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BITE-SIZE
BRIEFINGS

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A series of briefings that take a "bite-size" look at international trends in different jurisdictions, drawing on Baker McKenzie's expert financial services practitioners.

Culture & Conduct

This edition takes a bite-size look at culture as a means to tackle conduct risk across a number of jurisdictions, namely Australia, Hong Kong, Singapore, the United Kingdom and the United States. In recent years, there has been an increased focus on the importance of culture within financial institutions as a means of reducing conduct failings and better serving customers. Conduct risk represents systemic sectoral risk exemplified by LIBOR rigging, consumer product mis-selling and continuing money laundering scandals. In the light of the COVID-19 pandemic, with stressed markets and new working practices, regulators globally are paying special attention to this topic.

Australia

Conduct and culture remain a key focus for regulators in Australia in 2020. The fallout from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has continued with ongoing enforcement action against numerous financial institutions. These have resulted in multiple board member changes in the larger financial institutions, repayments to consumers of improperly charged fees, civil penalties and criminal charges against individuals. A number of enforcement actions have been brought in relation to anti-money laundering (AML) failures with record fines imposed by the relevant regulator in Australia, AUSTRAC. There are also investigations being led by the Australian Securities & Investments Commission (ASIC) (together with the Australian Prudential Regulatory Authority having delegated its powers to ASIC in order to combine its investigation) into potential breaches of the Banking Act (including the Banking Executive Accountability Regime (BEAR)) and the Corporations Act by the board of directors.

This year has also seen multiple proposals on how to increase the accountability for culture and conduct of senior management in the financial industry. Early in 2020, reflecting a commitment made by the Australian Government to act on certain key recommendations from the Royal Commission, a consultation was released by the Australian Treasury regarding the proposed extension of the BEAR regime to all APRA regulated entities and to provide joint administration to ASIC pursuant to the Financial Accountability Regime (FAR), as it will be known. Similar to the BEAR, FAR will impose accountability obligations on firms and individuals, require the preparation of accountability maps and

accountability statements, impose notification obligations and require deferred remuneration rules. The consultation process and draft legislative framework for FAR have been delayed by the impact of COVID-19 and will now likely be the subject of considerable review and discussion in 2021.

Looking outside of financial services and corporate conduct more generally, in March 2020 the Legal and Constitutional Affairs Legislation Committee published its report recommending that the Crimes Legislation Amendment (Combatting Corporate Crimes) Bill 2019 (Cth) be passed by the Australian Senate. The Bill would amend the Criminal Code 1995 (Cth) and Director of Public Prosecutions Act 1983 (Cth), and would bring Australia more in line with the regimes to combat corporate crime in the United Kingdom and other jurisdictions. The key elements of the Bill are to:

- Introduce a new offence of failure of a body corporate to prevent foreign bribery by an associate; and
- Implement a Commonwealth deferred prosecution agreement scheme.

The Australian Law Reform Commission (ALRC) has also released its final report on Corporate Criminal Responsibility making multiple recommendations aimed at simplifying or standardising the law, which currently involves over 3,000 corporate misconduct offences in 25 Commonwealth statutes. Whilst the interactions between the ALRC report, the FAR consultations and further actions by the Australian Government following the Royal Commission are yet to be seen, it is evident that the shake-up of corporate culture and conduct will continue for some time in Australia and continue to be a significant area to watch as reform unfolds.

Hong Kong

Hong Kong's financial services regulatory regime is industry or service-based and there is no single super-regulator. The regulatory status of an institution (e.g., bank, stored value facility operator, financial intermediary or insurance company) determines which regulator will have primary responsibility for overseeing its activities from both a prudential and a business conduct perspective. The principal regulators for each sector are as follows:

- Hong Kong Monetary Authority (HKMA): The principal prudential regulator and supervisor of banks and deposit-taking institutions, including virtual banks (commonly referred to as Authorized Institutions or AIs for short), in Hong Kong under the Banking Ordinance. The HKMA is also Hong Kong's de facto central bank and is responsible for maintaining monetary and banking stability.
- Securities and Futures Commission (SFC): Responsible for regulating the securities and futures markets in Hong Kong and the principal supervisor of intermediaries (e.g., brokers, investment advisers and fund managers), which carry out regulated activities under the Securities and Futures Ordinance.

Notwithstanding the challenges of 2020, a continued focus by the HKMA and the SFC on conduct and culture has been evident through measures including speeches to industry bodies, releasing a report of the results of self-assessments into culture by financial institutions, commencing consultations on a proposed new code of practice for trust business activities and proposing further combined thematic reviews. Whilst the HKMA and SFC have continued to rank management of conflicts of interests and spread charge arrangements as top priorities, it is clear that there will continue to be a multi-faceted focus on culture and conduct by both regulators into 2021.

Report on Review of Self-assessments on Bank Culture

In 2017, the HKMA launched a reform of bank culture through the promotion of a three-pillared framework of governance, incentive systems and assessment and feedback mechanisms — see here. The reform was aimed at:

- Encouraging banks to develop a sound corporate culture supporting prudent risk management;
- Incentivising proper staff behaviours leading to positive customer outcomes and high ethical standards in the banking industry; and
- Having banks put the interests of depositors and customers in addition to safety and soundness at the centre in the pursuit of commercial interests.

In 2018, the HKMA launched the supervisory measures through which these aims were to be achieved by AIs; namely self-assessment, focused review and culture dialogues. In May 2020, the HKMA published its Report on the Review of Self-assessments on Bank Culture, reflecting the findings from a self-assessment programme commenced in 2019 involving 30 banks (including all major retail banks and selected foreign bank branches with substantial operations in Hong Kong). The participating banks were required to conduct self-assessments on their culture-enhancement efforts and benchmark themselves against the findings of major conduct incidents outside of Hong Kong. The review process identified several common themes to which the HKMA encourages more attention be given by AIs as follows:

- Further work is needed to ensure incentive systems are designed to promote sound culture and prevent incidents of misconduct.
- Stronger links are required to connect Hong Kong operations with the culture efforts of headquarters or upstream entities as well as downstream operations, as appropriate.
- Deeper analysis is expected to benchmark themselves against the findings from reviews of major overseas misconduct incidents.
- More focus is needed to facilitate the undertaking by relevant staff of continuous professional development under the Enhanced Competency Framework or by other professional bodies to complement the effort of promoting sound culture.
- More effort is needed to tackle the key challenge of culture assessment to identify the gaps between the current progress and the desired culture.
- More work is needed in promoting an environment that provides "psychological safety" to encourage staff to speak up without fear of adverse consequences.
- Sustained effort is required in driving cultural changes and banks should be mindful of "culture fatigue."

The HKMA has indicated that while there is no "one -size-fits-all" approach, the key observations are relevant to all AIs and those not originally included in the review process are expected to consider the key observations. The HKMA has also indicated that it will conduct further focused reviews into the incentive systems of front offices in the business of distributing banking, investment and/or insurance products in retail banks. AIs engaging in those activities will need to consider these areas in detail as they may otherwise present potential areas for future enforcement action.

Singapore

In Singapore, actions taken by the Monetary Authority of Singapore (MAS) in the past two to three years highlight the financial regulator's continuing focus on culture and conduct among financial institutions. These actions range from the thematic inspections on incentive structures in 2018 and thematic reviews of culture and conduct in banks, insurers and capital markets intermediaries, to the formation of new culture and conduct industry steering groups to elevate culture and conduct among banks and insurers in 2019, and most recently the issuance of new individual accountability guidelines in 2020.

The MAS recognises culture, generally understood as "the shared values, attitudes, behaviour and norms in an organisation," as a key driver of conduct. On conclusion of the recent thematic review of banks, insurers and capital market intermediaries, MAS released an Information Paper: Culture and Conduct Practices of Financial Institutions, which sets out its approach towards culture and conduct.

MAS adopts a three-prong approach in culture and conduct to: (1) promote and cultivate; (2) monitor and assess; and (3) enforce and deter. Ultimately, it seeks to achieve two key objectives on culture and conduct in financial institutions:

- Ethical business practices to safeguard customers' interests and ensure fair treatment; and
- Prudent risk-taking and robust risk management to support financial institutions' safety and soundness.

Recognising that rules and regulations alone are insufficient to build and maintain a sound organisational culture, MAS requires the industry to go beyond doing what is required legally, to do what is right and ethical. Therefore, under the first prong, MAS engages institutions in regular dialogue to cultivate mindshare and awareness, understand operational challenges and share good practices, and collaborates with industry associations to promulgate best practices and guidelines. Under the second prong, MAS monitors and assesses a business' culture and conduct as part of its pre-emptive ongoing supervision. As a regulator it goes beyond a financial institution's frameworks, policies and procedures (i.e., the "hardware"), to focus on the values, attitudes and behaviour of the board, senior management and staff (i.e., the "software"). Finally, under the third prong, where lapses in risk management, misconduct, regulatory breaches or offences occur, MAS takes supervisory or enforcement action against institutions and individuals.

The Information Paper provides examples of good practices that financial services businesses can adopt, as well as setting out a number of outcomes that MAS expects from firms:

- **Governance**: The financial institution's board and senior management should have a holistic view of and proactively shape its culture. It should also identify and empower staff who are responsible for driving culture and conduct.
- **Hiring and on-boarding**: The financial institution incorporates culture and conduct considerations in its hiring process and training programmes.
- **Communication and feedback channels**: The financial institution cultivates psychological safety to foster a safe environment for staff to provide feedback and raise concerns. Its board and senior management communicate tone from-the-top and walk the talk.
- **Monitoring and assessment**: The financial institution considers culture drivers and conduct risk as part of its risk management framework.

- **Internal audit**: The financial institution incorporates assessments of behaviour and culture as part of its internal audit.
- **Performance management and incentive systems**: The financial institution has incentive structures that promote prudent risk-taking and ethical behaviour. MAS expects businesses to refer to the Information Paper on Incentives Structures in the Banking Industry for details of outcomes that MAS expects to see in all financial institutions (including non-bank FIs) to foster sound behaviour and conduct.
- **Individual accountability**: The financial institution holds senior managers accountable and ensures proper conduct among all employees. MAS expects all institutions to adopt the specific guidance and achieve the five outcomes set out in the Guidelines on Individual Accountability and Conduct (Individual Accountability Guidelines) to promote clear accountability and proper conduct.

The Individual Accountability Guidelines require financial institutions to achieve the following outcomes:

- Clearly identify senior managers who are responsible for managing and conducting their core functions.
- Ensure senior managers are fit and proper for their roles, and held responsible for the actions of their employees and the conduct of the business under their purview.
- Have in place a governance framework that supports senior manager's performance of their roles and responsibilities, with a clear and transparent management structure and reporting relationships.
- Ensure Material Risk Personnel (MRPs) are fit and proper for their roles, and subject to effective risk governance, and appropriate incentive structures and standards of conduct. MRPs are employees with authority to make decisions or conduct activities that can significantly impact the financial institution's safety and soundness, or cause harm to a significant segment of its customers or other stakeholders.
- Adopt a framework that promotes and sustains the desired conduct among all employees.

To better understand MAS' approach to investigations into financial services misconduct, financial institution should also refer to MAS' latest Enforcement Report, which summarises enforcement action taken in key areas of focus:

- Mis-selling of financial products;
- Breaches of business conduct rules; and
- Serious unfitness or impropriety.

MAS also adopts proactive surveillance to detect financial advisory misconduct in regulated payment services, such as virtual asset service providers, e.g., data analytics, over a wide range of public datasets.

United Kingdom

Although there is no "one size fits all approach," the Financial Conduct Authority (FCA) defines culture "as the habitual mind-sets and behaviours that characterise an organisation." Its 2020-21 business plan, in the context of supervision, talks about how culture shapes outcomes for consumers and

markets and why, therefore, its emphasis is on four key drivers in firms: their leadership, governance, purpose and approach to managing and rewarding employees. As discussed in our July 2019 edition, regulators in a number of financial centres are using new individual managerial accountability regimes (in the United Kingdom, the Senior Managers and Certification Regime) to promote good cultures that support fair customer outcomes.

With the onset of COVID-19, there was much concern that financial institutions might down play the importance of culture against a backdrop of emerging conduct risks, for example, in light of stressed market conditions and widespread home working giving rise to practical challenges of supervising market and client-facing staff. In other words, it would be relegated to a "nice to have." In fact, a more complex and varied picture appears to have emerged. On the one hand, anecdotally, many businesses appear to have "doubled-down" on facilitating healthy cultures as an enabler to reducing conduct risk to bring them through the crisis. On the other hand, there has been some concern from the FCA that extended home working has led to the loss of "watercooler moments" — informal social settings which facilitate the exchange of ideas and views among employees and, through this exchange, give rise to opportunities for grassroots culture challenge. It is, of course, only early days and further extended periods may yet put the strength of institutions' cultures to the test.

There is not always agreement on whether culture can be measured, but there is consensus to the effect that culture exists and its role in ensuring the financial sector serves the needs of its customers. While its importance was recognised coming out of the 2008 financial crisis, it has only been in the last few years that supervisors (and financial institutions) have sought to use it systemically as a tool. The FCA has facilitated a number of "CultureSprints" or workshops, published discussion papers, including DP 20/1 on Transforming Culture in Financial Services, which through a series of essays from industry leaders explores culture, including behavioural issues, and the part they play in reducing potential harm.

Most recently in September 2020, the FCA shared feedback obtained from wholesale banks through its 5 Conduct Questions programme, which seeks to help firms identify and manage conduct risks by posing a set of five simple questions on their conduct and culture programmes:

- what proactive steps they take to identify the conduct risks inherent within a business;
- how they encourage individuals to feel and be responsible for managing the conduct of their business;
- what support is provided to staff to improve the conduct of the business;
- how senior management oversee the business and consider the conduct implications of their strategic decisions; and
- if the firm assesses whether its other activities could impede efforts to improve conduct.

Financial institutions should pay attention to these questions, as they are central to how the UK conduct regulator supervises them. One motivation for seeking industry feedback is to avoid a multiplicity of expensive change management programmes by sharing knowledge of what does and does not work; a form of benchmarking. As the title of this year's feedback suggests, namely "Messages from the Engine Room," in contrast to earlier years, instead of speaking to CEOs, the FCA approached the equivalent of vice-presidents — the pool of future senior management — to not only get more of a "coal-face" view, but also to engage and enlist this future generation to the cause. More needs to be done. One finding, for instance, found that the depth of understanding and the ability to identify conduct risk remains unacceptably weak.

Perhaps most significantly, the report introduced an additional element in operationalising conduct and culture change beyond "tone from the top" to also include "tone from within." This approach represents one's individual mind-set, preferences, beliefs, habits and predispositions, and focuses not on how senior management or line managers might respond to a particular situation, but instead on how the individual might respond themselves. It includes reflections on how, where and why their instincts might differ from their peers or senior management. It is also clear that in the dispersed working environment arising from COVID-19 organisational arrangements, the "tone from within" approach is increasingly important.

The United Kingdom regulator says it will continue its dialogue with the sector while emphasising the regulatory obligations on firms around culture and conduct, where merely putting in place policy and process is insufficient.

United States

In the United States, the financial regulators have long recognised that the "tone from the top" is critical in shaping a culture of compliance, ethics, and risk management within financial institutions. More recently, however, the U.S. Securities and Exchange Commission (SEC) has used its rulemaking, examination, and enforcement authority to encourage a "bottom up" approach designed to ensure that the activities of financial institutions and their personnel are aligned with the best interest of clients and shareholders.

In its 2020 examination priorities, SEC staff recognised that "a commitment to compliance from C-level and similar executives to set a tone from the top that compliance is integral to the organization's success and that there is tangible support for compliance at all levels of an organization" is the most important hallmark of an effective compliance culture. In 2016, the Financial Industry Regulatory Authority formalised an assessment designed to evaluate firm culture and to better understand how firm culture affects compliance and risk management. FINRA's assessment focused on whether:

- Control functions are valued within the organization;
- Policy or control breaches are tolerated;
- The organization proactively seeks to identify risk and compliance events;
- Immediate managers are effective role models of firm culture; and
- Sub-cultures that may not conform to overall corporate culture are identified and addressed.

While the tone from the top will always be important, within the last couple of years, the SEC has focused more on managing conflicts of interest and adopting rules that require alignment between the interests of financial institutions and their clients. This approach is perhaps best reflected in the adoption and implementation of Regulation Best Interest (Reg BI), which establishes a standard of conduct that applies to broker-dealers and their representatives when providing advice to retail investors. Reg BI, which was effective on 30 June 2020, includes a general obligation under which a broker-dealer making a recommendation to a retail customer must act in the retail customer's best interest and cannot place its own interests ahead of the customer's interests. A parallel SEC interpretation of the standard of conduct for investment advisers (Adviser Interpretation) that was adopted at the same time as Reg BI also reiterates the fiduciary duty that prevents investment advisers from putting their own interests ahead of their clients. Although the SEC did not define the term "best interest," Reg BI and the Adviser Interpretation emphasise the importance of identifying conflicts of interest and disclosing or eliminating those conflicts — particularly financial incentives

(including sales contests, sales quotas, bonuses, and non-cash compensation) that may cause a broker-dealer or investment adviser to make a recommendation that is not in the best interests of the customer or client.

In light of the global pandemic, there was debate (and some wishful thinking) that the SEC might extend the 30 June 2020, implementation date of Reg BI due to the severe dislocation and redeployment of internal resources caused by COVID-19. However, rather than scrutinising culture and conduct during the global pandemic, the SEC continued to concentrate on investors. The Chairman of the SEC declined to extend the compliance date beyond 30 June 2020, for a number of reasons including the fact that the market volatility, economic downturn, complex products, and increase in fraudulent activity caused by COVID-19 emphasised the need for recommendations based on the best interest of clients. We expect the SEC staff to continue to actively examine financial institutions that are subject to Reg BI and the Adviser Interpretation to ensure that they have established policies and procedures reasonably designed to achieve compliance and to meet their obligations to investors.

On the public company side, we have seen the SEC focus on monitoring the activities of public companies and their senior executives through enforcement, rather than by engaging on culture and conduct. Recently, the Enforcement Division has been using quantitative tools, such as risk-based data analytics, to identify potential accounting and disclosure violations. This includes a current initiative focused on the improper reporting of quarterly earnings per share (EPS). The SEC recently brought settled enforcement actions against two public companies alleging that they departed from stated valuation practices or did not comply with generally accepted accounting principles in order to increase artificially the EPS at a time when the company would otherwise have fallen short of analyst consensus expectations. These cases, which were the first that were brought as a result of the EPS initiative, demonstrate that the SEC is currently focused on reinforcing organisational culture through data-driven enforcement actions designed to identify inappropriate activity and protect investors and shareholders.

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One Global Financial Services Regulatory Team

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