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CONDUCT RISK REPORT 2014/15

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EXECUTIVE SUMMARY

Thomson Reuters' second annual survey on how financial services firms are managing conduct risk has identified distinct industry-wide trends against which firms can benchmark their own progress. The main points were:

- Conduct risk continues to be a priority for regulators; however the survey found that 81 percent of firms remain unclear about what it is and how to deal with it. Hence it will still be a major challenge for firms in 2015 with significant resource dedicated to it.
- 2014 has seen the development of the regulatory approach to conduct risk. Some jurisdictions are more advanced than others when it comes to tackling conduct risk but 2014 has seen indications of the "twin peaks" of prudential and conduct regulation coordinating to reinforce the potential implications of getting conduct risk wrong. The survey showed that firms were reacting to this enhanced focus by creating specific teams or by employing conduct risk specialists at all levels of an organization.
- One of these perceptions was the risk of increased personal liability for those at the "top" of the organization. Sixty-seven percent of respondents said that the regulatory focus on conduct risk would increase the personal liability of senior managers.
- Global systemically important financial institutions (G-SIFIs) appeared to have done more, with only 6 percent reporting that no conduct risk-related changes had happened in the last 12 months.
- There was evidence that boards were setting the "tone from the top" of an organization but there was also evidence that the pressure was now on middle management to adopt and turn these cultural messages into workable operating arrangements with appropriate systems and controls, while maintaining board engagement. The need for effective corporate governance arrangements including clear reporting, adequate management information and improved training arrangements were examples of this.

"The years since the crisis have extensively been dedicated by international standard-setters and domestic authorities to both enhancing and reorienting financial sector regulations to ensure the sector's resilience in the face of present and future problems. However, even while standard-setters and regulators have remained engaged in plugging the regulatory loopholes, several instances of misconduct on the part of banks continue to come to light, which keep reminding us of the need to refocus on the issue of 'compliance' in banks."

Shri S S Mundra, deputy governor of the Reserve Bank of India, at the CAFRAL Conference of Chief Compliance Officers, August 2014

CONDUCT RISK – EXAMPLES OF DEVELOPMENTS

JANUARY

EBA – Implementation of Capital Requirements Regulation and Directive IV

ASIC – Benchmark - BNP Paribas asked for assurance regarding Australian interest rate benchmarks.

ASIC – Financial promotions - Media Super pays infringement notice in relation to superannuation advertising

HKSFC – Markets - Fines Sun Hung Kai International Ltd $12 million and suspends its license for IPO sponsor failures

FEBRUARY

FINRA – Markets - Rule Prohibiting Conditioning Settlements of Customer Disputes on a Customer's Agreement Not to Oppose Expungement.

FINRA – Markets - Fines Brown Brothers Harriman a record $8 Million for substantial anti-money laundering compliance failures.

Banking Standards Review Council created.

ASIC – Markets - ASIC accepted an enforceable undertaking from online foreign exchange broker Forex Financial Services Pty Ltd (Forex FS) for offering an account known as an individually managed account (IMA) which was a managed discretionary account (MDA).

MARCH

FINRA – Markets - FINRA and BATS Order Citigroup Global Markets Inc. to pay $1.1 million for illegal short selling in advance of five public offerings and for related supervisory violations.

APRIL

FCA – Consumer credit - New rules on consumer credit.

FCA – Consumer credit - New rules on mortgage business (Mortgage Market Review).

HKSFC – Markets - Reprimands and fines the Royal Bank of Scotland Plc $6 million for internal control failings.

MAY

ESMA – Markets - Review of MiFID Conduct of Business rules.

FCA – Benchmarking – Barclays fined £26 million for London Gold fixing.

Credit Suisse fined $2.6 billion for tax offenses.

FINRA – Markets – New rules on self-trading.

FINRA – Markets - FINRA fines Morgan Stanley Smith Barney LLC $5 million for supervisory failures related to sales of shares in 83 initial public offerings to retail customers.

HKSFC – Markets - Reprimands and fines Deutsche Bank Aktiengesellschaft $1.6 million for regulatory breaches.

INTRODUCTION

Managing and mitigating conduct risk continues to be one of the highest regulatory priorities, with regulators' attention and resources firmly centred on the behavior of firms and how they conduct their business. It is the responsibility of financial services firms themselves to define what conduct risk means in the context of their own business, and to determine how to manage, mitigate and report appropriately on it. In the continued absence of a universally-agreed definition of conduct risk, and in response to evolving regulatory expectations, compliance officers, risk managers and senior management of financial services firms are having to focus much of their resources on establishing what it means for their organization and to put in place systems and controls to manage the risks they have identified.

In 2013, Thomson Reuters undertook its first industry-wide survey into conduct risk to understand how financial services firms worldwide were implementing and managing this relatively new regulatory concept. This report seeks to understand in more depth the practical actions that firms have taken and to determine what changes and progress firms have made during the 12 months since the previous survey.

More than 200 compliance and risk practitioners from financial services firms were surveyed between September and October 2014. Responses were received from across Africa, the Americas, Asia, Australasia, Europe and the Middle East. They represented banks, brokers, insurers and asset managers. Firms were not only geographically widely spread but also represented a wide range of sizes, from the small to global conglomerates, and included the majority of global systemically important financial institutions (G-SIFIs).

The results from the survey will enable firms to benchmark their views, preparations and expectations against those of their peers. Where feasible, a year-on-year comparison provides insight into the direction and progress of managing conduct risk in the financial services industry. As well as providing deep insight into current industry thinking and practices, this report also seeks to demystify the uncertainty surrounding conduct risk and provide insight into developing regulatory expectations.

The results continue to reflect the uncertain approach to managing conduct risk. It is clear, however, that there has been a convergence and sharpening of focus in terms of the main elements that consistently underpin conduct risk across all types of firms and regions. Critically, and in line with the heightened regulatory focus, there has been a marked increase in board and senior manager-level interest and involvement in conduct risk management. Despite the ever-increasing volume of regulatory change and other competing demands which firms continue to face, the fact that conduct risk is now receiving this heightened level of scrutiny from the most senior managers emphasizes that conduct has become one of the highest priorities for financial services firms.

JUNE

ASIC – Markets - Trader banned for five years for not disclosing conflict of interest to UBS.

BNP Paribas fined $8.9 billion for violating sanction rules.

FINRA – Consumer credit - Fines Merrill Lynch $8 million; more than $89 million repaid to retirement accounts and charities overcharged for mutual funds.

JULY

FINRA – Markets - Goldman Sachs fined $800,000 for carrying out 400,000 trades at inferior prices.

EBA – Senior management - New rules on remuneration.

PRA/FCA – Senior management - New regulatory framework for Individuals.

FCA – Consumer credit – Price cap on high cost of credit.

ASIC – Consumer credit - New regulation of financial advisers providing tax advice.

AUGUST

FCA – Consumer credit - Mortgage advice – RBS and NatWest fined £14 million.

ASIC – Markets - Credit Suisse AG paid a penalty of $88,400 to comply with an infringement notice given to it by the Markets Disciplinary Panel. The penalty was for offering and allocating an error trade to a client in circumstances where that trade had not been obtained under instructions previously obtained from that client; acting in a manner which had a detrimental effect on that client's best interests; and failing to maintain a separate record of that error trade.

SEPTEMBER

FCA – Markets - Client money – Barclays fined £38 million.

FCA – Consumer credit - Implementing rules from Mortgage Credit Directive.

DFSA – Senior management – Released the results of its thematic review of corporate governance.

OCTOBER

ESMA – Markets - Consultation on amendments to Market Abuse Directive.

ASIC – Consumer credit - Following ASIC's intervention, Cash Loan Money Centres and Sunshine Loans agreed to stop offering "leaseback" arrangements to consumers who want a payday loan.

REGULATORY DEVELOPMENTS OVER THE PAST 12 MONTHS

"There are still many challenges ahead. The global financial crisis may be receding but industry-wide culture change does not happen overnight. If the first year has seen the concept of good conduct go to the top of the agenda in boardrooms across the City, in our second year we must push for this culture change to feed through from trading floors to high street bank branches ."

Martin Wheatley, chief executive, UK Financial Conduct Authority, in the FCA Business Plan 2014/15

All over the world regulators have underlined the importance of conduct with a wealth of rules, guidance, reviews and enforcements. In the UK the Financial Conduct Authority has powers to make interventions in the market place to ensure the interests of consumers are put first. From interest-only mortgages, general insurance add-ons and introductory interest rates on savings accounts, the FCA has been active in meeting its objectives of protecting consumers, enhancing market integrity and building competitive markets. The Australian Securities and Investments Commission (ASIC) has identified conduct as one of the main risks for the Australian financial services industry and has developed strategies to address these issues in its Strategic Outlook 2014-15.

In the U.S., all regulatory bodies, and in particular the Consumer Financial Protection Bureau (CFPB), the Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC) and the Federal Reserve, have all demonstrated a commitment to improving conduct within the industry.

In New Zealand the mandate of the Financial Markets Authority (FMA) is changing with effect from December 1, 2014. The Financial Markets Conduct Act 2013 has placed the good conduct of professionals and firms at the heart of the FMA's remit.

In 2014 the "twin peaks" of prudential and conduct regulation became more closely linked. For example, the EU issued final rules on remuneration requirements for capital adequacy in CRD IV. In the UK, the Prudential Regulation Authority issued a Statement of Policy on the use of its powers to address serious failings in the culture of firms. In the U.S., the Federal Reserve is expected soon to set out specific requirements for pay structures and internal risk management, as part of a drive to change the cultural mindset within banks. Undoubtedly, in coming years the twin peaks of regulation will become more interdependent and united.

To supplement the high-level strategic messages, regulators have also been keen to demonstrate a progressive approach to conduct risk in 2014. This has been seen through the issuing of rules, guidance, reports or enforcement actions. The timeline on the previous page gives some examples of issues and actions that regulators have dealt with during 2014. In general, these have been divided into five categories:

- Benchmarking
- Financial promotions
- Corporate governance
- Markets
- Consumer credit

BENCHMARKING

The regulators have continued their push to clean up the Libor, interest rate and Gold rate benchmark issues that were found after the financial crisis. In the UK Barclays was fined £26 million for fixing the Gold standard and Lloyds Bank was fined £105 million for Libor fixing. In Australia, BNP Paribas gave ASIC assurances about its management of the Australian interest rate and RBS was required to undertake remedial action with respect to the interest rate benchmark.

FINANCIAL PROMOTIONS

In the UK, the FCA has placed greater emphasis on firms to be clear, fair and not misleading when issuing financial promotions. The FCA has issued guidance/consultations on financial promotions in the consumer credit market and also for promotions which use social media. In addition it has fined Credit Suisse £2.3 million and Yorkshire Building Society £1.4 million for breaches of the financial promotions rules.

In Australia, Media Super paid an infringement notice in relation to superannuation advertising.

CORPORATE GOVERNANCE

In the UK, following the Parliamentary Commission on Banking Standards, Sir Richard Lambert, former head of the CBI, was asked to develop plans for a professional body to promote high standards in banking. A consultation paper was published in February 2014 outlining initial thoughts and generated support for its recommendations.

The Prudential Regulation Authority and the FCA have also jointly issued proposals for implementing the recommendations from the Parliamentary Commission on Banking Standards in new arrangements for making senior management accountable.

In Europe, the Capital Requirements Directive IV was implemented in January 2014. This included detailed requirements on remuneration structures.

In the Middle East, the Dubai Financial Services Authority released the results of a thematic review on corporate governance. The DFSA found a good level of compliance but noted that governance arrangements and responsibilities did not always align to business plans and strategies.

MARKETS

In the U.S. there has been a significant fine for BNP Paribas ($8.9 billion) for breaches of sanctions rules and Credit Suisse ($2.6 billion) for violations of tax laws. FINRA has fined Goldman Sachs $800,000 for carrying out 400,000 trades at inferior prices, Brown Brothers Harriman a record $8 million for substantial anti-money laundering compliance failures and Morgan Stanley Smith Barney LLC $5 million for supervisory failures related to sales of shares in 83 initial public offerings to retail customers.

In Asia, the Hong Kong Securities and Futures Commission has taken enforcement action against Deutsche Bank (failing to disclose to Stock Exchange of Hong Kong Ltd the changes to its percentage holdings in the issued share capital of Up Energy Development Group Ltd on 27 occasions) and RBS (detection and prevention of unauthorized trading activities and the conduct of its emerging markets rates business) for internal control failings. It has also acted against a number of firms and individuals for unacceptable market conduct. For example, it issued a restriction notice on Salisbury Securities Ltd to protect client assets and sanctioned and reprimanded Sun Hung Kai International Ltd, fined it HK$12 million, and suspended its license to provide advisory services on corporate finance for one year after finding serious deficiencies in the sponsor work relating to the listing of Sino-Life Group Ltd.

In Australia, there have been a number of enforcement actions by ASIC for poor market conduct. It has fined or imposed penalties on Merrill Lynch (failing to prevent an erroneous order), Credit Suisse and Citigroup (not documenting appropriate maximum price change limits).

There have been other instances: for example, ASIC accepted an enforceable undertaking from online foreign exchange broker Forex Financial Services Pty Ltd for offering an account known as an individually managed account which was a managed discretionary account. Forex was not allowed to manage this account as a managed discretionary account. Also, Instinet Australia Pty Ltd paid a penalty of $50,000 to comply with an infringement notice given to it by the Markets Disciplinary Panel. The penalty was for the entry of an erroneous order which resulted in the market for Renison Consolidated Mines NL March 2012 convertible notes not being both fair and orderly.

In the UK, the FCA has undertaken significant work on how firms manage client money. This has included changes to rules and guidance for firms as well as enforcement action, for example, Barclays was fined £38 million.

In Europe the European Securities and Markets Authority has consulted on an amended version of the Market Abuse Directive.

CONSUMER CREDIT

In the UK the FCA took responsibility for consumer credit firms in April. As part of this there has been an greater focus on customer affordability, including the intention to cap interest charges on high cost of credit facilities. The UK has also adopted changes to mortgage regulations in the form of its own Mortgage Market Review and the EU Mortgage Credit Directive. The FCA has taken enforcement action against a number of firms in this area, and RBS and NatWest were fined £14 million for inappropriate mortgage advice. In the U.S., FINRA fined Merrill Lynch $8 million, with a further $89 million required to be repaid to retirement accounts and charities overcharged for mutual funds.

In Australia, there have been a number of examples of the regulators enforcing the standards for consumer credit. For example, ASIC has begun legal proceedings against Gold Coastbased Teleloans Pty Ltd and Finance & Loans Direct Pty Ltd, and Cash Loan Money Centres and Sunshine Loans have agreed to stop offering "leaseback" arrangements to consumers who want a payday loan. There have also been a number of actions for inappropriate advice and mortgage fraud.

In the U.S. the CFPB has announced it is taking action to halt the operations of an online payday lender, the Hydra Group, which it believes is running an illegal cash-grab scam.

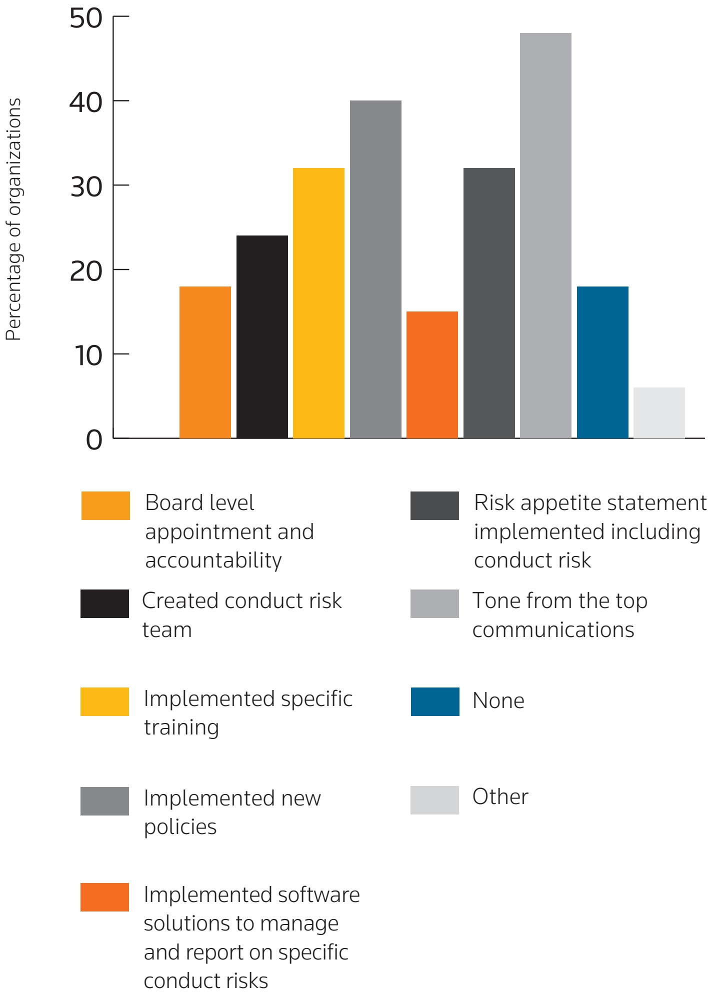
WHAT PROGRESS HAVE FIRMS MADE IN THE LAST YEAR?

"Needless to say, nothing here is meant to suggest that a focus on compliance is problematic. On the contrary, particularly as applied to areas like antitrust, securities laws and consumer protection, well-crafted compliance programs are essential. But what we want to see is good compliance, not mere compliance."

Daniel K Tarullo, Board of Governors of the Federal Reserve System, at the Federal Reserve Bank of New York Conference, October 2014

As we have seen, 2014 has been a busy year for the regulators but have firms kept up with this pace and has the survey shown any significant improvements or weaknesses in the last year?

IN THE LAST 12 MONTHS WHAT CHANGES HAS YOUR ORGANIZATION MADE TO ADDRESS CONDUCT RISKS? TICK ALL THAT APPLY



Conduct risk is occupying a significant amount of senior managers' time in financial services firms. The survey identified a number of areas where changes have been made in the last year. Respondents reported that communication of the tone from the top (48 percent) was the greatest change made in 2014, backed up with the implementation of new policies and procedures (40 percent) and undertaking training (32 percent). Firms also appear to have taken steps to reinforce expertise in this area, with the creation of specific conduct risk teams (24 percent) and board appointments (18 percent). It is a matter of potential concern that more than 18 percent of respondents indicated that no changes had been made in the last 12 months.

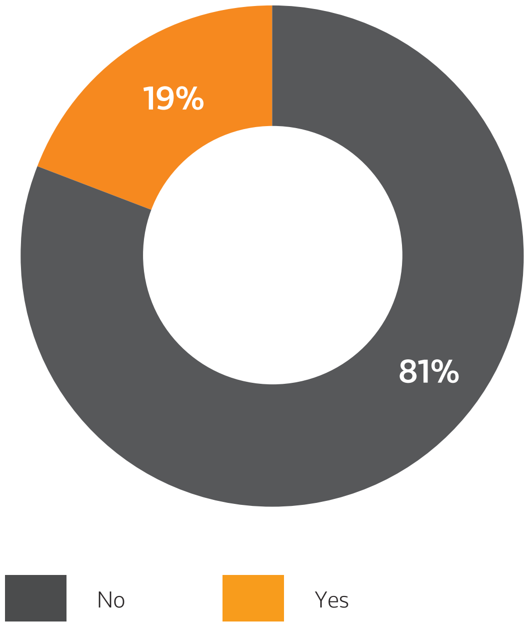
From a regional perspective, communication of tone from the top was overwhelmingly seen as the biggest change in the last 12 months. Respondents rated it the number one change in Asia (61 percent), Europe (42 percent), the Middle East (50 percent), the UK (57 percent) and North America (34 percent). This was supported by being second choice in Africa (45 percent) and second choice in Australasia (27 percent). In Africa the joint first choices were implementing training (55 percent) and implementing policies and procedures (55 percent) and in Australasia joint top choices were implementing policies and procedures (36 percent) and implementing risk appetite (36 percent). This was in contrast to 36 percent of respondents from Australasia saying they had made no changes this year and 27 percent from Africa.

These results, by and large, show a willingness by firms to try to embrace the concept of conduct risk, perhaps motivated by enhanced regulatory focus. Embedding takes time and needs to be underpinned by a range of activities but the true test of whether changes have been successful in firms is not the introduction of policies or training programs but a noticeable change in behavior within firms. There is still a concern that although these results show that firms are doing the right things (ticking the boxes), these changes and actions may not be manifesting themselves in true change of behaviors and that, in the future, some time needs to be devoted to measuring this sort of change.

"A major strength of our approach is that it aims to ensure that regulatory compliance does not become a substitute for risk management. Indeed, financial institutions cannot comply with our expectations unless they actively measure and manage their own risks."

Jeremy Rudin, superintendent, Office of the Superintendent of Financial Institutions (Canada), September 2014

DOES YOUR FIRM HAVE A SEPARATE WORKING DEFINITION OF CONDUCT RISK?



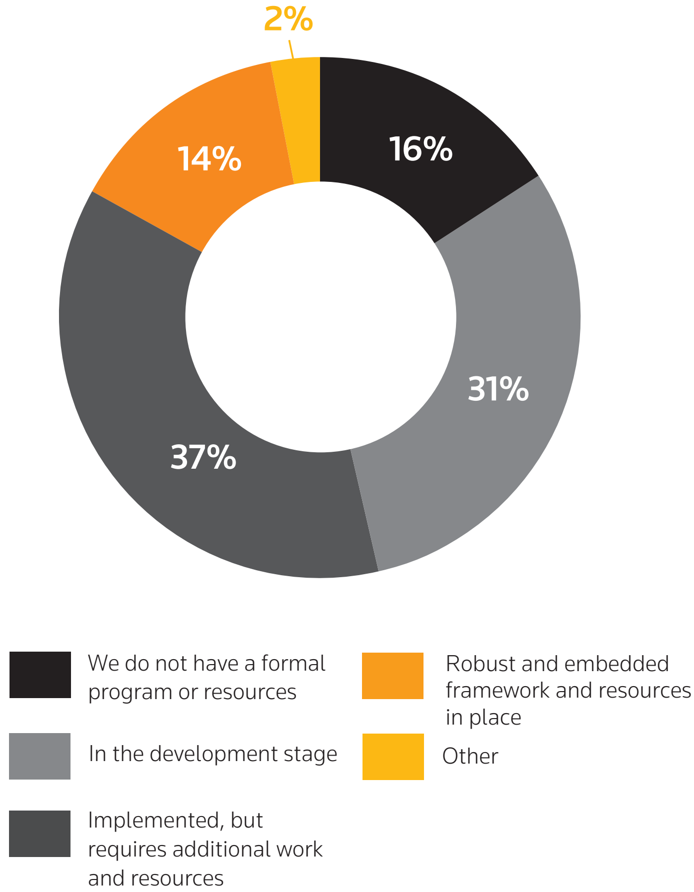
The survey highlighted the top two challenges to implementing conduct risk management as, firstly, understanding what conduct risk means to the firm and, secondly, the changing regulatory environment. Perhaps an underlying factor regarding the lack of a working definition is the deliberate decision taken by regulators not to create an overarching definition of conduct risk but rather to leave it to firms themselves. Regulators have made it clear that they expect firms to come up with their own definition. The 2014 survey results have shown that the majority of firms (81 percent) have still not established a working definition of conduct risk. This is slightly better than last year, when 84 percent had no working definition.

The regional results showed that 100 percent of respondents from the Middle East did not have a working definition of conduct risk, and nor did 91 percent in Australasia, 90 percent in Africa, 84 percent in North America, 83 percent in Asia, 81 percent in Europe and 73 percent in the UK.

Only 74 percent of G-SIFI firms said that they did not have a working definition of conduct risk.

It may be that firms are taking a similar stance to the regulators and are finding that operating without a definition means that more focus can be placed on individual examples of poor conduct within their firms. The absence of a definition does, however, hinder clarity and increases the risk not only that regulators will object to a lack of a firm-specific definition but also that poor conduct may end up only being detected after the event, and not prevented beforehand.

IN YOUR OPINION HOW MATURE IS YOUR ORGANIZATION'S APPROACH TO CONDUCT RISK MANAGEMENT?



The 2014 survey results showed a developing picture when it came to the maturity of a firm's approach to conduct risk. Many firms rated their approaches as either implemented but requires further work (37 percent) or in development (31 percent) with only 14 percent considering their approaches to be robust and embedded. In 2013, 62 percent of respondents said that they had implemented arrangements but work was still needed on them. Twenty-two percent said that arrangements were in development or no formal program existed with 16 percent of firms having a robust and embedded framework. These results show a contrast in that firms appear to have significantly progressed their approaches to conduct risk but that progress is not, as yet, being evidenced in embedded frameworks.

For G-SIFI firms 21 percent of respondents claimed to have a robust and embedded framework, with 46 percent rating their approach as implemented but requiring additional work, 25 percent in development and only 7 percent reporting that they had no formal program.

These results show the continuing challenges being faced by firms. Conduct risk covers such a broad variety of different areas, and given that some firms will be attempting to implement changes which straddle the globe, complete adoption of an effective conduct risk approach is going to take time. Regulators will no doubt show a risk-based approach to implementation and expect firms to do the same. So although firms may not have a fully developed approach to conduct risk it is important that for the main conduct risks in their firms they are more advanced and can demonstrate that their approach does control these risks effectively. It will be equally important that the board and senior managers are able to articulate both progress made and direction of travel in the embedding of conduct risk to stakeholders in general and regulators in particular.

> "The [Financial Markets Conduct Act] also places the good conduct of professionals and firms at the heart of the FMA's remit. Conduct regulation is new to New Zealand and will deliver a step change in the way financial services are provided in the years ahead."
>
> **Rob Everett, chief executive, New Zealand Financial Markets Authority, to the Institute of Finance Professionals New Zealand, October 2014**

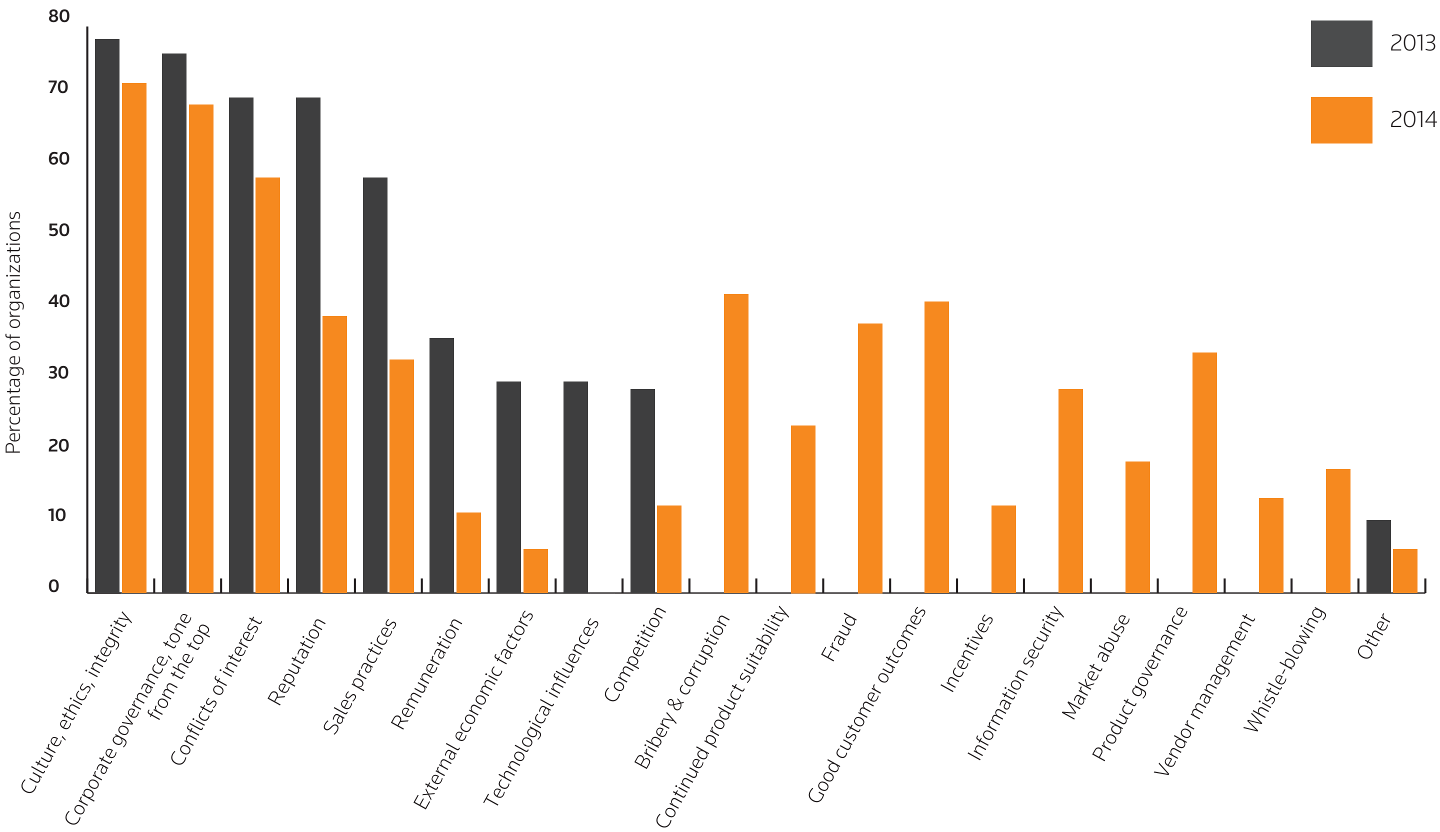
For 2014 the survey expanded the choices that were given to firms regarding the components that make up conduct risk to include other areas such as bribery and corruption and fraud. Nevertheless, the survey showed that the top three components were the same as 2013, namely: 1) culture, ethics and integrity (70 percent); 2) corporate governance and tone from the top (67 percent) and 3) conflicts of interest (57 percent). The results showed a dilution over the other categories with less emphasis placed on reputation (2013: 68 percent, 2014: 38 percent) and sales practice (2013: 57 percent, 2014: 32 percent) but both bribery and corruption (41 percent) and customer outcomes (40 percent) proved frequent choices among respondents in 2014.

From a regional perspective differing emphasis was placed on specific components. In the UK (85 percent), North America (70 percent) and Australasia (82 percent), culture, ethics and integrity was the leading component of conduct risk, whereas in Asia (67 percent), Europe (67 percent) and the Middle East (83 percent), conflicts of interest came top. Respondents from Australasia (82 percent) put conflicts of interest joint top. Corporate governance came out top in Africa and joint in the UK (85 percent).

When taking the G-SIFI results in isolation the same trends were seen. Culture, ethics and integrity (81 percent) was seen as the main component of conduct risk followed by corporate governance and tone from the top (68 percent) and conflicts of interest (58 percent).

There is no doubt that at the heart of conduct risk is the behavior of financial services firms, and therefore culture, ethics and integrity and how they are controlled through corporate governance are vital elements of conduct risk. It is however surprising that "good customer outcomes" was not a more popular choice. To operate in a customer-focused manner is equally at the heart of conduct risk and it is customer outcomes that may drive the culture and governance of a firm's approach to conduct risk. It may be that firms have determined the desired customer outcomes they wish to deliver and have turned their attention to controlling the mechanisms for doing this. If firms have not considered their approach to customer outcomes they are missing an important step when developing their approaches to conduct risk.

IN YOUR FIRM WHAT ARE CONSIDERED TO BE THE KEY COMPONENTS OF CONDUCT RISK?



KEY COMPONENTS OF CONDUCT RISK

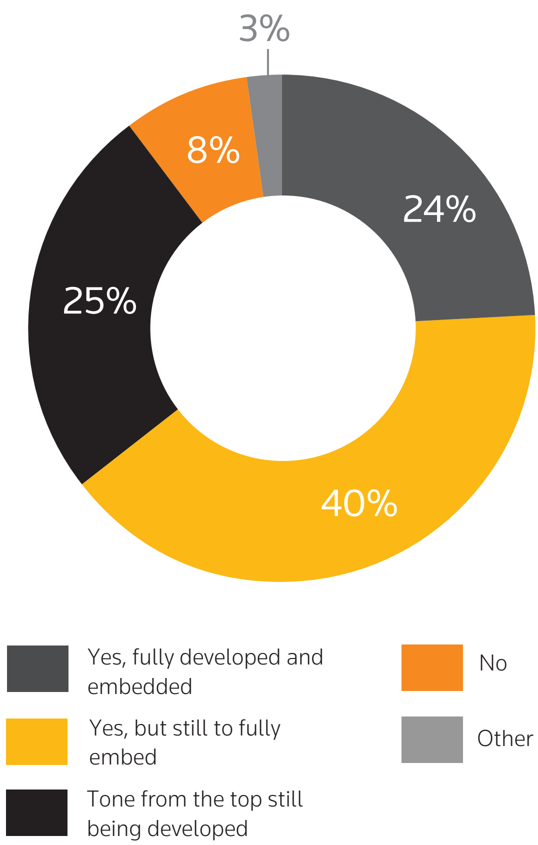
TONE FROM THE TOP

> "Senior leaders must take responsibility for the solution and communicate frequently, credibly and consistently about the importance of culture. Boards of directors have a critical role to play in setting the tone and holding senior leaders accountable for delivering sustainable change. A healthy culture must be carefully nurtured for it to have any chance of becoming self-sustaining."
>
> **William Dudley, president and chief executive officer, Federal Reserve Bank of New York, October 2014**

Boards and senior managers have grown used to the mantra of "tone from the top", and the need for the leadership of a firm to be seen to be setting and driving a suitably compliant approach to all aspects of the business. There is a clear regulatory expectation that boards need to be, and to be seen to be, front and centre when leading the approach to the successful implementation and embedding of conduct risk. The survey asked about the changes made in the last year to address conduct risks, with the largest response highlighting tone from the top communications as an area of focus. Other areas of change included the implementation of new policies, the implementation of specific training and updating the risk appetite statement to include conduct risk (32 percent). Given the intensity of focus from regulators regarding culture and conduct risk, and given the number of best practice examples where specific (very) senior level accountability is mandated, it is perhaps surprising that fewer than a fifth of respondents reported that a board-level appointment had been made in the last year with accountability for conduct risk. This may of course be a quirk of this year's responses, with the majority of firms having had a named responsible board member for more than a year, but given the relatively new focus on conduct risk that seems unlikely.

> "We should not want board meetings to be spent just looking at compliance tables. But by the way, accepting responsibility for high standards is not in my view the same as mere compliance. It's the culture of a business that is most important, not a box-ticking mentality."
>
> **Jonathan Hill, EU commissioner for Financial Stability, Financial Services and Capital Markets Union, November 2014**

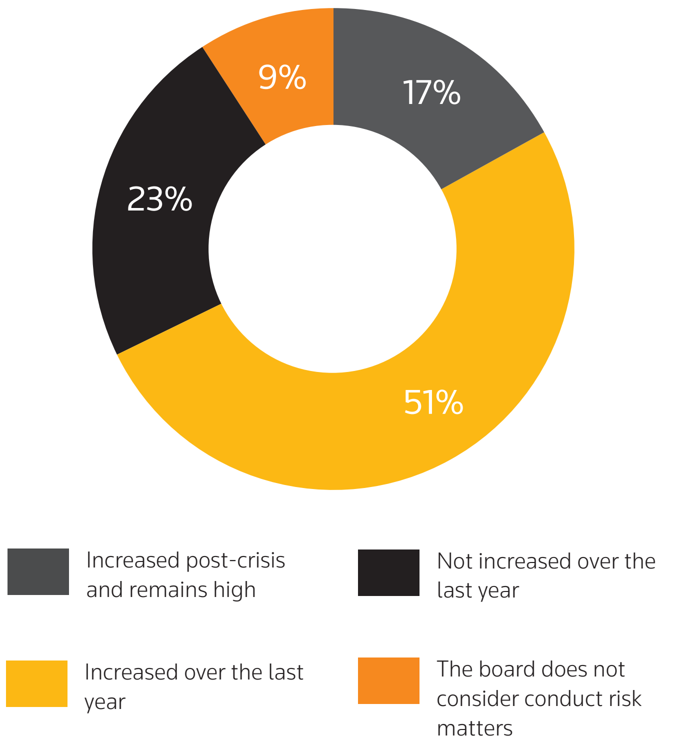
DOES THE TONE FROM THE TOP SET BY THE BOARD SET THE APPROPRIATE CULTURAL AND GOVERNANCE MESSAGES?



The results show some distinct variations when those respondents who considered themselves to be part of a G-SIFI were split out. In the G-SIFI population, for instance, 39 percent of respondents stated that they had made a board-level appointment with accountability for conduct risk. Fifty two percent reported that a conduct risk team had been created in the last year as opposed to 24 percent of respondents in the full population, and 19 percent of G-SIFIs had implemented software solutions to manage and report on specific conduct risks (15 percent in the full population). G-SIFIs were seen to have done more, with only 6 percent reporting that no conduct risk related changes had happened in the last 12 months.

Taking the tone from the top one stage further the survey asked whether or not the tone from the top espoused by the board set the appropriate cultural and governance messages. Just under a quarter (24 percent) of respondents were able to respond not only positively but also to state that the tone from the top messages were fully developed and embedded. Those firms in the 25 percent where the tone from the top messaging is still being developed need to ensure that it is being given an appropriate level of priority at board level, though it is likely that they are in a distinctly better place than the 8 percent of respondents who reported that the tone from their particular top did not set the appropriate cultural and governance messages.

AT BOARD LEVEL HAS THE AMOUNT OF FOCUS ON CONDUCT RISK:

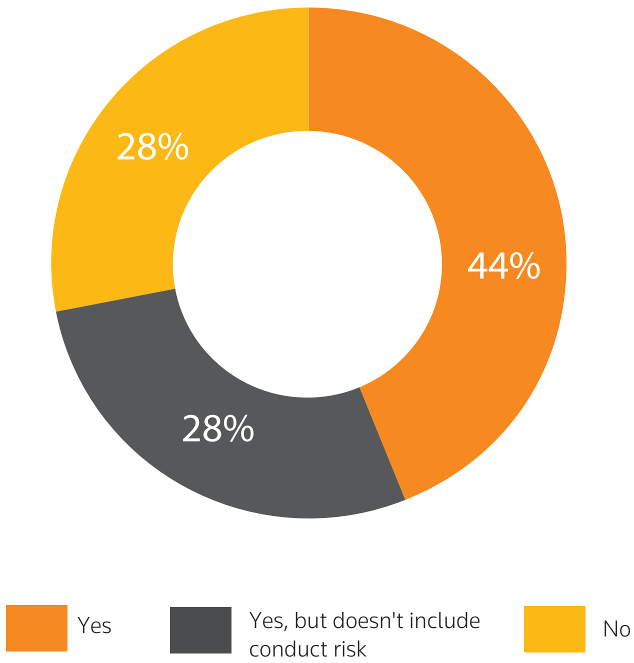


At the board level there was a mixed message as to the amount of focus on conduct risk. Respondents reported that the focus had increased for 68 percent of boards, with 51 percent stating that the focus had increased in the past year. Those firms where the focus had not increased in the last year (23 percent) and those where the board did not consider conduct risk matters (9 percent) need to take a long hard look at the reporting to and updating of the board with regard to regulatory matters. Any board with a financial services business in their group that does not consider conduct risks and has not increased its visible focus on conduct and culture is likely to be particularly vulnerable to intense regulatory scrutiny.

There were regional variations in the level of focus devoted at the board level to conduct risk issues. In Asia the increase in the last year peaked at 70 percent, although no Asian respondents reported any increase post crisis. At the other end of the scale only 17 percent of respondents from the Middle East reported an increase in focus over the last year. Of perhaps most concern was the 36 percent of Australasian respondents reporting that their board did not consider conduct risk matters.

> "The FCA does not tolerate conduct which imperils market integrity or the wider UK financial system. [These] record [Forex] fines mark the gravity of the failings we found and firms need to take responsibility for putting it right. They must make sure their traders do not game the system to boost profits or leave the ethics of their conduct to compliance to worry about. Senior management commitments to change need to become a reality in every area of their business."
>
> **Martin Wheatley, chief executive, UK Financial Conduct Authority, November 2014**

HAS YOUR FIRM DEVELOPED A FORMAL RISK APPETITE, AGREED AT BOARD LEVEL, WHICH INCLUDES CONDUCT RISK?



Board involvement, indeed active involvement, in culture and conduct risk is essential. The Financial Stability Board made it clear in its guidance on supervisory interaction with financial institutions on risk culture finalized in April 2014, that it considers the role of the board to be fundamental in the promotion of a sound risk culture within a firm. The FSB identified core practices and attitudes which could be used as indicators of the firm's risk culture, as well as criteria for assessing the strength and effectiveness of a firm's culture in managing risks. The FSB broke down the indicators into four parts which need to be considered collectively, and as mutually reinforcing. The FSB made it clear that looking at each indicator in isolation would ignore the multi-faceted nature of risk culture. The four parts are:

- *Tone from the top:* The board and senior managers are the starting point for setting the financial institution's core values and expectations for the risk culture of the institution, and their behavior must reflect the values being espoused. One important value that should be espoused is the expectation that staff act with integrity (doing the right thing) and promptly escalate observed non-compliance within or outside the organization (no surprises approach). The leadership of the institution promotes, monitors and assesses the risk culture of the financial institution; considers the impact of culture on safety and soundness; and makes changes where necessary.
- *Accountability:* Relevant employees at all levels understand the core values of the institution and its approach to risk, are capable of performing their prescribed roles, and are aware that they are held accountable for their actions in relation to the institution's risk-taking behavior. Staff acceptance of risk-related goals and related values is essential.
- *Effective communication and challenge:* A sound risk culture promotes an environment of open communication and effective challenge in which decision-making processes encourage a range of views; allow for testing of current practices; stimulate a positive, critical attitude among employees; and promote an environment of open and constructive engagement.
- *Incentives:* Performance and talent management encourage and reinforce maintenance of the financial institution's desired risk management behavior. Financial and non-financial incentives support the core values and risk culture at all levels of the institution.

The guidance then breaks down each of the four indicators, highlighting identifying factors and behavior for supervisors to consider when assessing the strength and effectiveness of a firm's culture in managing risk. One overarching recommendation is for all regulators to assess how the board and senior managers systematically consider and review the culture of their firm, the quality and rigor of the documentation of the findings and how any deficiencies in risk culture are then addressed. Critically, a firm's willingness to document sufficiently the elements supporting its risk culture has been highlighted as being an important part of the regulator's overall assessment.

NEXT STEPS FOR THE BOARD

In the first Conduct Risk Report, five steps which Boards might wish to take were identified. These are still applicable. The focus on culture and conduct risk will remain and boards need to ensure that they and the business activities they manage are operating in line with all relevant regulatory expectations. The five steps are:

- *Define* – firms need to define what "good" in terms of conduct risk looks like for their particular business. The regulators have repeatedly said that conduct risk is not a one-size-fits-all and that boards need to decide for themselves how conduct risk should be managed within their firm. The definition of conduct risk will not remain static and should be considered as something to be reviewed and re-reviewed on a regular basis. The iterative development of the working, firm-specific, definition of conduct risk will change in line with lessons learned, changing regulatory expectations as well as changes to the business activities or operating model.
- *Assess* – once firms have decided how they wish to consider and manage conduct risk issues a gap analysis needs to be undertaken to highlight any and all areas where current practice is out of step with where the firm wishes to be.
- *Reform* – all areas from the gap analysis need to be considered and prioritized. Resources and, where needed, sponsorship from the very highest levels of the firm should be devoted, and importantly be seen to be devoted, toward bringing the firm's activities into line with the defined appetite and stance on conduct risk and culture. The clock can now be considered to be ticking with regard to the need to implement any remedial actions. Any firm which does not prioritize the implementation and embedding of all actions identified by a gap analysis will have some very uncomfortable questions to answer from a range of stakeholders, including of course relevant regulators.
- *Measure* – all firms need to be able to measure and report on the qualitative as well as any quantitative elements making up the diverse concept of conduct risk.
- *Evidence* – All of the above activities need to be clearly evidenced, so that a transparent audit trail is available and all material decisions recorded. This is for the benefit of internal staff and will aid with reporting to the board (and elsewhere), and to assure the regulators that a firm has a strong grip on all aspects of its governance and control of conduct risk.

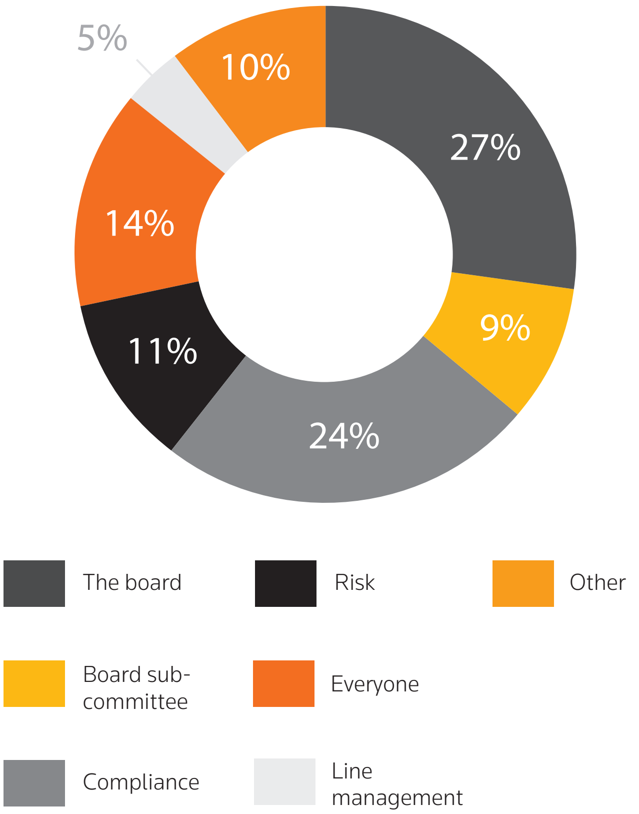
PERSONAL LIABILITY

Life can be tough at the top. Financial services regulators are working to ensure that senior managers can more readily be held liable and accountable for compliance failings; an increasingly tough environment made all the more challenging by the deliberate lack of prescription around conduct risk.

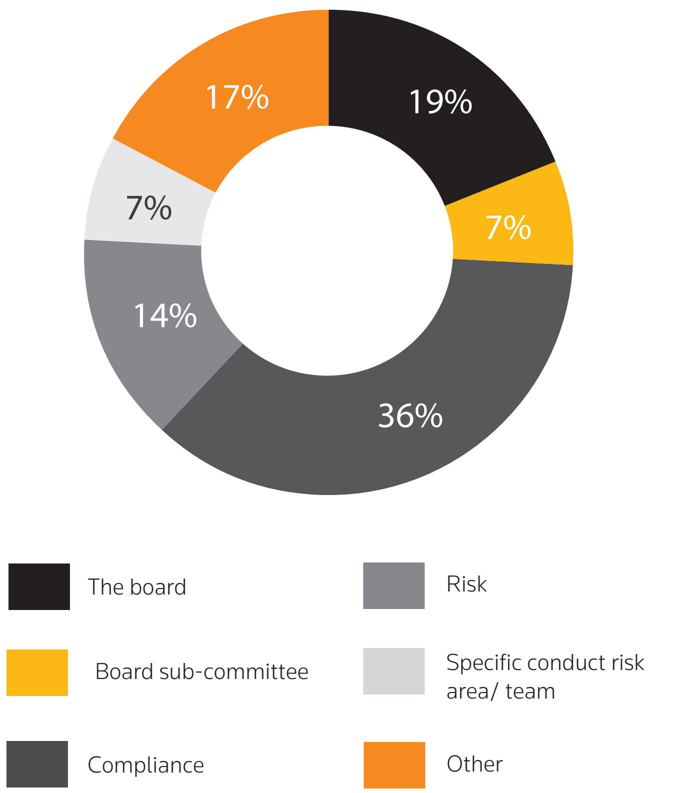
The survey asked respondents who owned conduct risk in their organization. The responses showed no single majority approach, although the largest response was the board, at 27 percent, with a possible additional 9 percent where a board sub-committee was seen as owning conduct risk. Compliance was a close second at 24 percent. Firms where the board did not own, and was seen not to own, conduct risk may be vulnerable to additional regulatory scrutiny. The expectation is that the board of a firm will not only set and agree the approach to conduct risk but will also "own" it to give it the gravitas and impetus to be taken appropriately seriously throughout all levels and areas of the business. There were some marked regional variations in the responses. Of perhaps most concern was the Middle East, where no one reported that the board owned conduct risk, and compliance ownership was at 50 percent. At the other end of the scale in Africa, 28 percent had ownership at the board level, rising to 46 percent when the board sub-committee was added in.

As a corollary to asking about the ownership of conduct risk the survey also asked who was accountable for implementing conduct risk, with again a diverse range of responses. Compliance came out on top with 36 percent. In second place was the board at 19 percent with a further 7 percent responding that a board sub-committee was accountable for the implementation of conduct risk. For G-SIFIs the percentage with a board sub-committee accountable rose to 10 percent (the board percentage falling slightly to 17 percent). In the G-SIFI population 45 percent reported that compliance was accountable for conduct risk implementation with 10 percent allocating accountability to a specific conduct risk team (7 percent in the wider population). Implementation does not necessarily need to be at the highest levels of the firm but it is essential that the board has strong line of sight to all risks, the progress made towards the implementation of the approach to conduct risk, as well as any issues or actions arising. Very senior individuals in a firm will be expected to be conversant with the exact state of play regarding culture and conduct risk issues and any senior person who is unaware of either the firm's own agreed approach or the progress made toward embedding that policy is likely to face some particularly tough regulatory scrutiny.

WHO OWNS THE CONDUCT RISK POLICY IN YOUR ORGANIZATION?



WHO IS ACCOUNTABLE FOR IMPLEMENTING THE CONDUCT RISK POLICY IN YOUR ORGANIZATION?

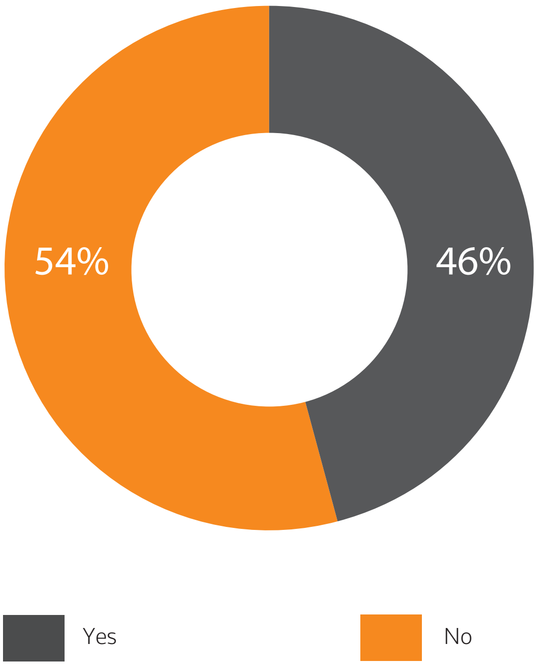


"Internal gatekeepers play just as vital a role in compliance. Compliance officers must design, test, and update firm policies. Firm management and the board generally must approve these policies and monitor compliance with them. Executives, hopefully with the help of a good chief compliance officer, must establish a strong 'tone at the top'. Because, as we all know, the compliance function won't work without buy-in and commitment at the top."

Kara Stein, commissioner, U.S. Securities and Exchange Commission, May 2014

Regulators have demonstrated a continuing trend toward encouraging and often requiring firms to allocate responsibility for particular areas or issues to named individuals. The growing use of personally signed attestations is a case in point. Forty six percent of respondents said that a senior manager had been made responsible for conduct risk. This rose to 71 percent in the G-SIFI population. Firms that have not named a specific (very) senior individual as responsible for conduct risk should be prepared for questions from the regulator as to why not. It is possible that firms may have other, equally appropriate infrastructures in place to maintain the focus on conduct risk but they should be prepared to explain why they have chosen not to name an individual and why their alternative approach is just as effective.

DO YOU HAVE A SENIOR MANAGER RESPONSIBLE FOR CONDUCT RISK?

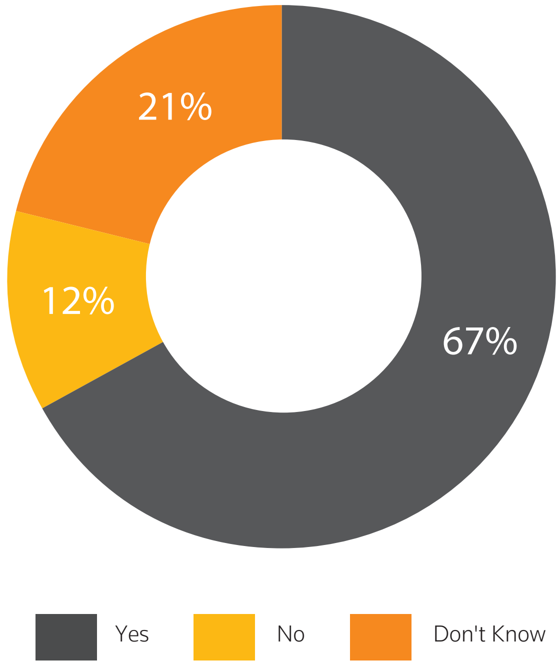


Perhaps the most pertinent of all the questions posed in the Conduct Risk Survey was whether or not respondents thought that the regulatory focus on conduct risk would increase the personal liability of senior managers. A resounding two-thirds (67 percent) thought that it would. This rose slightly to 75 percent in the G-SIFI population of responses, which then begs the question as to how senior managers can seek to manage their own personal regulatory risk arising from the expectations around conduct risk? In theory, senior individuals should have control over the internal environment of their firm but the levels of line of sight and control can, however, be illusory in a large, complex firm.

Senior managers need to be realistic about the implications of their accountability and their ability to discharge their roles and responsibilities. There are a number of points for firms and senior individuals to consider. The first is the need to articulate with great care the accountabilities and responsibilities of each and every senior person in their job description. All too often job descriptions are only considered in detail when someone is new in their role, and even then it tends to be a high-level and general document. Almost nowhere is the interlinking between roles, job descriptions and accountabilities routinely considered.

One immediate area for consideration is for all senior managers to review and document exactly what their roles cover and how those obligations are discharged. This activity needs to be done on a firm-wide basis to ensure that the resulting aggregation of all the (much) more detailed job descriptions come together into a seamless whole. For the whole process to be effective it then needs to be kept up to date.

DO YOU THINK THAT THE REGULATORY FOCUS ON CONDUCT RISK WILL INCREASE THE PERSONAL LIABILITY OF SENIOR MANAGERS?

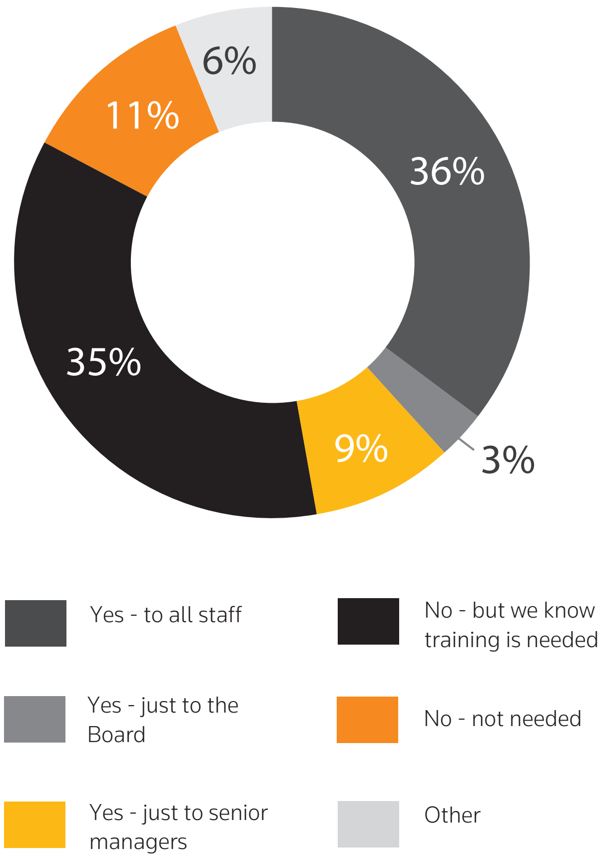


One area for review is that of reporting and management information. Good management information is the lifeblood of any firm and in the current regulatory environment management information could be seen as the need for evidence, evidence and more evidence that a firm and the senior managers running it have done all of the right things in all of the right ways. It is a measure of how seriously the need for good quality management information is now being considered that the FSB has made it a key consideration in the assessment of risk governance.

Previously, "inappropriate" risk governance behavior for a senior manager might well have been gross misconduct or fraud, but the net has widened significantly, with raised supervisory expectations including, as an example, the board's attitude and approach to the risk information provided to it. In early 2013, the FSB found that "the information provided to the board was voluminous and not easily understood which hampered the ability of directors to fulfill their responsibilities". In other words, the FSB has drawn a direct link between the type and quality of risk reporting received and the adequate discharge of senior individuals' personal accountability.

Senior managers need to be able to contribute to their firm being compliant and must also be able to demonstrate their own discharge of their personal regulatory obligations and accountabilities. As part of the daily management of the firm, senior individuals will routinely need to collect and maintain the evidence to show how they discharged all their obligations and responsibilities. When roles change, detailed documented handovers need to become the norm to ensure that all concerned can manage their personal regulatory risk. It could easily be seen as a cottage industry but the greater level of documentation regarding job descriptions is an essential part of enabling senior managers to demonstrate the appropriate performance of their responsibilities.

HAS YOUR FIRM IMPLEMENTED TRAINING ON CONDUCT RISK?



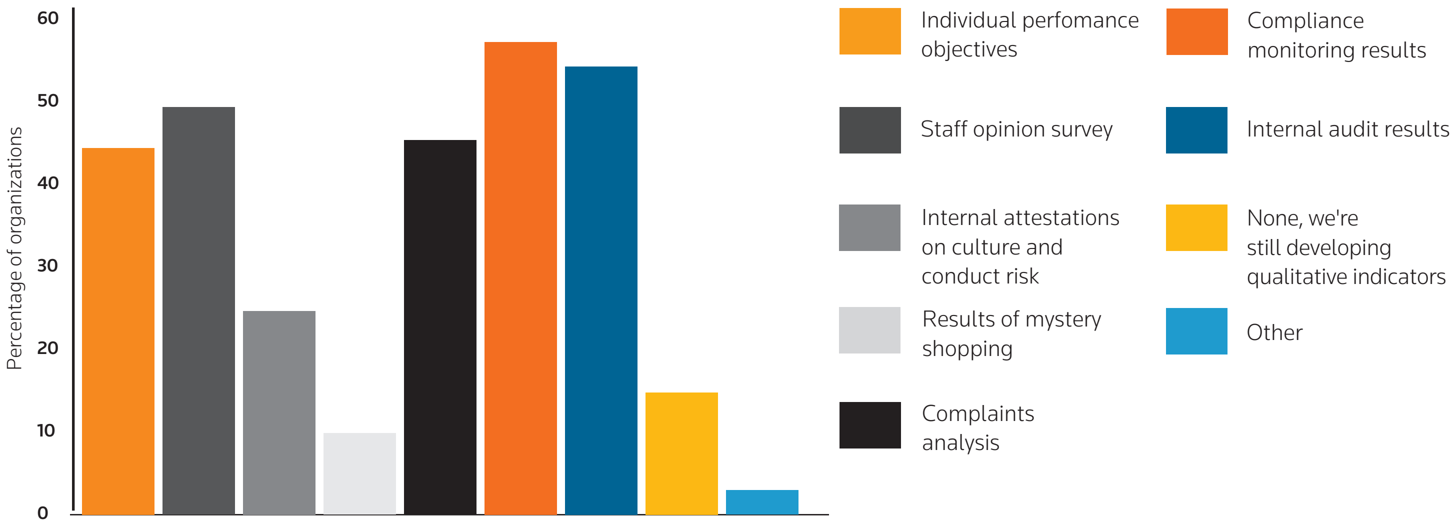
Along with the collection and maintenance of evidence one of the best ways to protect an individual from personal liability is training. Engaging in a rolling regulatory training program is one option; there is a significantly increased likelihood of enforcement action for any unprepared or unaware individual. Senior managers who ignore the brave new regulatory world are likely to feel the full brunt of supervisory enforcement. Even if a senior manager is not banned as part of any enforcement action it is unlikely that an individual who has "only" been fined will work again in a senior capacity in financial services.

The survey question regarding training on conduct risk yielded a wide range of results. Thirty-six percent of respondents reported that training had been given to all staff with a worrying 35 percent also stating that there had been no training as yet, although the need had been acknowledged. In contrast, 57 percent of the G-SIFIs had trained all staff. Again, there were some distinct regional variations. Some potentially worrying high figures were reported for the "no training but knew it was needed" response, with Africa at 55 percent, the Middle East at 50 percent and Europe (excluding the UK) at 49 percent. Firms must not only to define what conduct risk means to them but also to institute a comprehensive training program across their business without delay.

MONITORING AND REPORTING

Monitoring and reporting are essential governance activities for conduct risk. For approaches to conduct risk to be successful firms need to have determined what areas of conduct they should monitor and how they are going to achieve this. Firms need to develop effective reporting lines to promulgate both strengths and weaknesses, to feed conduct results into key decision areas and to establish any improvements that are necessary.

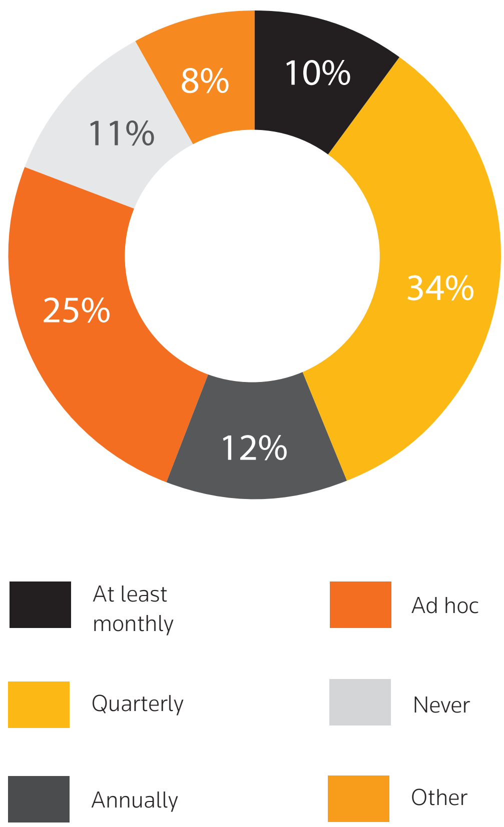
WHAT QUALITATIVE INDICATORS DO YOU USE TO ASSESS CULTURE? PLEASE TICK ALL THAT APPLY



The results from the survey showed that firms were generally relying on existing activities such as compliance monitoring (58 percent) and internal audit (55 percent). Staff surveys (50 percent) came third, followed by individual performance reviews (45 percent). When broken down the G-SIFI results were similar. Sixty-five percent used internal audit results, 65 percent compliance monitoring results and 61 percent staff surveys. The change of focus from compliance monitoring to internal audit in G-SIFI firms may reflect the emphasis that regulators have placed on internal audit since the financial crisis, especially in large firms. Indeed, 15 percent of firms were still developing indicators to monitor conduct risk. In G-SIFI firms this was slightly less, at 10 percent.

All these indicators are important within a firm but it is also important not to over-rely on one monitoring activity. For example, using staff surveys on a very frequent basis does not allow change to take effect and may antagonize staff who are faced with similar questions on a regular basis but have not had the chance to implement changes. Firms should look to develop a range of monitoring activities so that results can be verified appropriately and should not only look at the tried and tested methods but develop other new, imaginative ways of monitoring.

HOW OFTEN DOES YOUR BOARD REVIEW CONDUCT ISSUES?

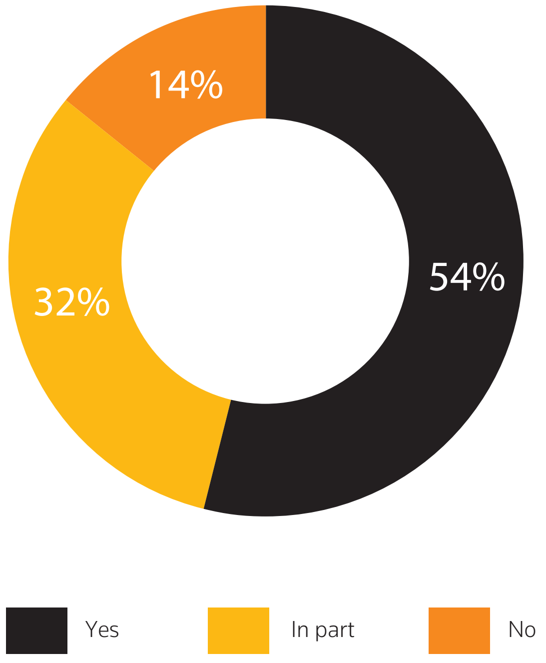


The results showed that 44 percent of boards reviewed conduct risk issues on either a quarterly or monthly basis with a further 12 percent annually. It is a matter of concern that 11 percent of firms are potentially vulnerable as their boards never review conduct risk issues. This shows a mixed picture since the 2013 survey. There has been improvement in the frequency of boards reviewing conduct risk (in 2013 only 46 percent of respondents' boards reviewed conduct risk either monthly or quarterly) but there has also been an increase in those firms that never review conduct risk issues (6 percent in 2013).

When assessed by region, 67 percent of respondents from the UK said that boards reviewed conduct risk at least quarterly. This compared with 35 percent in North America, 38 percent in Europe, 46 percent in Africa and 29 percent in Asia. In the Middle East respondents said that 66 percent of boards reviewed conduct risk annually with no respondents reviewing quarterly or monthly. In Australasia, respondents said that boards mainly reviewed conduct risk on an ad hoc basis (46 percent) and Australasia had the largest percentage of respondents where the board did not review conduct risk issues (36 percent).

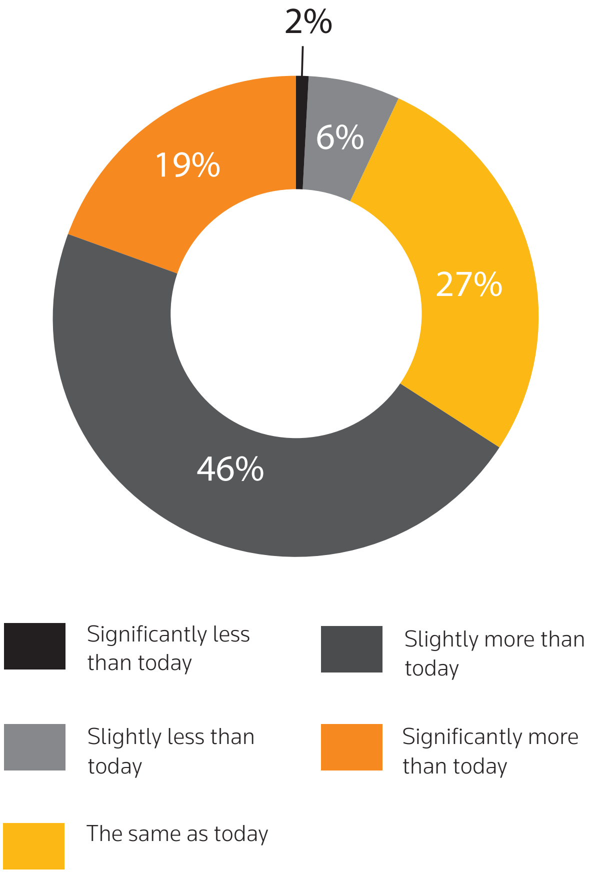
The frequency of reporting depends on the size of the firm and the conduct risks that it runs. It is positive, therefore, that so many firms are adopting a proactive approach to reporting to the board.

FOR CONDUCT RISK, ARE REPORTS TO THE BOARD FROM THE RISK AND CONTROL FUNCTIONS ALIGNED?



There is still some way to go, however, in aligning reports from control functions. A combined view from all control functions giving the board and senior managers a single clear view on the state of conduct risk management in their firm is recognized best practice. With this in mind, 54 percent of respondents said that they did align reports from control functions but 32 percent said they did not and 14 percent did so in part.

OVER THE NEXT 12 MONTHS, I EXPECT THE COST OF TIME AND RESOURCE DEVOTED TO CONDUCT RISK ISSUES TO BE:



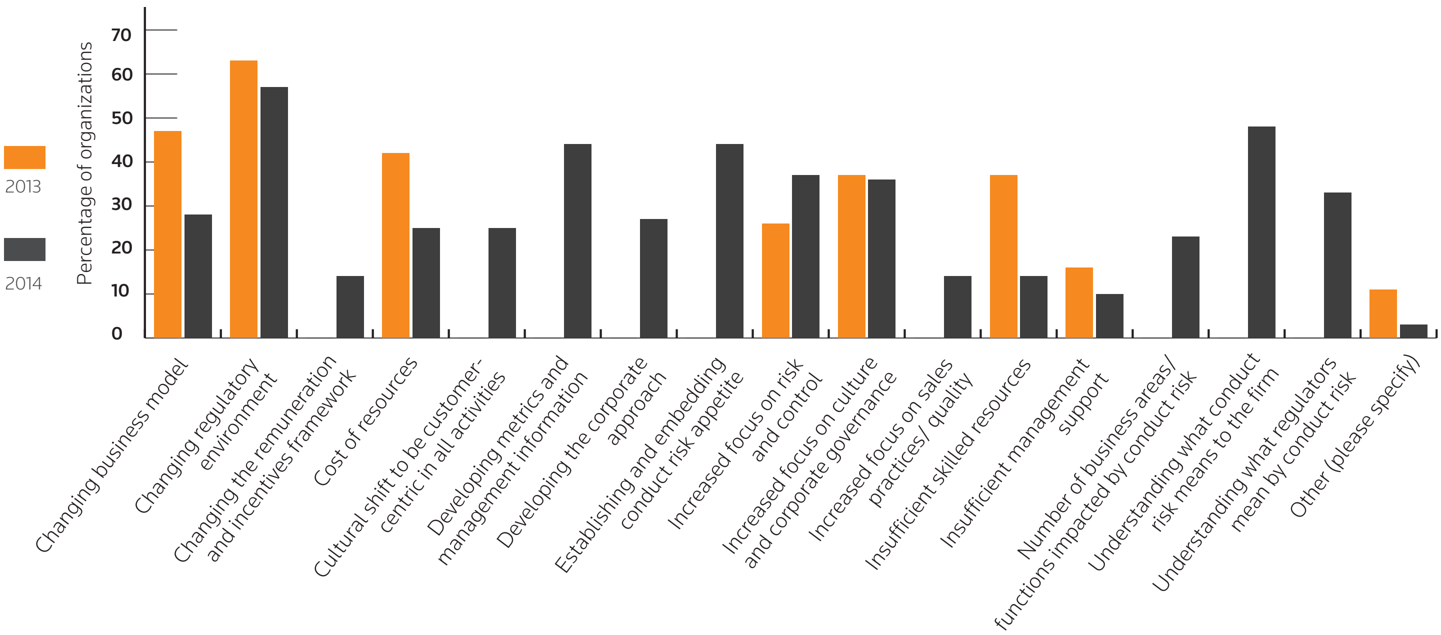
CHALLENGES AND EXPECTATIONS FOR THE YEAR AHEAD

There is no doubt that the heightened focus seen throughout 2014 on conduct risk will continue over the next 12 months. This was reinforced by more than two-thirds of respondents (46 percent plus 19 percent), who were expecting to devote more time and resource to conduct risk during 2015. That extra resource and effort will include training for the third (35 percent) of firms which recognize that they will need to implement specific training on conduct risk.

Firms were asked to identify the top five greatest challenges they were expecting when implementing conduct risk in the year ahead. The changing regulatory environment continued to rate most highly as the greatest challenge, albeit slightly less of a challenge than it posed in 2014. Three of the most crucial elements required for the practical implementation of conduct risk management were also called out as the biggest challenges, namely understanding what conduct risk meant to the firm (48 percent), establishing and embedding conduct risk appetite (44 percent) and developing metrics and management information (44 percent). It is clear that many firms still have much work to do in understanding, embedding and demonstrating effective conduct risk management within their organization. It comes as no surprise then that firms are dedicating so much attention to this area when they recognize that the fifth-biggest challenge for the year ahead is the increased focus on risk and control.

From a regional perspective, the results show consistency in the areas of focus with Africa being the only region that did not follow the wider findings. Its top three areas of focus were greater focus on culture and corporate governance (64 percent), understanding what conduct risk meant to the firm (64 percent) and more focus on risk and control (55 percent). In Australasia, the greatest challenge for the year ahead was greater focus on culture and corporate governance, which supports the work and focus of the continuing Financial System Inquiry in Australia.

WHAT ARE THE KEY CHALLENGES TO THE ORGANIZATION WHEN IMPLEMENTING CONDUCT RISK IN THE YEAR AHEAD? PLEASE SELECT YOUR TOP FIVE.

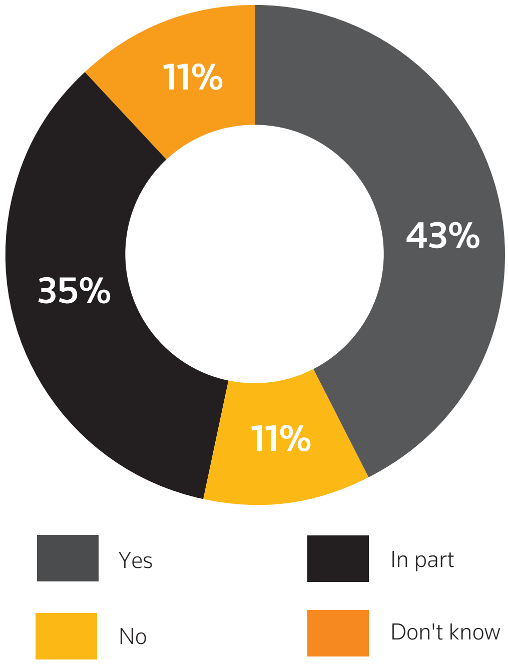


Respondents were also asked about the greatest conduct risk challenges they expected their board to face in the next 12 months, in relation to conduct risk. The challenges identified by respondents were very much in line with those affecting the wider organization. They centred on greater focus and scrutiny, including enhanced regulatory focus and supervision plus an enhanced focus on culture and corporate governance. They also pinpointed the practical aspects of embedding the conduct risk framework and developing metrics and management information. In line with boards' greater involvement in conduct risk there was clear recognition that one challenge was the increasing focus on personal liability, both gaining buy-in and demonstrating senior management accountability.

GREATEST CONDUCT RISK CHALLENGES FIRMS EXPECT THEIR BOARD TO FACE IN THE NEXT 12 MONTHS

All of the components that make up conduct risk are fundamental to maintaining fair outcomes for customers while dealing with increased regulatory scrutiny. It makes sense, therefore, that the overwhelming majority of firms are taking conduct risk factors into account, at least in part, when determining their business strategy. This may be of concern to the 11 percent of firms that are specifically not taking it into account as part of their strategy.

ARE CONDUCT RISK FACTORS CONSIDERED WHEN BUSINESS STRATEGY IS BEING DISCUSSED?



CLOSING THOUGHTS

Conduct risk is not a flash in the pan. It is not a here today gone tomorrow regulatory fad which will gradually disappear if firms and their senior managers ignore it for long enough. If the repeated statements made by regulators were not sufficient the International Monetary Fund's October 2014 Global Financial Stability report empirically validated the international supervisory approach taken including verifying the concept that a company's culture (and by association conduct risk) has a large influence on a bank's risk-taking. As part of the same work the IMF also validated much of the approach taken to the global regulatory reform of corporate governance and executive pay. All firms need to be aware that the focus on culture, governance and accountability of individuals as the central tenet of conduct of business regulation in firms is set to be reinforced and enhanced as the planned regulatory reforms continue to be rolled out. Indeed, the point about individual accountability was repeated in the October 2014 Future of Finance panel session on ethics and finance run by the IMF. Panel members included Mark Carney, Governor of the Bank of England and head of the FSB, who, among other things, spoke about the reality of greater personal responsibility and the need for those unwilling or unable to take such responsibility to leave their (senior) role in a firm.

Much has changed in the last year with regard to the development of the approach to conduct risk but there are some consistent themes regarding the need for continuing board engagement, really high-quality reporting and management information, all overlaid with the practical reality of increasing personal liability. The G-SIFIs are leading the way in the response to implementation and roll-out of conduct risk, and pretty much across the piece have been seen to have done "more". Other firms could do worse than to seek to benchmark their approach to conduct risk against the stance and focus shown by the largest firms in the world.

Regulators have made clear their expectations for conduct risk and culture. It is now up to firms and the senior individuals who lead them to respond by implementing and embedding a consistently strong approach to conduct risk which can be demonstrably evidenced. Only then will it be possible to discharge the growing liability, for both firm and individual.

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