ASIC

Australian Securities & Investments Commission

Keynote address: Regulatory perspective on conduct risk, culture and governance

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Risk Australia Conference (Sydney, Australia)
18 August 2016

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Why ASIC

Thank you very much for having me at your conference again.

You may have been wondering why an ASIC Commissioner is speaking to you today, when the conference agenda is primarily focused on prudential regulatory initiatives. What does a market and conduct regulator like ASIC have to say about, for example, fundamental review of the trading book or the leverage ratio?

Taking a step back, ASIC does care about the outcomes of regulatory reform initiatives. Not just because many of the firms that are Australian Prudential Regulation Authority (APRA) stakeholders are also ASIC stakeholders.

ASIC is a market and conduct regulator. From this 'lens' – and the lens of financial services entities having a 'social licence' – we care about how the banks, sell-side entities and market infrastructure operators will serve their clients, both wholesale and retail. We care about how firms and market infrastructure operators will provide their services, including through their role in our capital markets. We care about whether the way these services are provided will continue to promote the fair and efficient functioning of our financial markets and economy. And, we care about facilitating change, innovation and new technology, if that would promote these objectives.

What I would like to talk to you about, in this keynote address, comes from this perspective. The themes I will touch on are:

- technology and regulatory technology (regtech)
- why governance, culture and conduct matters when firms are implementing major reforms, and
- what governance and culture means for your business.

Regulatory reform and technology

From our own experience we know that implementing new, often complex, pieces of regulation presents real challenges for firms. Firms need to meet a number of deadlines. These often require system changes or new system builds. New system development needs to fit in with existing – or legacy – systems. More and more, regulatory initiatives require firms to retain, and be able to make sense of, large volumes of information. In particular, firms are under greater pressure to retain and make sense of large volumes of data, both structured and unstructured, from different parts of the firm's business.

From ASIC's side, we are undergoing our own journey with data from over-the-counter (OTC) derivatives trade reporting.

Since we have started receiving reported data for OTC derivatives, we have been undertaking quite an ambitious project to analyse that data and incorporate it into our everyday work. We are working on using data to:

- detect anomalous trading activities, including activities that are related to on-exchange trading
- support investigations into potential market misconduct, and
- paint a picture of behavioural trading patterns over extended periods of time. On this last point, we would like to use that information to assess market quality and inform future policy formation.

In the future, we would like to use data analytics to better inform and target our surveillance and enforcement activities for example, by:

- using data analytics to build a 360 degree view of regulated entities, or
- changing, or making more effective, the way we collect surveillance and compliance data from regulated entities.

Why governance, conduct and culture still matters

But rather than talk about data or trade reporting first thing in the morning, I would like to talk to you about how regulatory reforms may change firms' businesses, and how firms service their clients. In doing so, I am drawing a link between the focus of the topics at this conference, and a topic that is dear to ASIC's heart – culture, conduct and governance.

At this point you may be asking:

- Why should we consider governance and conduct when implementing regulatory reform?
- Does culture matter when we are ‘in the weeds’ of reform implementation?

Regulatory change, system builds and innovation can change the structure or nature of the compliance function. Technology is not just a tool that will allow firms to continue to operate as they currently do. Technology – and system change – can also be a catalyst for further change.

As financial services firms and market participants, you are no stranger to the dynamics of change – competition can drive innovation, which drives further change. I think a parallel can be drawn with large regulatory reform projects, or the adoption of regtech.

And that’s where, I think, attention should come back to the human element. Technology, calculators, dashboards do not replace the human actor in the firm. Technology and other tools can be used to simplify, automate, reduce operational risk, and deepen insight into a whole range of areas. But, particularly when it comes to governance and compliance, they do not replace the need for humans to make decisions about risk management, how the firm treats its clients, and how your firm complies with regulation day to day.

As such, I’d like to pose some questions for you as you are navigating your way through reforms that can be very focused on numerical measures and outcomes. My questions are:

- Implementing regulatory reform can mean changing how things are done in the business, and that can flow through to how the performance of salespersons and traders are measured. Do these changes also create new or different behaviour incentives and, if so, what kind of behaviours are incentivised?
- If changes in systems and technology, financial targets or even processes create different behaviour incentives, are these incentives the right ones and are the wrong incentives being mitigated? Has the firm also reviewed its monitoring, governance and conduct controls to target the wrong kind of behaviour?
- From the perspective of both staff and supervisors, are people encouraged to do the right thing and call out the wrong kind of behaviour?

What is culture and conduct?

Culture is a concept that we, at ASIC, talk about a lot. Culture reflects the underlying ‘mindset of an organisation’. It directs how an organisation and its staff think, make decisions and actually behave. Poor culture can be a driver of poor conduct. In a financial services firm, culture is an important driver of outcomes for investors and financial consumers.

Firms should also be interested in culture because many studies have found that good culture is good for business and generating long-term shareholder value.

Poor culture, on the other hand, can lead to misconduct and result in significant financial costs, including the cost of remediation, compensation and fines, as well as failing to attract and retain staff. Not to mention, the costs associated with damaging a business's brand and reputation.

It's not just ASIC who is focusing on culture and conduct. APRA has been examining firms' risk culture as one part of overall organisational culture. Other overseas regulators are adding culture into their supervisory programs. Last year, Christine Lagarde, the head of the International Monetary Fund (IMF), also spoke about ethics, culture and behaviour in the financial industry.

APRA hosted a visit from the Dutch prudential regulator recently, and kindly arranged for De Nederlandsche Bank N.V. (DNB) to speak to us about their work on conduct and culture. Two points from their presentation particularly resonated with me and with the work ASIC is doing on culture:

- First, what are the indicators of an immature risk culture that regulators should look for? In particular, the DNB called out firms that neglected the human factors and placed an over reliance on models and dashboards.
- Second, the importance of seeing teams as social systems – what is it about some systems that trigger or cultivate particular behaviours? What is the human element in everyday decisions about behaviour and how to comply with rules and policies?

To me, that says technology and supervisory tools do not replace the need for an experienced business leader or compliance professional, but are only aides to do these jobs.

Examples from ASIC's current work

Let me give you some examples that came to mind during our discussions with DNB from ASIC's experience 'on the beat'.

ASIC's confidential information report

ASIC recently published Report 486 *Sell-side research and corporate advisory: Confidential information and conflicts*. In doing the groundwork for this report we found a number of inconsistent practices in how conflicts are managed, including a lack of research independence and inadequate separation of research and corporate advisory activities. We also found that it is common among mid-sized firms for staff to receive allocations and trade in securities of companies the firm is managing a capital raising for, which is of obvious concern to us.

Some other examples of poor practices we have observed include:

- Client bids being scaled back in well-supported capital raising transactions to allow for staff participation. In one case, an initial public offering that was heavily oversubscribed saw client bids being scaled back to allow for the firm's own staff to participate.
- Corporate advisory staff trying to influence their research team to cover particular companies or to adjust their approach to valuation. For example, trying to influence the profit margins used in preparing prospective financial information in a research report.

- Staff marketing research on companies to clients with a ‘buy’ recommendation while simultaneously selling their own personal shareholdings in the company.
- Companies being selected by firms for research coverage or corporate business, when senior staff at the firms held shares in the companies (which can increase the risk of these firms using ‘pump and dump’ strategies).
- Poor or non-existent practices for the approval and monitoring of staff trading. For example, staff with knowledge of research coverage decisions trading ahead of, or contrary to, their research recommendations.

In some of these cases, the structure of the firms contributed to these poor practices, including inadequate physical and technological separation, remuneration models, and reporting lines that may encourage inappropriate behaviour.

We intend to follow up this report with industry consultation on proposed guidance to ensure good research practices are followed. And, as always, if we think there has been conduct that has breached the law, we will consider whether to pursue enforcement action.

While these examples are focused on equities and equity capital market businesses, I hope you can see that a poor firm culture and remuneration structures can give rise to poor conduct and non-compliance.

Conduct risk survey

We are currently completing a survey of market participants on conduct risk. This survey look at how firms are actually reflecting the firm’s values in policies, business practices and governance structures.

We think this is really important. Otherwise, messages about firm values and good conduct may not be adequate to change behaviour. For example:

- new and junior staff often interpret rules based on what they learn as acceptable conduct from their managers and colleagues – and the attitude of their managers and colleagues towards compliance, and
- if staff see that the top performers are successful despite, or even because of, poor conduct, then the behaviour incentives may be at odds with the firm’s values.

We plan to give private feedback to the firms that took part in the conduct risk survey. But to give you an early overview, we are seeing that:

- Firms are implementing frameworks to address conduct risk. However, some have not yet distinguished conduct risk from other risk areas, such as operational risk.
- A number of firms have scope to strengthen their arrangements to identify and monitor material conduct risk takers – these are the people whose remuneration is performance-based and whose actions can affect an entity’s Australian financial services (AFS) licence.
- Some firms have policies dealing with detecting misconduct and communicated the consequences of misconduct clearly. Others showed gaps in these areas.

Diversity

In addition to formal policies and tools, it is also important to have a culture that encourages staff to call out undesirable behaviour incentives. From ASIC's work on diversity in our own organisation, I think that fostering a diversity of perspectives in the firm can contribute to this kind of culture.

If we spend most of our working lives specialising in a particular area, we can become used to looking at information in a certain way. Having diversity of thought and perspectives throughout an organisation, including at the executive and board level, can help to challenge these established views. This can help to identify issues so they are not neglected – which can contribute to sound risk management and compliance.

Summary

I hope what I've just said helps to explain why we think governance and conduct are live questions relevant across a range of businesses. And that is why I ask you – as your firms undertake reform implementation programs – to not forget the 'softer' indicators and risks around governance and conduct.

What does this mean for the firms?

Since culture is not something that can be easily measured, we have had questions from businesses about what the regulators' expectations are. But I'd like to put the question back to you.

ASIC is a principles-based regulator, we do not see it as the appropriate role for a regulator to tell you how to structure your business. Rather, it is for businesses to come to a view about their business structure and how it fits into the current environment.

At the start of this talk, I referred to firms being required to comply with quite complex pieces of regulation. For example, enhanced reporting or record-keeping requirements.

Many firms are looking at technology – particularly regtech – to help them better manage regulatory change and comply with regulatory requirements. Regtech is 'a sub-set of fintech [financial technology] that focuses on technologies that may facilitate the delivery of regulatory requirements more efficiently and effectively.'

We know some firms are being nimble and forward-looking, seeing these new technologies as an opportunity to improve the efficiency of their businesses and improve risk management. For example:

- Firms are improving their record-keeping arrangements, including recording of pre-trade emails, chats and phone calls. While some firms are doing the minimum necessary to comply, others are embracing this opportunity to improve their internal monitoring or their ability to respond to inquiries.
- Better capture of trade information, including execution prices for voice brokered and request for quote (RFQ) trades, may allow firms to demonstrate the ability to

model certain risk factors – and to determine the amount of capital that firms will be required to hold.

At ASIC, we are very interested in the potential offered by technology and innovation, and are collaborating with our peer regulators, including the UK Financial Conduct Authority (FCA) and the Monetary Authority of Singapore to facilitate fintech innovation.

In this environment, perhaps 'how does ASIC expect a firm to structure its business?' is not the right question, because those questions may only deal with the here and now. Instead, we can make this question more forward-looking by going back to the fundamentals, by asking 'how do you apply and comply with your AFS licence obligations?'

The obligations have always been there – to provide the financial services covered by your AFS licence honestly, and fairly, and effectively; and to adequately manage/avoid conflicts of interest. What these obligations mean are always intended to depend on the nature, scale and complexity of your business. That is, ASIC does not take a 'one-size-fits-all' approach to regulation. Instead, we acknowledge that what you need to do to comply with your obligations will vary according to factors such as:

- the products and services you provide
- the diversity and structure of your operations
- how many of your clients are retail versus wholesale, and
- the number of people in your organisation.

Trust and confidence

Going back to the concept of a social licence, having good culture and ensuring good conduct is about building trust and confidence in our financial institutions.

As we have said a number of times already – it can take a long time to build up investors' trust and confidence. The same trust and confidence can be lost very quickly when there is misconduct, and can take even longer to restore.

ASIC considers building trust and confidence to be a joint exercise between the official sector and industry.

As part of the official sector, the question for the regulator is:

- What is a sustainable business environment that will support fair, orderly and efficient financial markets that serve our economy, and protect our investors and financial consumers?
- In that context, what is the right regulatory framework?

And, for industry, the question is how will you use this framework to deliver trust and confidence for our investors and financial consumers? In the context of this conference, the questions may be:

- Has introducing a new system or process affected your governance and reporting arrangements, or the effectiveness of your supervisory arrangements?
- Whether new systems or processes have created new or different conduct incentives and, if so, what kind of incentives?
- Will any of these changes in governance and conduct incentives create new issues and/or risks to monitor?

Martin Wheatley, the former head of the FCA, spoke of the importance of business leaders not just asking is ‘a product or strategy legal’ but also ‘is it right’? While practices can evolve with the business and regulatory environment over time, these basic questions remain the same.

Conclusion

In conclusion, it has been a busy few years for the financial sector with regulatory reform and the changing dynamics of competition. And, given the agenda of today’s conference, this may be the case for a while longer.

During this period of change, ASIC’s focus is still on investor trust and confidence in our financial markets so they can continue to play a vital role in funding our economy.

For this reason, it is important to focus on governance, conduct and culture while an organisation is undergoing change and implementing significant regulatory reform. We know implementation tasks often require fundamental changes to technology and operations but, please remember, these changes will likely affect the way your firm does things and so has broader cultural implications.