A NEW GLOBAL TOOLKIT FOR FIGHTING MISCONDUCT RISK: WHAT DOES THIS MEAN FOR FIRMS AND REGULATORS?

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Legal Briefings – By **Will Hallatt and Emily Rumble**

On 20 April 2018, the Financial Stability Board (**FSB**) released its long awaited toolkit (**Toolkit**) for firms and regulators' use in fighting misconduct risk. The Toolkit forms part of the FSB's workplan to mitigate misconduct risk, and builds on existing measures such as the FSB's guidance on sound compensation practices.

The Toolkit sets out 19 tools for use by firms and regulators to strengthen governance frameworks in order to reduce misconduct risk. The tools within the Toolkit reflect a growing consensus that more aggressive measures need to be taken to prevent, or at least reduce, misconduct by financial institutions before it occurs, rather than harshly punishing that misconduct "after the fact". The 19 tools within the Toolkit are focused on what the FSB consider to be three key areas of misconduct risk:

1. The role of (poor) culture in driving misconduct within a financial institution;
2. Lack of individual responsibility and accountability; and

3. The “rolling bad apples” phenomenon through which individuals who engage in misconduct move between financial institutions without their misconduct being disclosed to their new employer.

BREAKFAST SEMINAR IN HONG KONG – 17 MAY 2018

We have been following these developments for some time and will be holding a breakfast seminar in Hong Kong to share our insights on how these developments might impact conduct and culture in Hong Kong, and more broadly across APAC:

Date:	Thursday 17 May 2018
Time:	8:30 - 9:30 am Registration and breakfast from 8:15 am
Venue:	Herbert Smith Freehills, 23/F Gloucester Tower, 15 Queen's Road Central, Hong Kong Please click **here** to view map

If you would like to attend please click **here** to RSVP.

OUR THOUGHTS ON THE TOOLKIT

In releasing the toolkit, the FSB has emphasised that these tools are not intended to be a “one size fits all” solution for misconduct risk, and that it is up to individual firms and national regulators to decide how to apply the tools. We anticipate domestic regulators will respond to the toolkit by carefully considering whether, and how, to enhance their existing regulation of misconduct risk by incorporating use of these tools. In particular, we anticipate:

- that regulators that have not already introduced senior management accountability regimes will be drawn to the prospect of following the lead of the UK, Australia and Hong Kong in introducing such regimes;
- a renewed, and more data-driven focus by regulators on the culture of financial institutions, building on the work already done in this area by regulators like the UK Financial Conduct Authority (**FCA**) and the Australian Securities and Investments Commission (**ASIC**); and

a new emphasis on deterring "rolling bad apples", by encouraging meaningful information sharing between financial institutions.

Given this, we recommend that financial institutions proactively seek to mitigate conduct risk by considering which of the tools included by the FSB for implementation by firms might be appropriate for their institution, and taking steps to put those tools to use.

IDENTIFYING, MITIGATING AND SUPERVISING POOR CULTURE

The Toolkit identifies seven tools for firms and regulators to use in relation to cultural drivers of misconduct. These seven tools are broadly focused on the role of senior management in setting a firm's culture, as well as the use of data to assess poor culture.

The Toolkit includes three tools for firms to use in identifying and mitigating what it calls "cultural drivers of misconduct":

1. Articulation of a "clear cultural vision" by senior management;
2. Identification of significant cultural drivers of misconduct which conflict with this vision; and
3. Acting to shift behaviour norms to mitigate these cultural drivers.

The Toolkit also includes four tools for use by regulators in assessing firms' management of cultural drivers of misconduct:The Toolkit builds on the work already done by regulators like the FCA, ASIC and Hong Kong Monetary Authority to encourage senior management to "set the tone from the top". However, the Toolkit goes beyond this existing work by encouraging senior management to develop a data and risk driven cultural vision for their firm which specifically addresses the types of misconduct risk inherent to their firm. To this end, the FSB encourages the use of both quantitative and qualitative data to generate this vision, identify drivers of misconduct and methods through which behavioural norms might be adjusted.

1. Building a supervisory programme focused on culture;
2. Using a risk-based approach to focus on reviewing firms which demonstrate significant cultural drivers of misconduct;
3. Using a broad range of information and techniques to assess culture, including

quantitative and qualitative data; and

4. Engaging with senior management with regards to regulators' observations on culture and misconduct.

As noted above, many regulators already proactively engage with firms regarding ways to improve poor culture. For these regulators, the tools outlined by the FSB may lead to a more data-driven approach, but seem unlikely to prompt a significant shift in regulatory focus. However, for those regulators who are yet to focus on culture as a driver of misconduct, it seems likely that the Toolkit may lead to the adoption of such a focus

STRENGTHENING INDIVIDUAL RESPONSIBILITY AND ACCOUNTABILITY

The Toolkit includes several tools focused on strengthening individual responsibility and accountability in order to reduce misconduct. Importantly, the FSB has identified three of these tools as for use by firms and regulators, being:

1. Identifying key responsibilities and clearing assigning them to the holders of specific positions;

2. Increasing individual accountability, through a combination of legislative / regulatory provisions, a firm's internal processes (including employment arrangements), supervisory action and enforcement; and

3. Assessing the suitability of individuals who hold key responsibilities, both at the time they commence in their positions and on an ongoing basis.

In addition to this, the FSB has, importantly, also suggested the development by regulators of a "responsibility and accountability framework". The Toolkit does not prescribe a precise form for this framework, and instead suggests a variety of options which regulators might use to implement such a framework (including, for example, a responsibilities map). However, it seems likely that the inclusion of this framework by the FSB will lead to the implementation of more senior management accountability regimes globally, following the lead set by the UK, Hong Kong and Australia.

ROLLING BAD APPLES

While a number of regulators globally have been focused for some time on bank culture and individual responsibility, comparatively less attention has been paid to addressing the issue of "rolling bad apples". Accordingly, the inclusion of five tools for firms and two tools for regulators in this area in the Toolkit may prove to be one of its most significant contributions.

The FSB encourages firms to introduce a range of measures to reduce the likelihood of hiring a “bad apple”, including communicating conduct expectations early in recruitment processes, enhancing interview techniques to focus on individuals’ behavioural and conduct histories, and leveraging public and private sources of information about candidates. The Toolkit also suggests reassessing employee conduct more frequently (as is already required in jurisdictions with ongoing “fit and proper” requirements) and conducting exit reviews of outgoing employees’ conduct.

The Toolkit also includes two suggested tools for regulators, being increased supervision of firms’ practices of screening prospective employees and monitoring current employees, and providing methods for firms to exchange meaningful information on employees, including by encouraging firms to include information in databases of financial services professionals where these databases exist. Importantly, the FSB has noted that such measures should aim to provide protection against the legal risks (such as breach of employment and / or privacy laws), which often deter meaningful information sharing between financial institutions about employees who have been terminated for misconduct, contributing to the “bad apple” phenomenon.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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