to engage and use costly third parties or skilled persons.
- Increased regulatory scrutiny, complexity, regulatory change and customer distrust are set to continue as a result of the widespread compliance failures.
- Action needs to be taken at the most senior levels not only to be compliant but also to avoid the growing costs of non-compliance.

"On a firm-specific level, we have taken a range of early intervention actions. The outcomes of these can range from consumer contact; reviewing certain lines of business; taking sales staff off the road and retraining; withdrawing financial promotions all the way up to changes to boards and governance arrangements. Historically this was not an area where enforcement was typically involved. That has been very different this year..."

Speech on Sustainability by Tracey McDermott, director of enforcement and financial crime, UK Financial Conduct Authority, at the Thomson Reuters Compliance & Risk Summit, June 2014

INTRODUCTION AND BACKGROUND

The costs of non-compliance are many and varied and cover far more than the headline fines handed down by regulators. Financial services has changed almost out of all recognition since Thomson Reuters' first review of this area in 2008 and the costs of non-compliance and the widespread ramifications of getting compliance wrong have moved on significantly. In 2007, the first tremors of the financial crisis had already been seen in the UK with the fall of Northern Rock. The collapse

of Bear Stearns, HBOS, Lehman Brothers and Royal Bank of Scotland had yet to happen.

This costs of non-compliance report is quite distinct from the analysis into the financial services industry's cost of compliance which the authors also benchmark on an annual basis. That separate report provides global insight into the costs, availability and allocation of compliance resources and the challenges firms expect to face in the year ahead.

REGULATORS AND THEIR APPROACH

Before the financial crisis regulators around the world were by and large content to punish regulatory breaches by imposing fines on the firm concerned. In a post-crisis world both the approach taken and the regulators themselves have changed. That is not to say that fines are any less prevalent, but rather that they have grown immensely without appearing to have changed the underlying behavior. It was to tackle the fundamental need to change the how, as well as the what, of business conduct that new regulators with new powers came into being: regulators who were willing and able to use a deliberately more holistic approach to discouraging poor behavior by both firms and, critically, individuals.

Regulators have been consistent in their desire to encourage good conduct but the financial penalties levied in the past have not had the desired result and lessons have patently not been learnt. Although they have not discarded the use of monetary penalties regulators have changed their approach, deliberately and significantly.

At the supranational level, the Financial Stability Forum has evolved from being an obscure body reporting into the G20 to become the Financial Stability Board, a well-resourced body with a mandate to lead policy development and change in financial services. In Europe, the committee structure of policymakers has been replaced with a trio of supervisory authorities that not only make policy but also implement and oversee detailed rulebooks. In the UK, the Financial Services Authority has been split and new regulators created to focus on prudential and conduct of business issues. In the United States the Consumer Financial Protection Bureau was established as part of the Dodd-Frank reforms with the aim of making "markets for consumer financial products and services work for Americans". Similarly, in the Asia-Pacific region, there have been a number of wide-ranging policy initiatives by governments and regulators, and even government enquiries into the performance of regulators. Regulators everywhere have been granted a growing arsenal of supervisory and enforcement powers which they are being encouraged to use to rebuild and uphold the integrity of their relevant markets, with the emphasis on investor protection.

"We have all seen the conduct-related events over recent and not so recent times and their cost — not just the immediate regulatory fines and redress costs, but also perhaps the more damaging erosion of trust in financial services and uncertainty about future business models of firms."

Clive Adamson, director of supervision, UK Financial Conduct Authority, March 2014 in a speech entitled "A sustainable conduct environment"

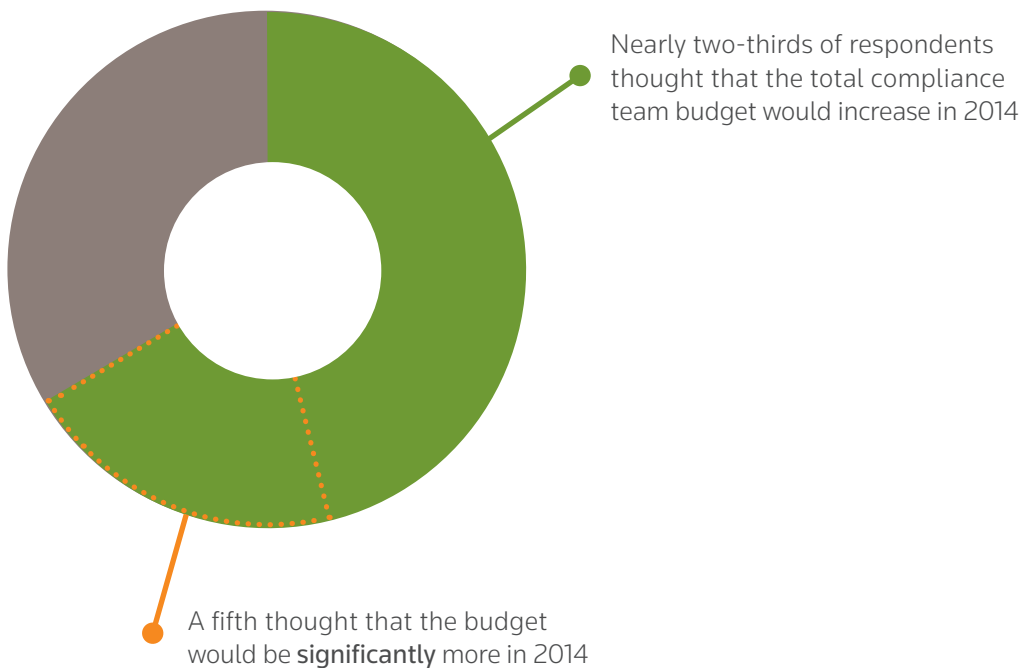
COST-CUTTING: A WARNING FROM HISTORY

Thomson Reuters' first review, in 2008, took place at a time when financial services firms were faced with unprecedented economic uncertainty and as a result compliance budgets were under threat. Even though regulators worldwide were warning of the dangers of cost-cutting within control functions, in practice compliance practitioners were both expecting and experiencing significant budget constraints. The Thomson Reuters survey of 280 compliance professionals at the end of 2008 found that 56 percent of practitioners expected their budget would either be frozen or cut in 2009. **Many of the compliance failures and weaknesses in systems or procedures that are now being punished are a direct result of that cost cutting.** As has been seen in the U.S. and Europe in particular, many firms gave the impression they had sufficiently strong compliance frameworks and expert resources in place to manage their business operations effectively. The financial crisis, however, revealed major

weaknesses in policies, procedures and cultures of big financial institutions that caused significant losses to investors and taxpayers alike. To some extent, many major firms are still dealing with this fall-out.

Although budgets will always remain under review, firms are now much more committed to providing the financial resources for compliance and control activities. In the 2014 Thomson Reuters GRC Cost of Compliance Survey Report, nearly two-thirds of respondents thought that the total compliance team budget would increase in 2014 and a fifth (20 percent) thought that the budget would be significantly more in 2014. The new challenges that firms face are in the recruitment of skilled resources to manage and undertake their compliance activities, the sheer amount of management time that now needs to be devoted to risk and compliance and, more crucially, to change and embed behavior throughout the entire organization so that they focus on delivering the right consumer outcomes.

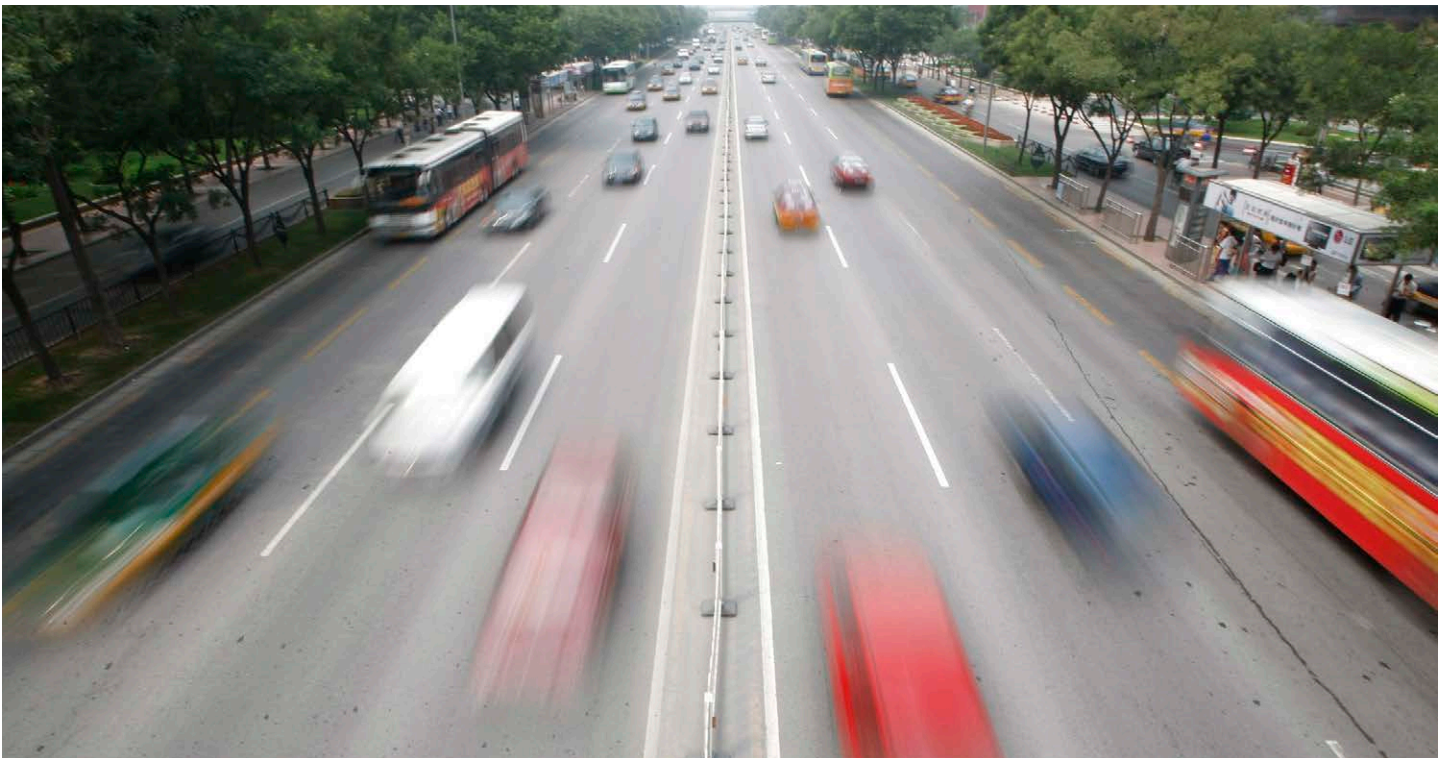
2014 THOMSON REUTERS GRC COST OF COMPLIANCE SURVEY REPORT



WHY REVIEW THE COSTS OF NON-COMPLIANCE AGAIN?

There is a gathering consensus that the fines imposed, despite being huge, are perceived as being nothing more than a cost of doing business and are not a deterrent for either the firm or the market place. Regulators appear to have lost faith in firms' ability to clean up their own act; they are under pressure themselves, and this has led them to seek more creative

measures to drive good behavior and to drive up the cost and consequences of non-compliance. Individuals are being targeted, business activities are being curtailed, share prices have been affected and compensation and remedial action programmes, which used to be imposed only occasionally, are now the norm.



There are numerous ways to carve up the consequences of non-compliance. To highlight the sheer breadth of the practical implications there are at least 16 distinct but often overlapping areas that are all part of the costs of non-compliance and which can be summarized as follows:

FINANCIAL:

- Monetary fines
- End of a business or business line
- Increased capital, liquidity or solvency requirements
- Impact on share price
- Competitive disadvantages
- Opportunity costs of non-compliance

PERSONAL:

- Increased personal liability
- Forced changes to senior management
- Need for more highly-priced risk and compliance skills
- Claw-backs invoked on bonuses

OPERATIONAL:

- Expensive and time-consuming remedial actions including redress
- Enforced changes to business
- Expensive and time-consuming use of third party or skilled persons
- Inability to recruit and retain high quality skilled resources

REGULATORY:

- Greater regulatory scrutiny
- More regulation, cost and complexity for all



MONETARY FINES

In the period since the 2008 review, the financial and regulatory landscape has changed beyond recognition, with the collapse of regulated firms and the taxpayer bailing out long-standing names in the marketplace.

Widespread and persistent negative media coverage has been responsible, at least in part, for driving up the levels of monetary fines. Firms needed to be seen to be punished and headlines covering ever-bigger fines were a predictable regulatory response.

Equally, the regulators themselves have been under immense political and public pressure to hold those responsible to account. The flaw that has emerged in the trend for super-size fines has been that not only did they quickly lose the power to shock, but also that they failed to drive the much-needed positive change in behavior. Furthermore, being fined no longer creates the level of reputational damage that it once did. Indeed, **we are now in an era where every global systemically important bank, as defined by the FSB, has been fined**, making it increasingly difficult for end customers, investors and other stakeholders to distinguish, and choose to do business with, firms with an unblemished record.

Despite the lack of overt change, regulators are unlikely to back away from big penalties, which increase for repeat offences. That said, firms need to be acutely aware that the headline fine is likely to be the tip of the iceberg in terms of the costs of non-compliance.

- Monetary fines are now routinely in billions rather than millions. The 2008 review showed that the total fines levied in 2008/9 by the UK Financial Services Authority totaled around £26 million, which included the then-largest retail conduct of business fine of £7 million. Just a few years later, this compares with a total of over £474 million levied in 2013, including a penalty in excess of £137 million for JPMorgan's serious failings relating to its Chief Investment Office's "London Whale" trades. There has been similar fine inflation around the world. The total fines levied by the U.S. Financial Industry Regulatory Authority in 2008 were estimated to be \$40 million, and these have grown by half in five years, with FINRA levying fines of more than \$60 million in 2013.

TOTAL FINES LEVIED BY UK FINANCIAL SERVICES AUTHORITY IN MILLIONS



TOTAL FINES LEVIED BY US FINANCIAL INDUSTRY REGULATORY AUTHORITY IN MILLIONS



- Regulators in the Asia-Pacific region have required firms to pay directly into investor education trusts following non-compliant actions; this amounts to de facto fines. For example, in 2013 and 2014, the Australian Securities and Investments Commission required National Australia Bank, UBS AG, BNP Paribas and Royal Bank of Scotland to pay A\$1 million each into an education fund for investors, following the rigging of the Australian Bank Bill Swap Rate.

"In recent weeks, however, I have started to become more concerned about one particular risk: that of 'fine inflation' in the banking industry. Clearly, banks have attracted many fines in the post-financial crisis world, as regulators and policy-makers have cracked down on past and ongoing wrongdoings in the industry. The size of the fines, however, appears to be increasing."

Neil Woodford, head of investment, Woodford Funds blog, September 2014

The numbers have reached huge proportions. Academic research by the London School of Economics found that in the last five years fines and damages paid and estimated for misconduct in 10 leading banks had amounted to £157 billion worldwide. In the UK alone the figure, on average, was nearly £6 billion per annum.



END OF A BUSINESS OR BUSINESS LINE

Withdrawing a firm's ability to undertake regulated business on either a temporary or permanent basis is becoming a regular feature of enforcement actions. This is over

and above the steady stream of firms

around the world which have their licenses withdrawn as they become insolvent, fail to pay their fees or are merged with another regulated entity.

- **PricewaterhouseCoopers:** In August 2014 it was announced that PricewaterhouseCoopers' Regulatory Advisory Services arm would be suspended from accepting consulting engagements at NYDFS-regulated financial institutions for 24 months. In addition, PwC had to pay a \$25 million fine and make a series of conflict of interest reforms after improperly altering a report submitted to regulators regarding sanctions and anti-money laundering compliance at Bank of Tokyo Mitsubishi, which itself was fined \$250 million for sanctions violations in June 2013. PwC is paying a high price for bowing to client pressure to water down its report. Although PwC is a consultant rather than a mainstream financial services provider, the regulator, the supervisory approach, the depth of detail published and the focus on the actions and statements made by key individuals are all the same.
- **HSBC:** HSBC signed a five-year deferred prosecution agreement and paid fines totalling \$1.9 billion in 2012 after admitting that it had processed drug trafficking proceeds through Mexico and transmitted funds from sanctioned countries. The deferred prosecution agreement has been described by Stuart Gulliver, the chief executive of HSBC, as a "sword of Damocles" hanging over the bank, putting it at risk of both a criminal conviction and the potential loss of its vital U.S. banking licenses if it is non-compliant in that period. U.S. regulators have placed around 100 staff inside HSBC, checking that the remedial actions are being implemented. As a result of the U.S. enforcement action HSBC has, since 2011, withdrawn from or disposed of 74 businesses considered to now be too risky.
- **Standard Chartered:** The sword of Damocles described by Gulliver has already fallen on Standard Chartered. In 2012 it paid a fine of \$340 million for money laundering failings and agreed a series of remedial actions. Part of the fallout was parallel enforcement action against Deloitte in June

2013 resulting from the inadequacy of its consulting work on Standard Chartered's money laundering issues. Deloitte was suspended for one year from all consulting work at NYDFS-regulated firms and paid a \$10 million fine. In August 2014 the NYDFS published details of further enforcement action against Standard Chartered for failing to sort out its money laundering issues. The cost of continuing non-compliance now includes:

- the suspension of dollar clearing through the New York branch for high-risk clients at its Hong Kong subsidiary;
- exiting high-risk client relationship with certain business lines at its branches in the United Arab Emirates;
- not accepting new dollar-clearing clients or accounts across its operations without prior approval from the NYDFS;
- paying a further \$300 million penalty;
- the appointment of "a competent and responsible" executive who will report directly to the CEO to oversee the remediation;
- extension of the regulatory monitors installed inside the bank for two additional years, and the implementation of a series of enhanced due diligence and know-your-customer requirements.

On a more operational level firms are making strategic decisions driven by regulatory change and scrutiny. In the UK, Barclays has chosen to wind down its debt-collecting company Mercers ahead of the UK Treasury Committee's probe, announced in July 2014, into banks that reportedly send letters to customers falsely appearing to be from independent solicitors. All debt collection will be carried out under the Barclaycard name in an effort to be more transparent to customers. On a more fundamental level the entire business model of Card Protection Plan in the UK has been affected. The firm mis-sold card protection and/or identity protection products directly or indirectly to around 7,000,000 people. The total redress bill could be up to £1.3 billion.

There can be more indirect ramifications from non-compliance on business activities. One case is Credit Suisse which in July 2014 reported its biggest quarterly loss since the height of the financial crisis, as the result of the \$1 billion fine imposed by the U.S. authorities for helping its clients evade tax. Specifically, Credit Suisse also announced that it was "abandoning its commodities trading business as part of the efforts to cut costs in the wake of the American fine".

"We should [...] think more creatively about corporate penalties in a way that will help move the needle when it comes to deterrence. As one alternative example, [...] we could ban a company from conducting the type of business that was at the heart of its misconduct for an extended period."

Remarks of Superintendent Benjamin M. Lawsky on Financial Regulatory Enforcement at the Exchequer Club, Washington DC, March 2014



INCREASED CAPITAL, LIQUIDITY OR SOLVENCY REQUIREMENTS

One of the first areas of focus once the white heat of the financial crisis had passed was for firms to repair and rebuild their balance sheets.

Even before the policymakers revamped Basel, regulators were already encouraging banks in particular to rebuild their balance sheets. While an instruction to a firm to hold more capital, liquidity or solvency is unlikely to be made public, regulators have been clear that they can and will use the powers or regulatory toolkit available to them to take early action to prevent a firm from failing. Measures range from enhanced supervisory protocols, increased capital and solvency risk-adjusters in pillar 2 of either Basel or (in Europe) Solvency II, to the higher international capital requirements for global systemically important financial institutions.

Non-compliance, particularly evidenced by a poor culture, is likely to set alarm bells ringing for prudential supervisors. In June 2014 the UK Prudential Regulation Authority published a statement of policy outlining how it intended to use its powers

to address serious failings in the culture of firms. From the PRA's perspective, **the culture of a firm has a significant impact on the regulator's objectives of promoting safety and soundness of firms and, for insurers, an appropriate degree of protection for policyholders.** Specifically, the culture of a firm includes its standards of behavior. In other words the PRA is drawing a direct line between non-compliance and the need to hold additional capital, liquidity or solvency.

The balance sheet implications of non-compliance are more transparent, and are visible through the provisions made by firms against either known prior breaches or likely future enforcement action. Again the numbers have reached epic proportions. For example, in August 2014 it was reported that JPMorgan Chase & Co needed to increase its possible legal costs in excess of litigation reserves at \$4.6 billion (£2.73 billion) at the end of June, up from \$4.5 billion at the end of March. In the UK it is now estimated that banks have made provisions totaling more than £22 billion for payment protection insurance mis-selling compensation claims.

"More often than not, excessive risk exposures, credit losses, liquidity problems and capital shortfalls stem from weaknesses in corporate governance (e.g., weak oversight by the board of directors, absence of an effective risk appetite framework), compensation policies (e.g., those focused on short-term earnings, without risk adjustments) and internal control systems."

Basel Committee on Banking Supervision, "Supervisory Guidelines for Identifying and Dealing with Weak Banks", June 2014



IMPACT ON SHARE PRICE

One of the many sets of stakeholders in financial services firms are shareholders, who are often financial services firms themselves, as asset managers and insurers with large portfolios. There is no simple correlation between share

prices and the announcement of enforcement action. What is apparent is share price volatility, particularly if there are rumors of a substantial fine ahead of the publication of the details. **Often the share price falls on the rumors and then bounces back (at least somewhat) once the detail has been made public.**

A case in point is the June 2014 action taken against BNP Paribas. Shares in the bank rose when it confirmed that it had sufficient funding to pay its \$8.9 billion fine but the share price was still substantially down, with a decline in market value of around 12 billion euros since the first \$1.1 billion provision was taken in February 2014.

Neil Woodford, a high-profile fund manager, announced in September 2014 that he had sold his £159 billion holding in HSBC as a direct result of concerns about the impact of future fines, despite praising the chief executive's great work over the past four years.

"The size of any potential fine is unquantifiable, so this represents an unquantifiable risk. Nevertheless, a substantial fine could hamper HSBC's ability to grow its dividend, in my view. I have therefore sold the fund's position in HSBC, reinvesting the proceeds into parts of the portfolio in which I have greater conviction."

Neil Woodford, head of investment, Woodford Funds blog, September 2014

There can also be market-wide implications if an area of business is perceived to be potentially non-compliant, or regulatory action is expected. Share prices in UK insurers fell heavily in the spring of 2014 following an unofficial announcement from the UK Financial Conduct Authority that there was to be an investigation into certain long-standing customers in life insurance. Shares recovered as the regulator published a "statement of clarification". The market reaction suggests it was widely believed that UK insurers were holding extensive back books of potentially non-compliant business which, if it became the target of regulatory attention, could be exceedingly expensive to remediate.



COMPETITIVE DISADVANTAGES

Firms embroiled in remediating non-compliance will have less time and management attention, and fewer resources, to devote to their current client base and to invest in their future. Although at least some of the

remediation for non-compliance is likely to go into rebuilding or strengthening the risk and compliance infrastructure, the focus will be on fixing the past rather than on the sustainability of the future. **When reputational damage is added into the**

mix then it becomes even more apparent that those firms that thrive in the medium and long term will be those that can demonstrate strong compliance.

Anecdotally, the implications are twofold. First, clients are seeking financial services firms which put their interests first, are not seen to mis-sell or otherwise condone risky behavior or products. The corollary to this is that skilled staff are beginning to move from heavily-fined firms and move to firms where the focus is on the client and not on fixing past non-compliance.



OPPORTUNITY COSTS OF NON-COMPLIANCE

The opportunity costs of dealing with the aftermath of non-compliance and resulting enforcement actions are much more subjective, and are harder to quantify financially, but no less significant. **The diversion of**

senior management time to speak with and respond to regulators, to agree and oversee the implementation of remedial plans and to review the progress of corrective actions take senior managers away from other growth and business performance activities upon which they might otherwise have focused. The distraction can extend further into middle management.

The impact on staff time extends much more widely across the organization. Widespread negative media activity needs to be actively managed. This encompasses everything from providing responses to media outlets, such as requiring senior managers to be interviewed publicly, through to internal communications to staff to restore staff morale. Similarly, disgruntled customers and members of the public, who have become much more aware of and interested in the failings in financial services firms as a result of the financial crisis, can cause significant disruption, particularly at annual general meetings and other public meetings.

“Banks in the UK have failed in many respects. They have failed taxpayers, who had to bail out a number of banks including some major institutions, with a cash outlay peaking at £133 billion, equivalent to more than £2,000 for every person in the UK. They have failed many retail customers, with widespread product mis-selling. They have failed their own shareholders, by delivering poor long-term returns and destroying shareholder value. They have failed in their basic function to finance economic growth, with businesses unable to obtain the loans that they need at an acceptable price.”

Report of the UK Parliamentary Commission on Banking Standards, “Changing Banking for Good”, June 2013



INCREASED PERSONAL LIABILITY

Regulators and policymakers have recognized the need to change the behavior of financial services firms, both to improve customer outcomes and to avoid a repeat of the financial crisis. The supervisory focus on

individuals, and particularly those in senior positions, has sharpened considerably, with regulators seeking to hold senior managers to account for any compliance breach. Indeed, **2013 was the first year in which the UK Financial Conduct Authority sanctioned more individuals than firms.**

The need for more clearly-defined roles, documented discharge of responsibilities and the formalization of the handover of accountabilities are all becoming features of the new world for senior managers. The FSB has gone so far as to set out the criteria to be included in a number of job descriptions, including the chief executive. Regulators are also now regularly using attestations as a formal supervisory tool. These are intended to drive positive compliance by gaining personal commitment from senior individuals that actions have been or will be taken, and to ensure there is clear accountability.

operations for one year. Critically the bank was also required to take action against senior executives and other employees. In total, including those dismissed, it was reported that BNP Paribas took action against 45 employees, with levels of discipline including dismissals, cuts in compensation and demotion. Other significant ramifications were a budget of \$268 million set aside to strengthen the bank's compliance program; a new supervisory and control committee overseen by chief executive officer Jean-Laurent Bonnafé and the retirement of Jean Clamon, BNP Paribas's top compliance officer since 2008.

- **Royal Bank of Scotland:** Also in the U.S., Royal Bank of Scotland was, in December 2013, required to pay \$100 million for violations of law in connection with transactions involving regimes and entities subject to international sanctions. Senior individuals who were found to have engaged in misconduct were also targeted as part of the enforcement action. Those who were dismissed included RBS's head of banking services for Asia, Middle East and Africa, and the head of its Money Laundering Prevention Unit for Corporate Markets.

"We need to separate the major mistakes from the small ones which will always happen. Under the proposed rules we will run the risk that people spend their time avoiding accountability as they fear being prejudged as guilty when they get something wrong. We want to make sure that bankers, like any other profession, operate to the highest standards but we have to be fair in how we judge them."

António Horta-Osório, chief executive officer, Lloyds Banking Group, talking about the proposed new Financial Conduct Authority senior managers' regime in an interview with Sky News, August 2014

"During the fiscal year, the agency also broadened our coverage of market participants, pursuing actions against a range of individuals and entities, including gatekeepers, like accountants and fund directors; exchanges and other trading platforms that lack required system controls; and municipal advisers, to name a few."

Mary Jo White, chair of the U.S. Securities and Exchange Commission, from Fiscal Year 2013 Agency Financial Report, Message from the Chair

It has now become routine for senior executives to be named, shamed and often dismissed as part of a big enforcement case, the upshot being that even if they are not facing personal enforcement action their career and future prospects have been damaged.

- **BNP Paribas:** In June 2014 the New York State Department of Financial Services was one of a number of regulators which took enforcement action against BNP Paribas. The violations included schemes designed to evade U.S. sanctions requirements which, with the knowledge of multiple senior executives, concealed more than \$190 billion in transactions for clients in jurisdictions such as Sudan, Iran and Cuba. BNP Paribas was fined a total of \$8.9 billion (\$2.24 billion of which was payable to the New York State Department of Financial Services) and forced to suspend U.S. dollar clearing

- **Monte dei Paschi di Siena:** The Bank of Italy opted to fine more than a dozen directors of Monte dei Paschi di Siena in the summer of 2013 for breaches of the remuneration practices requirements. Under the administrative sanction, the bank held the board jointly and severally liable for the breaches and fined its members on an individual basis.

The stakes for individuals in Asia are potentially even higher, with jail sentences a regular feature of market abuse cases and even the occasional capital punishment handed down for the worst corruption cases. In Hong Kong, the Securities and Futures Commission routinely focuses on the actions of individuals and highlights successful prosecutions of individuals, disciplinary action against licensees and fines levied. The HK SFC also uses the full range of its powers to ensure the costs of non-compliance are clear to the marketplace, which even extend to those no longer actively engaged in financial services. For instance, in August 2014 it

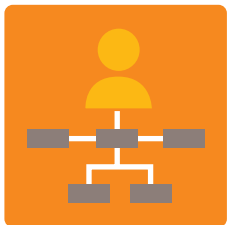
banned Roger Tsui Chi Fung, a former licensed representative, from re-entering the industry for nine months after he failed to disclose the disciplinary action taken against him by FINRA.

In Australia, a Senate Inquiry reviewed the performance of the Australian Securities and Investments Commission, one result of which was enforcement action being taken against the financial planning arm of the Commonwealth Bank of Australia. ASIC suspended CBA's license and forced it to review the files of thousands of elderly investors who may have suffered loss and damage as a result of the bank's negligence and failures in basic compliance procedures. Separately, the Senate Inquiry recommended that ASIC be given enhanced regulatory powers in the imposition of penalties.

The focus on greater accountability and personal liability has not been an easy path for regulators to take. While firms all too often see enforcement action as simply another cost of doing

business, when an individual is targeted for action it is only natural that they seek to defend themselves from what could be a career-ending penalty.

- **Hannam:** In July 2014, a long-running disputed enforcement action between the FCA and former JPMorgan banker Ian Hannam was resolved and a £450,000 fine for market abuse was upheld. This was one of the largest fines levied against an individual in the UK, despite the judgment making it clear that Hannam's integrity had not been questioned. Hannam fought for two years to overturn the findings and fine but lost his appeal, which focused on how confidential information should be treated during deals. The case hinged on emails Hannam sent on behalf of a client. No one traded on the information but the FCA accused Hannam of having a "relaxed and improper" and "casual" attitude to disclosure beyond that allowed and necessary to do his job.



FORCED CHANGES TO SENIOR MANAGEMENT

Closely linked to the increased personal liability for senior managers are the forcible changes imposed following non-compliance.

Instances of senior dismissals, demotions and pay cuts have already

been highlighted, with further examples including Deutsche Bank and Brown Brothers Harriman.

Deutsche Bank: In August 2014 Deutsche Bank named Nadine Faruque (previously at UniCredit) as the new global head of compliance and a member of the bank's executive committee. The previous incumbent, Andrew Procter, left the role as a result of pressure from the German regulator BaFin to make changes in senior personnel following a series of enforcement

actions and investigations around the world. Deutsche Bank has paid 5.6 billion euros (\$7.5 billion) in the past two years in fines and settlements and expects to pay another 3 billion euros in 2014.

Brown Brothers Harriman: It is not just the nuclear option of requiring the dismissal of employees which has been used by regulators. In February 2014, Brown Brothers Harriman paid an \$8 million civil fine for "substantial" violations involving its program to detect and prevent money laundering. The fine was the highest levied by FINRA for violations of the securities industry's anti-money laundering compliance rules. FINRA also levied a \$25,000 fine against the firm's former anti-money laundering compliance officer and suspended him for 30 days.



NEED FOR MORE HIGHLY-PRICED RISK AND COMPLIANCE SKILLS

Risk and compliance skills have never been in greater demand. Firms need to remediate prior poor behavior, respond to regulatory change,

manage new regulatory relationships as well as continue with day-to-day monitoring and reporting of compliance and risk issues. Equally, regulators themselves have needed to up-skill in the face of criticism for their role in the financial crisis.

The Thomson Reuters Cost of Compliance Survey Report 2014 found that two-thirds of respondents expected the cost of senior compliance to increase in 2014 with more than a fifth (21 percent) expecting costs to rise significantly.

In parallel, nearly two-thirds thought that the total compliance team budget would increase in 2014 and a fifth (20 percent) thought that the budget would be significantly more in 2014.

Firms are committed to investing substantially in risk and compliance. For example, HSBC stated in August 2014 that it was spending between \$750 million and \$800 million a year on its compliance and risk program, an increase of between \$150 million and \$200 million from last year, and a further rise is expected next year. As a result, HSBC now has 24,300 staff specializing in risk and compliance, representing almost 10 percent of its entire workforce.



CLAW-BACKS INVOKED ON BONUSES

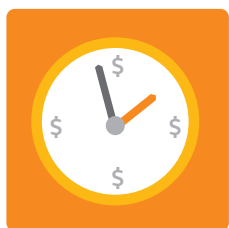
The first area tackled by the Financial Stability Board post-crisis was compensation for individuals, which was seen to be grossly out of line with the risks, and subsequent losses, being taken by firms. The initial policy

measures were designed to ensure that individuals were not being rewarded for taking excessive or undue risks. Later iterations have focused on the need to be able to “claw back” bonuses where it is subsequently found that inappropriate risks were taken, products mis-sold or losses made.

Policy is beginning to move into the rulebook. The UK Prudential Regulation Authority’s new requirements for claw-back require variable remuneration, both deferred and undeferred, to be subject to claw-back for a period of at least

seven years from the date of award. This rule, which will apply to awards made from January 1, 2015, applies to all material risk takers at PRA-regulated firms. The regulators have further proposed that firms should provide an option for the claw-back period for senior managers to be extended by up to a further three years at the end of the normal seven year claw-back period (i.e., to 10 years) in certain circumstances.

The cost of non-compliance to the individual is the potential claw-back of bonuses. The cost to the firm of the same non-compliance is the need to build and resource the policies, procedures and reporting mechanisms required to implement the new requirements and, critically, to provide evidence to all relevant regulators that the appropriate remedial, compliant, action has been taken.



EXPENSIVE AND TIME-CONSUMING REMEDIAL ACTIONS INCLUDING REDRESS

Additional skilled staff, past business reviews, wholesale policy and procedural reform, and widespread compensation schemes are just some

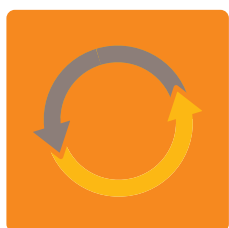
of the remedial actions imposed on firms over and above the monetary fine. **There is an old rule of thumb that fixing the underlying problems costs 10 times the size of the fine imposed. This may no longer hold as true in the current era of super-size fines but it is unlikely to be too far off.**

Many examples of remedial actions have already been highlighted. Not linked to a single enforcement action, in late 2013 it was reported that JPMorgan intended to spend an additional \$4 billion and commit 5,000 extra employees to clean up its risk and compliance problems. As part of a company-wide effort, it was estimated that the bank was to spend an additional \$1.5 billion on managing risk and complying with regulations, including a 30 percent increase in risk-control staffing.

Frequently, the costs of contacting customers and paying redress and compensation significantly outweigh any financial penalties levied. In the UK widespread mis-selling of payment

protection insurance has led to £16 billion in redress being paid out so far to customers, with the total bill likely to be in the region of £22 billion. In parallel to this are the significant operations that firms have needed to implement to review past business and identify and contact customers. In similar but different circumstances, in Hong Kong the SFC has secured redress for more than 30,000 investors who lost money in the complex Lehman mini-bond product. More than 20 banks and brokers have paid in excess of HK\$6.5 billion in compensation to settle the mis-selling allegations.

In Australia, CBA and Macquarie have been required to devote significant resources to reviewing negligent advice allegations by investors. More widely, banks in Australia are under fire for illegally overcharging on fees in circumstances where senior executives may have been aware that they were acting contrary to the law. In December 2013, proceedings commenced against the ANZ Bank on behalf of 43,500 customers claiming A\$57 million for excessive credit card "service fees." The case was successful, although as of September 2014 it was subject to appeal. Its success has led to a class action suit being launched against all the major Australian banks.



ENFORCED CHANGES TO BUSINESS

Regulators are also attempting to influence appropriate behavior by imposing a variety of enforced changes to businesses, ranging from product bans to limitations on specific business activities to suspension of licenses.

The underlying theme is that all such **enforced changes are intended to protect customers and the marketplace and to set clear lessons for other firms to learn.**

- **United Investment Bank:** The Dubai Financial Services Authority agreed an enforceable undertaking with United Investment Bank Ltd. UIB paid a fine of AED183,500 (\$50,000) and has agreed to cease providing custody services until it has implemented remedial actions to address the lack of required systems and controls.
- **Single premium payment protection insurance:** In the UK single premium payment protection insurance was banned following widespread customer detriment. The ramifications have been profound. Regular premium payment protection insurance has triggered market-wide past business reviews and billions of pounds in compensation payments and the product, though not itself banned, has now fallen into disuse. Systemic non-compliance led to regulatory action, which has forced businesses to rewrite their business plans as an entire line of activity was no longer possible. The experience

with payment protection insurance in the UK was one of the regulators' main drivers for seeking early product intervention powers and the ability to pull a product from the market before customer detriment became systemic.

"In practice, this means that the FCA will be able to, without consultation, intervene quickly and ban products for up to a year to prevent or minimize harm to consumers in a transparent way before it becomes widespread. It also means we'll be able to ban financial advertising and promotions immediately and publish details so that the industry is clear about what we expect."

Speech by Linda Woodall, director of mortgages and consumer lending, UK Financial Conduct Authority, September 2013

A similar but different use of the ability to enforce business change involved the use of a recruitment ban.

Financial Group: In July 2014, the UK Financial Conduct Authority banned two of the Financial Group's subsidiaries from recruiting new appointed representatives and individual advisers for four and a half months following inadequate supervision, in an attempt to minimize the risk of mis-selling.



EXPENSIVE AND TIME-CONSUMING USE OF THIRD-PARTY OR SKILLED PERSONS

Regulators have long used skilled persons reports, or reports by independent third-party experts (often known as “s166” reports in the UK) to investigate potential breaches or non-compliance in a firm. The remit is usually agreed between the firm and the regulator, the firm pays for the work undertaken and the report is delivered to the regulator. As the PwC enforcement case has shown, this does not always go well for either the firm or the skilled person.

In the UK the Financial Conduct Authority has reported the median cost of a s166 report to be £160,000 for 2013/14.

This is the amount paid to the skilled independent person, and masks the overall costs to the firm in terms of management time, distraction and resources, not to mention the focus

needed from the risk, compliance and internal audit functions throughout the process.

Interest-rate hedging: The interest-rate hedging enforcement and remedial action taken by the UK Financial Conduct Authority takes the use of skilled persons to a significantly heightened level. The voluntary agreements establishing the interest rate hedging product scheme are supported by s166 independent reviewers. In addition to the estimated £1.2 billion of redress payable to customers, the banks have set aside money to cover the costs of having to get out of these products (the payments customers would have made in the future), the costs of employing more than 3,000 people to carry out the exercise, as well as the costs of engaging independent reviewers to look at every case. The level of administration involved, all again paid for by the banks concerned, is significant.



INABILITY TO RECRUIT AND RETAIN HIGH-QUALITY SKILLED RESOURCES

The financial crisis and its continuing ramifications have deterred some of the best new talent from a possible career in financial services. Firms have noticed and are taking action, with reports in August 2014 suggesting that Bank of America planned to boost salaries by at least 20 percent next year for junior staff in trading and investment banking worldwide, and Goldman Sachs likely to follow suit.

Anecdotally, firms are finding senior compliance and risk positions harder to fill as the perceived liability attached to senior roles has increased and individuals seek compensation packages to reward not only the scarce skill sets but also the greater accountability.

With skilled compliance officers able to pick and choose which firm they join it is even more critical for firms to devote adequate budgets and resources to the compliance function. Specifically, budgets will need to reflect the substantial cost of hiring experienced, skilled personnel who can help firms to understand and implement increasingly technical regulatory developments and who can also deal with a less prescriptive, judgment-based style of supervision and a marked increase in personal liability. Any firm which has limited or inadequate compliance resources is unlikely to thrive in the highly-regulated world of financial services and may well end up facing enforcement action for having made insufficient investment in its compliance arrangements..

REGULATORY



GREATER REGULATORY SCRUTINY

The higher level of scrutiny which tends to follow examples of non-compliance can take many forms, from U.S. regulators embedding “monitors” in a firm to the UK invoking proposed “enhanced supervision”

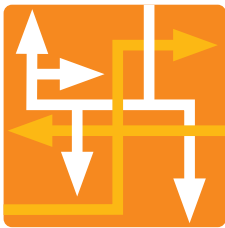
measures. Where there has been widespread non-compliance the scrutiny will be applied market-wide and will often involve a review of the entire sector.

Firms have also told Thomson Reuters that they now have significantly more contact with regulators, notably multiple and often overlapping requests for information and more frequent visits and reviews, which all create more work and distraction for compliance teams and senior management.

This level of scrutiny looks set to grow still further. In the summer of 2014 the UK Competition and Markets Authority

(CMA) consulted on its provisional decision that there should be a joined-up, in-depth investigation into the markets for personal current accounts and SME banking. Any market investigation carried out by the CMA will be expensive for firms. They will need to gather evidence, lobby and assess the likely impact and may also potentially need to rewrite business plans, build or rebuild infrastructure and perhaps even be forced to sell businesses or branch networks, as has happened with other competition-related remedies.

There has been a similar increase in regulatory scrutiny across the Asia-Pacific region with regulators looking in particular at benchmark-rigging, overcharging of fees, credit advice to investors and capital requirements. The focus in China is on anti-corruption in financial services firms, with the government undertaking a wide-ranging review which has already led to a number of senior executives being imprisoned.



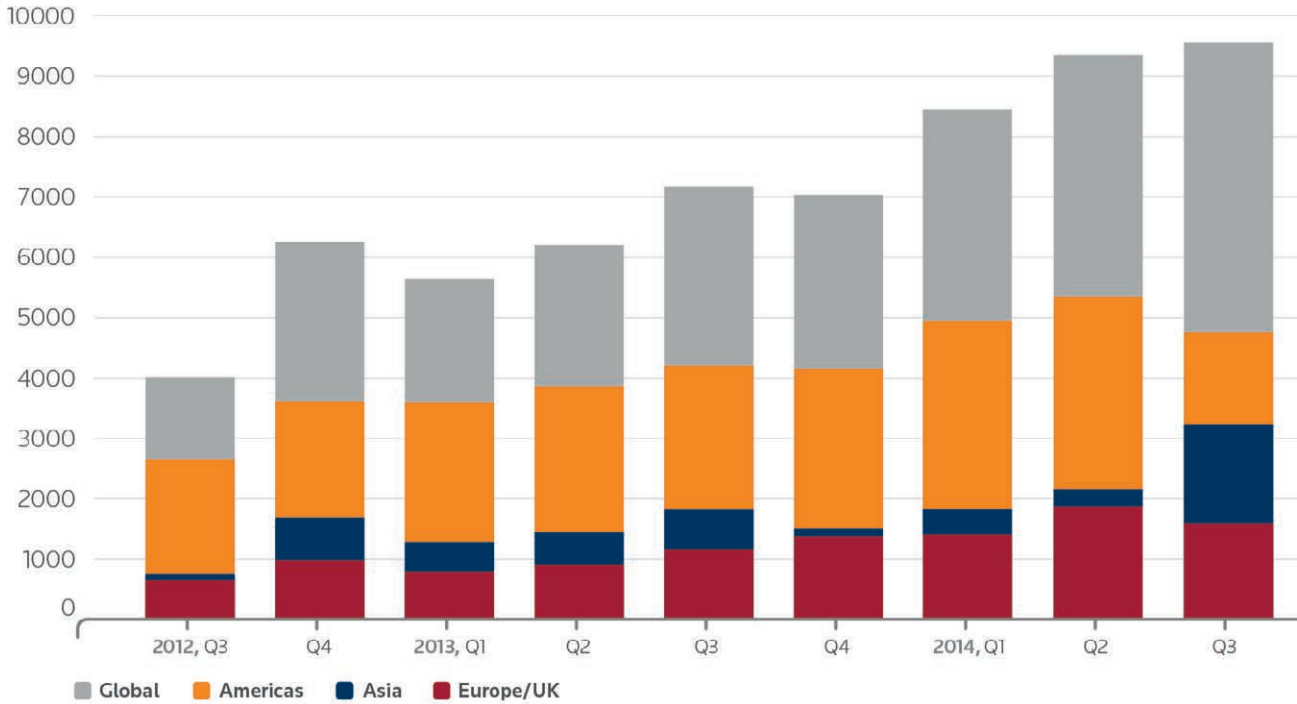
MORE REGULATION, COST AND COMPLEXITY FOR ALL

The remediation of non-compliance and the policy measures being developed and deployed to minimize the chance of another financial crisis have proliferated. The sheer volume of regulatory change is huge.

“The events which have shaped the evolution of financial regulation include crises, scandals, innovation and liberalization. Each has elicited a response, typically the addition of a new regulatory layer. The cumulative consequence has been a regulatory tide which has tended to flow in only one direction towards a lengthier, more complex rulebook.”

Andrew Haldane, executive director, financial stability and member of the Financial Policy Committee, Bank of England, at the International Financial Law Review Dinner, April 2013

Total Regulatory Alerts Year-On-Year



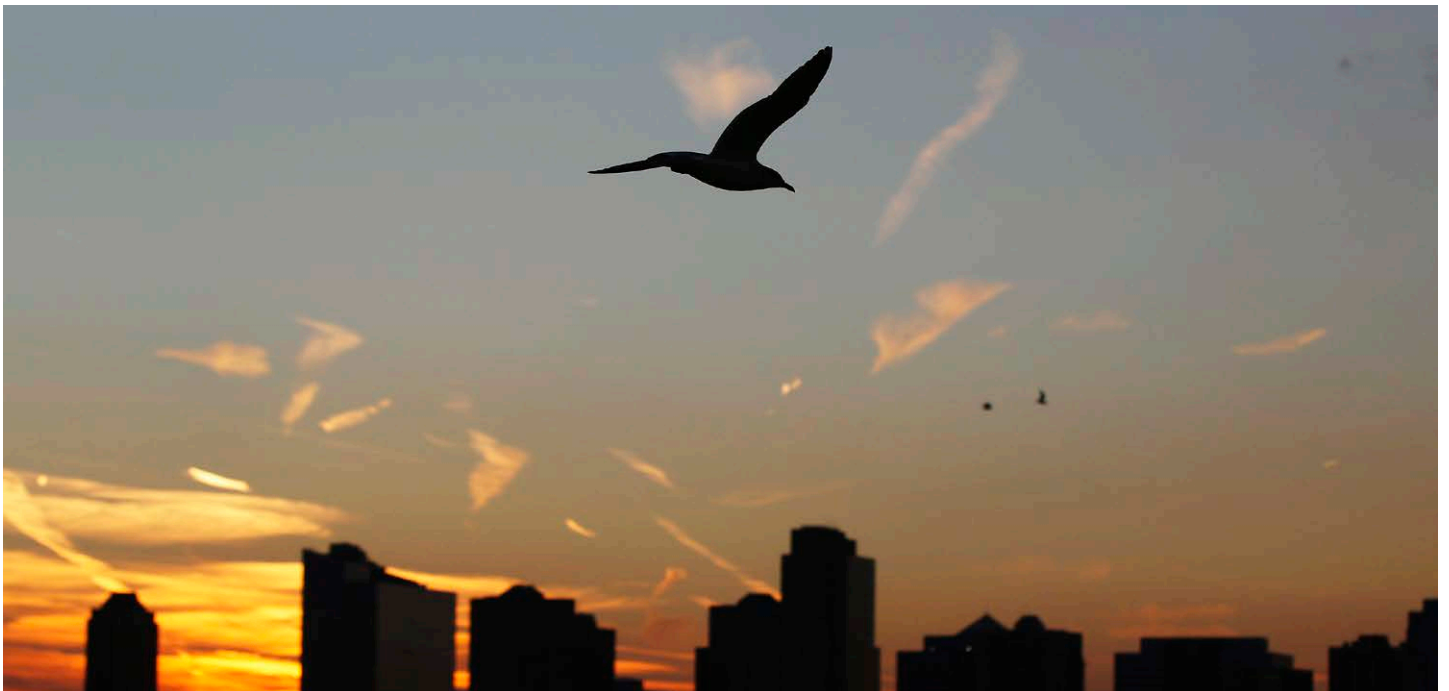
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**NOTE: Tracked activity includes document changes, announcements and enforcements by regulators. Q3 Average Daily Alerts = Total alerts to September 30, 2014 / 261 working days*

Firms have to contend not only with jurisdiction-specific changes but also with multiple levels of changes which are not necessarily aligned when it comes to cross-border business. Regulatory divergence, particularly regarding areas such as the trans-Atlantic trading and settlement of derivatives, has become the norm and will require significant political and regulatory effort to resolve.

The proliferation of claims management firms has again added to the complexity and costs. There has been an exponential

growth in companies which have been set up to profit from UK customers' redress claims, when those customers could otherwise have gone direct to the regulatory bodies without paying any third-party fees or commission. The widespread advertising that claims management companies have undertaken to encourage members of the public to make a claim has led to a massive increase in complaints across the industry. A proportion of these will prove to be invalid claims, but firms and regulators are still faced with the significant operational costs of dealing with them.



CLOSING THOUGHTS

Regulation has changed almost out of all recognition since the financial crisis. Non-compliance is treated with ever-increasing fines backed up with other remedial actions and sanctions imposed on firms and individuals. Regulators have lost patience with the simple rulebook-based approach which firms have abused, and have, under the leadership of the FSB, begun to overlay their supervisory approach with expectations for culture and conduct risk. This is a double whammy. Not only is there a deliberate lack of precise detailed rules and prescriptive requirements from regulators for conduct risk but the penalties, from the end of a career to the end of a firm, for getting it

wrong have never been higher. Regulators have shed their reticence about taking against individuals for non-compliance which highlights the dangers faced by individuals in significant positions.

The board and senior individuals need to be front and centre in setting and leading a compliant tone from the top. The Thomson Reuters 2014 Cost of Compliance Survey Report showed that the greatest challenges seen to be facing boards encompass many of the issues highlighted. Boards need to move from understanding the issues to implementing and embedding effective compliance solutions.

GREATEST COMPLIANCE CHALLENGES FACED BY BOARDS IN 2104 FROM THOMSON REUTERS COST OF COMPLIANCE SURVEY REPORT 2014



Some of the headline breaches which regulators are acting against today send the clearest warning against the dangers of cost-cutting and a failure to take compliance seriously. A high profile case in point is that of HSBC in the United States. In July 2012, the Senate Permanent Sub-Committee on Investigations published a report into U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing using HSBC Group plc as a case history. The report was a precursor to several fines for anti-money laundering failings and provided an unparalleled detail into the operations and associated compliance, risk and AML issues arising in a global financial services firm.

The report appears to have been a major influence for sweeping changes and substantial investment in risk and compliance in HSBC as the firm responded to the impression of a business where compliance was known to be poorly resourced and the business routinely over-ruled risk-based decisions. There would appear to have been more focus on keeping clients happy rather than promoting a compliant culture uniformly throughout the firm. By all accounts this approach has changed radically. HSBC, along with many other firms, continues to pay the wide-ranging costs of non-compliance but appears to have invested heavily in systems and people to both remedy the past and build for the future.

Governments and regulators expect high compliance standards and require senior managers to act with integrity and in the interests of customers. Any lapses in these standards will result in additional regulatory scrutiny, enforcement action

and litigation. Compliance and compliant behavior must be embedded and evidenced as embedded throughout firms. For many businesses significant investment is likely to be needed to build and rebuild the infrastructure required and reinforce the new mindset needed to not only avoid non-compliance but to be able to meet enhanced regulatory expectations. Those that invest should benefit from the competitive advantage of being able to focus on their core businesses and benefit from the regulatory dividend of less scrutiny.

“In conclusion, if those of you here today as stewards of these large financial institutions do not do your part in pushing forcefully for change across the industry, then bad behavior will undoubtedly persist. If that were to occur, the inevitable conclusion will be reached that your firms are too big and complex to manage effectively. In that case, financial stability concerns would dictate that your firms need to be dramatically downsized and simplified so they can be managed effectively. It is up to you to address this cultural and ethical challenge. The consequences of inaction seem obvious to me—they are both fully appropriate and unattractive—compared to the alternative of improving the culture at the large financial firms and the behavior that stems from it. So let’s get on with it.”

William Dudley, president and chief executive officer, Federal Reserve Bank of New York, October 2014 in a speech entitled “Enhancing Financial Stability by Improving Culture in the Financial Services Industry”

ABOUT THE AUTHORS

STACEY ENGLISH

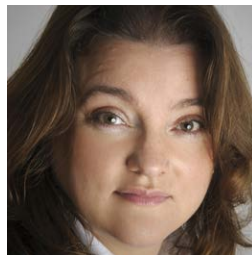


Stacey English is Head of Regulatory Intelligence. She joined from Barclays Bank where she was head of governance, reporting and intelligence. Stacey has over 17 years' compliance, risk and audit experience within UK financial services, is a qualified accountant, having gained

the highest results worldwide; and has first class degrees in BSc (Hons) Applied Accounting and BA (Hons) Business Administration plus the Financial Planning Certificate.

Stacey began her regulatory career with the UK regulator, undertaking supervisory inspections, mis-selling investigations and drafting new rules for the industry. She spent two years as an internal auditor reviewing the regulator's own controls and conduct. Stacey moved into the insurance industry where she was responsible for designing and embedding risk management frameworks and risk and board reporting as a senior manager for Aviva and latterly with Lloyd's of London. She has also provided risk consultancy services to Lloyd's syndicates.

SUSANNAH HAMMOND



Susannah Hammond joined the regulatory intelligence team from GE Capital Bank where she was head of compliance. Susannah has over 20 years' wide-ranging experience in international and UK financial services.

A qualified chartered accountant, Susannah began her compliance career at SG Warburg where she became head of European compliance. She was the global head of compliance and a founding employee of Caspian Securities, a start-up international full service investment bank focused on the emerging markets. Susannah left Caspian to join PricewaterhouseCoopers as a consultant. Susannah was head of international regulatory risk for the Halifax Group and became head of retail regulatory risk for HBOS plc upon Halifax's merger with Bank of Scotland.



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