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3 September 2020

To: All market intermediaries

Conduct risk management: Supervision of market intermediaries

Our supervisory review of market intermediaries' conduct risk management has highlighted a number of better and poorer practices. Like all non-financial risks, *conduct risk*[1] should be actively identified and monitored by senior management. Boards also need to exercise active stewardship in their oversight of conduct risk. Where oversight and management of conduct risk is not well managed, it can lead to significant reputational and financial consequences for the intermediary.

Approach to assessing conduct risk management

We undertook supervisory reviews of five market intermediaries with a significant presence in securities markets. We assessed the extent to which their approach to managing conduct risk was professional and robust by looking at how they:

1. proactively identified conduct risk
2. encouraged accountability for conduct across all areas of the firm
3. supported staff to improve conduct
4. oversaw conduct risk.

We consider there are four key drivers of culture which market intermediaries can manage to influence positive conduct:

1. leadership and professionalism
2. governance and individual accountability
3. performance and consequence management
4. conduct and culture training.

The board and senior management of market intermediaries must shape and cultivate a positive conduct culture in their firms – one which promotes a culture of good behaviour, ethics and constructive challenge, and has zero tolerance for poor conduct. Individuals at all levels should

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[1] *Conduct risk* is 'the risk of inappropriate, unethical or unlawful behaviour on the part of an organisation's management or employees': see p. 9 of Report 631 *Director and officer oversight of non-financial risk* (REP 631).

feel responsible and be held accountable for their own conduct. There should be a clear framework for recognising and rewarding good conduct and denouncing poor conduct.

The board and senior management should be mindful of their duties when monitoring and overseeing all non-financial risks, including conduct risk. In REP 631, the boards ASIC reviewed found managing important elements of non-financial risks challenging, and their oversight was less mature than required. This resulted in instances of systemic and significant misconduct.

If conduct risk is not managed appropriately, breaches of Australian financial services (AFS) laws may occur. See the appendix for a summary of some of the relevant legislation and the culture drivers that affect compliance.

Poorer practices

Our supervisory reviews indicated that some firms had a more professional and robust approach to managing conduct than others. Examples of poorer practices included:

1. inadequate distinction between conduct risk and operational risk controls
2. instances where conduct did not appear to inform individual performance outcomes and remuneration
3. limited influence of the compliance function in decision-making processes that considered conduct breaches
4. failure to firmly embed conduct and culture training in regular training schedules for existing staff.

Better practices

Some of the better practices we observed for managing conduct risk may help market intermediaries meet their regulatory obligations.

1. Leadership and professionalism

Board and senior management play a crucial role in creating and driving a positive culture, including by ensuring competence and conscientiousness (i.e. the professionalism) of staff. For example:

1. Senior management directly leads and monitors the implementation of any conduct risk management initiatives and frequently reports to the board.
2. The board exercises active stewardship in their oversight of conduct risk. This includes holding senior management to account when the market intermediary operates outside the board's stated risk appetite by:
    a. challenging actions and timeframes proposed by senior management to resolve conduct issues
    b. requiring analysis of material or recurring conduct breaches to identify the root cause
    c. overseeing the consequences that apply to identified conduct breaches.
3. All staff are held responsible for their conduct and must adhere to internal policies and procedures (e.g. Code of Conduct).

2. Governance and individual accountability

There should be well-established and documented frameworks for managing conduct risk, including accountability at all levels of a firm. For example:

1. Use of risk appetite statements by board and senior management to assist monitoring and oversight of conduct risk. Development of reporting to track culture and conduct risk.
2. Clear delineation between global and regional risks for conduct and culture, and local risks in Australia. Local risk metrics are scoped to the conduct arising from the intermediary's financial services operation in Australia and the board's stated appetite.
3. Management of conduct risk across all three lines of defence and at all levels, including ownership by Line 1 responsible managers to encourage individual staff accountability.
4. There should be a consistent approach for escalating and reporting conduct breaches. Governance frameworks that outline how conduct breaches that are significant breaches of AFS law are brought to the attention of senior management and the board, and are reported to ASIC in a timely way. Specific conduct risks are also defined with consideration of real-life examples.
5. Direct engagement and influence of the compliance function in performance and consequence management decisions of conduct breaches.

3. Performance and consequence management

Embedding key performance indicators in a clear and established performance, remuneration and consequence framework is used by some intermediaries to incentivise good conduct and compliance. For example:

1. Performance rating documents and dashboards contain key indicators for good conduct and compliance.
2. Career progression is contingent on positive conduct and compliance outcomes.
3. Where an employee has demonstrated poor conduct and compliance, disciplinary action includes a freeze on potential promotions for a period.
4. Employees are made aware that conduct and compliance breaches will result in a downward adjustment to their remuneration through:
   a) discussion with employees of the specific breaches that affected their remuneration, and/or
   b) specification of the dollar or percentage amount the employee's remuneration was reduced by because of any conduct and compliance breaches.
5. There are both individual and divisional team consequences for conduct matters.
6. There are clear criteria to determine appropriate and consistent consequence management outcomes for conduct breaches.
7. Good conduct and compliance is publicly acknowledged outside the performance review cycles.

4. Conduct and culture training

Most of the market intermediaries we reviewed had mature mandatory conduct and culture training programs for all employees. For example:

1. Where market intermediaries rely on a global conduct risk framework and training program, training is tailored by country to ensure local regulatory obligations are clearly set out and understood.
2. Face-to-face training provided to Australian employees is also delivered at the same time to overseas-based employees who provide services to Australia (time zone permitting).

3. Conduct and culture training and messaging are ongoing. Training is focused on both new starters and existing employees and goes beyond a yearly employee declaration.
4. Real-life examples of employee misconduct are used as case studies in conduct and culture training.

Next steps

While these observations are drawn from a sample of securities market intermediaries, we encourage all market intermediaries to consider them in the context of their own business and practices.

As part of our proactive supervision approach, we will select additional firms to periodically test how market intermediaries are operating against the four key culture drivers. We will also continue to engage with market intermediaries to gather information on market trends, identify risks, and monitor changes in governance and individual accountability practices.

To ensure market intermediaries meet their regulatory obligations and implement appropriate and timely remedial action to address any non-compliance, we will take further action where necessary and appropriate.

Appendix: Summary of relevant provisions of the Corporations Act and ASIC market integrity rules and the culture drivers that affect compliance

Legislation	Requirement	Culture drivers
AFS licensee obligations **(s912A)**	An AFS licensee must: • do all things necessary to ensure their financial services are provided efficiently, honestly and fairly • comply with financial services laws and take reasonable steps to ensure their representatives do likewise • have adequate compliance arrangements • have adequate resources, be competent, and ensure that representatives are adequately trained and supervised.	• Leadership and professionalism • Governance and individual accountability • Performance and consequence management • Conduct and culture training
Significant breach reporting **(s912D)**	An AFS licensee must notify ASIC within 10 business days of a significant breach or likely significant breach of their obligations under s912A (including their licence conditions), or AFS laws.	• Governance and individual accountability
Directors' and officers' duties (s180–184)	Directors and officers have duties to act: • with due care and diligence • in the best interests of the corporation • for a proper purpose. To discharge their duties, directors must take necessary steps to enable them to guide and monitor management of the organisation.	• Governance and individual accountability
ASIC Market Integrity Rules (Securities Markets) 2017	Part 2.1 management requirements: • management structure (Rule 2.1.1) • supervisory procedures (Rule 2.1.3) – see Regulatory Guide 265 *Guidance on ASIC market integrity rules for participants of securities markets* at 265.62 – RG 265.113 • unprofessional conduct (Rule 2.1.5) and responsibility for individuals involved in the business (Rule 2.1.6). Part 2.3 supervisory staff: • ongoing responsibilities of market participants in relation to supervisory staff (Rule 2.3.2).	• Leadership and professionalism • Governance and individual accountability • Performance and consequence management • Conduct and culture training
ASIC Market Integrity Rules (Futures Markets) 2017	Part 2.2 supervision and risk management: • prohibited employment (Rule 2.2.3) • supervisory procedures (Rule 2.2.8).	• Leadership and professionalism • Governance and individual accountability • Performance and consequence management • Conduct and culture training