

Measures to reduce misconduct risk

Progress Report

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Measures to reduce misconduct risk

Progress report

Executive Summary

The FSB Chair's letter¹ to the February G20 Finance Ministers and Central Bank Governors meeting stated that the FSB will coordinate efforts to address emerging vulnerabilities from misconduct, noting that the scale in some financial institutions has risen to a level that has the potential to create systemic risks and undermine trust in financial institutions and markets. The implications of such misconduct can be far-reaching, contributing to financial exclusion, and limiting the potential of finance to serve real economies and foster global economic growth. The use of fines and sanctions acts as a deterrent to misconduct, but preventative approaches are also needed that can mitigate the risk of misconduct through improved market organisation, structure and behaviour of market actors. Addressing the issue calls for a multifaceted approach.

The FSB agreed in early 2015 a workplan on measures to reduce misconduct risk, which was sent to the June G20 Deputies meeting, to examine:

- whether the reforms to incentives, for instance to risk governance and compensation structures, are having sufficient effect on reducing misconduct and whether additional measures are needed to strengthen disincentives to misconduct;
- the progress of ongoing reforms to benchmarks, and whether steps are needed to improve global standards of conduct in the fixed income, currency and commodities (FICC) markets;
- whether there are ways that authorities could enhance coordination in the application of conduct regulation and the need for credible deterrence; and
- together with the World Bank and other relevant bodies, the extent of potential withdrawal from correspondent banking, its implications for financial exclusion, as well as possible steps to address this issue.

This report provides a summary of progress made so far and planned next steps across the first three streams. A separate report examines the extent of potential withdrawal from correspondent banking and the actions being taken to address that issue, which has implications for financial inclusion, as well as for the addressing of misconduct.²

The future actions planned for these three workstreams are as follows (with timelines specified in Annex I):

1. Role of incentives in reducing misconduct

- FSB to establish a working group to exchange good practices on the use of governance frameworks to address misconduct risks with a view to potentially developing a

¹ <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf>

² See <http://www.financialstabilityboard.org/2015/11/fsb-releases-report-to-g20-on-the-decline-in-correspondent-banking/>

supervisory tool kit or guidelines, taking into account the work of the standard setting bodies.

- FSB to facilitate sharing of national experiences on the role of bank regulators' (and possibly other regulators') enforcement powers in addressing misconduct by individuals.
- FSB to further examine the use of compensation tools such as malus and clawbacks and the use of different instruments as an element of deferred compensation and if appropriate make recommendations on better practices.

2. *International coordination on conduct in FICC markets*

- BIS Markets Committee to finalise its FX Code of conduct standards and principles, and proposals to ensure greater market adherence than to existing codes.
- FSB to publish a report on further progress in implementing the work plan on interest rate benchmarks.
- IOSCO to publish its final report on its follow-up review of key interest rate benchmark administrators.
- IOSCO to conduct a follow-up review of major global FX benchmark providers.
- IOSCO to publish its report to further strengthen the current global framework to address misconduct by firms and individuals in professional markets.

3. *Coordination in the application of conduct regulation and need for credible deterrence*

- Senior officials from prudential and conduct financial authorities on an ongoing basis to share information on their respective powers and approaches to the supervision and enforcement of conduct rules.

A timetable of these action items is attached as Annex I.

In addition, as part of its ongoing work to address new and emerging risks and vulnerabilities, the FSB will continue to keep under review whether there are any additional misconduct issues with the potential to create systemic risks that should be addressed.

I. The role of incentives in reducing misconduct in markets and institutions

A number of post-crisis reforms are aimed, amongst other things, at strengthening incentives for good conduct. FSB jurisdictions have done much already to implement agreed reforms. Nevertheless, in light of continuing cases of misconduct, the FSB has been reviewing whether the reforms to incentives have had their intended effect on conduct with a view to, if necessary, making proposals to reinforce or supplement the reforms to support effective implementation by jurisdictions.

This section summarises three areas of work undertaken by the FSB to examine the role of incentives in reducing misconduct:

- Analysis of the role of compensation standards and rules in incentivising appropriate conduct, undertaken as part of the FSB overall monitoring of the implementation of the FSB Principles and Standards on Sound Compensation Practices;
- Outcomes of an FSB roundtable on the effectiveness of governance frameworks in addressing misconduct risk; and
- A stocktake of the enforcement powers of banking regulators in FSB member jurisdictions against misconduct by individuals.

1. Compensation structures

Compensation structures are important not only to provide incentives for sound risk taking but also to disincentivise misconduct cases. The FSB agreed Principles and Standards for Compensation Practices³ in 2009, and monitors implementation of through its Compensation Monitoring Contact Group (CMCG). The FSB's fourth progress report on implementation, published in November 2015,⁴ concluded that almost all FSB jurisdictions have now fully implemented the Principles and Standards for banks.

As part of its monitoring, the CMCG's annual questionnaire on the implementation of the Principles and Standards in 2015 included a section dedicated to compensation and conduct, exploring (i) the extent to which employees' performance assessment and compensation take into account compliance with regulation, firm guidance and other conduct issues; (ii) the role of the Board of Directors and the governance of compensation structures for conduct purposes; (iii) the conduct profiles and triggers taken into account in performance measurement indicators; and (iv) the use of malus and clawback clauses in addressing conduct. The responses to the questionnaire indicate that the overall level of implementation of the Principles and Standards by firms is generally assessed by their supervisors as high, although with some challenges in the areas of governance and risk alignment, and in the application of malus and clawback clauses.

The FSB held roundtables in April and May 2015, with the banking and the insurance industry respectively.⁵ The roundtables focused among other things on the role of compensation in incentivising conduct. One of the findings of the roundtables was that boards are increasingly focusing on conduct issues, consistent with their fiduciary responsibility. Members of boards are asking whether risk-takers understand what the firm expects of them, what conduct issues should impact compensation, and where and how to draw the lines in terms of which individuals should be held accountable and what the right impact on compensation should be. Industry participants emphasised that conduct remains a collective issue that affects the business unit, individual and supervisor. The focus of boards is not only on appropriate compensation policies for those staff with low adherence to values, but also on how to adjust compensation to encourage positive behaviour.

³ See FSB Principles for Sound Compensation Practices, April 2009 (http://www.financialstabilityboard.org/wp-content/uploads/r_0904b.pdf) and FSB Principles for Sound Compensation Practices Implementation Standards, September 2009 (http://www.financialstabilityboard.org/wp-content/uploads/r_090925c.pdf).

⁴ See [LINK]

⁵ <http://www.financialstabilityboard.org/2015/06/third-fsb-workshop-on-compensation-practices/>

The overall findings of the questionnaire and the roundtables are detailed in the 2015 FSB Progress Report.

Both firms and supervisors are of the view that the existing tools, if appropriately calibrated and used in practice, should enable firms to more effectively prevent or deter misconduct. If applied rigorously, deferrals aligned with the time horizon of risks (particularly for employees in roles where the risks are harder to measure or will be realised over a longer time frame), as well as adjustments to variable pay (e.g. “zeroing out” current-year bonus if misconduct is detected, or *ex post* risk adjustments such as malus and clawback) can be effective in demonstrating a firm’s intent to take action in the event of misconduct.

However, the effectiveness of these mechanisms remains largely untested and more analysis is needed to assess whether tools such as malus and clawbacks are sufficiently developed and effectively used to deter conduct risks. Supervisors have only sparse information at this stage on the use of malus, and this is insufficient for them to properly assess whether there is any direct evidence that compensation has been appropriately adjusted in cases of misconduct. The evidence on the application of clawback to vested awards is even more scant given the scarcity of experience and jurisprudence, which is often due to legal impediments (mainly labour law and tax-related).

Establishing a more direct, transparent and immediate link between conduct issues and the award of variable remuneration could help to reduce the incidence of misconduct. The FSB through its CMCG will continue to collect information and examine the case for strengthening disincentives to misconduct through compensation-related tools and if appropriate will make proposals. In particular, the CMCG will continue its current study of malus and clawback practices and the use of different instruments as an element of deferred compensation and if appropriate will make recommendations on steps to incentivise better practices for significant firms, while recognising that individual jurisdictions also may want to consider application to a broader range of firms, in the next progress report in 2017.

More generally, firms and supervisors point out that compensation is not the only tool for management to address misconduct. A combination of strong leadership and governance processes, robust risk and control environments independent from inappropriate influence by lines of business, and consideration of conduct-related performance when deciding upon promotion are seen as key drivers of firm culture. All these aspects, together with compensation awards, have an important role to play in demonstrating the extent of firm’s intolerance for certain behaviour.

2. Governance and culture

A strong governance framework is essential to determining the allocation of authority and responsibilities in a company, in particular its board and senior management; monitoring performance, including incentives and decision-making at all levels of the firm; and ensuring that employees in all parts of the institution conduct business in a legal and ethical manner. The governance weaknesses exposed by events in recent years included weak processes for defining, detecting and addressing misconduct risks. Many of these weaknesses have been

identified in the FSB thematic peer review of risk governance frameworks at banks,⁶ which also set out a list of sound practices. As a follow up to the peer review, the FSB issued in 2013 the Principles for effective risk appetite frameworks and in 2014 the Guidance on supervisory interaction with financial institutions on risk culture.⁷

As part of continuing efforts to promote market confidence and business integrity, G20 Finance Ministers endorsed at their September 2015 meeting updated G20/OECD corporate governance principles.⁸ One long-standing principle has been the importance of both boards and key executives setting the “tone at the top” in establishing firm-wide codes of behaviour with respect to conduct, and this has been strengthened in the updated G20/OECD principles by the identification of good practices.

Meanwhile, the BCBS published in July 2015 its revised guidelines for corporate governance principles for banks,⁹ which draw from the G20/OECD principles of corporate governance that are applicable across business sectors. The BCBS revisions explicitly reinforce the collective oversight and risk governance responsibilities of the board and senior management, including to define conduct risk based on the context of the bank’s business and to develop a written code of ethics or a code of conduct. The code is intended to foster a culture of honesty and accountability to protect the interest of its customers and shareholders.

Collectively, the revised guidance from the BCBS and principles from the OECD reiterate the importance of ethical conduct and place responsibility and accountability on the board and senior management.

Given recent events, a better understanding is needed of the effectiveness of financial institutions’ governance frameworks and the tools, beyond compensation schemes, to promote appropriate behaviours. This should involve both supervisors and institutions: supervisors generally assess whether an institution’s governance framework and processes are adequate and are effective.

The FSB engaged with the financial industry in September 2015 at a roundtable on the effectiveness of governance frameworks to address misconduct risks. The detailed findings from the roundtable are reported in Annex II. After the roundtable, experts from FSB member organisations discussed ways to give further impetus in this area, such as:

- i) Continuing the dialogue with the financial industry and other stakeholders (such as shareholders and auditors) on the effectiveness of efforts to promote appropriate behaviours at firms.
- ii) Further exploring mechanisms for individual accountability for misconduct and the role and responsibilities of the board of directors, in particular non-executive directors, as well as executive and middle management in implementing such frameworks.

⁶ See http://www.financialstabilityboard.org/2013/02/r_130212/.

⁷ The FSB risk appetite principles and guidance on risk culture can be found at <http://www.financialstabilityboard.org/what-we-do/policy-development/enhanced-supervision/>

⁸ See <http://www.oecd.org/corporate/principles-corporate-governance.htm>

⁹ See <http://www.bis.org/bcbs/publ/d328.htm>.

- iii) Better exploring supervisory approaches and practices to address governance, culture and conduct risks, which vary across jurisdictions, with a view to develop, if appropriate, a supervisory tool kit, on the premise that supervision – alongside regulation – should play a powerful role and complement effective enforcement programmes.

3. Enforcement powers of banking regulators and supervisors

Clear standards of conduct, accountability and enforcement mechanisms at all levels are critical to effective operation of governance frameworks. Bank regulators generally have licensing and supervisory mechanisms covering persons with significant responsibility for the operation of banks. As part of the FSB's workplan on measures to address misconduct risks, it conducted a stock take among its members of the enforcement powers bank regulators currently have to address misconduct by individuals as part of their enforcement actions against banks. The questionnaire focused on the source and scope of regulatory authority in this regard; the standards of conduct which give rise to legally enforceable duties; the persons and functions covered by these standards; the availability of supervisory and preventative mechanisms; available remedies and sanctions; and mechanisms for information sharing and coordination among relevant domestic and international authorities.

The survey found that bank supervisors in all FSB member jurisdictions, in the exercise of their prudential responsibility to maintain the safety and soundness of their systems, have the authority to examine the adequacy of a bank's management of conduct risk as part of their mandate. Bank supervisors' powers generally extend to administrative enforcement actions against banks, including in cases of misconduct, based on the collective responsibility of the board and management and where internal risk management and control frameworks are deemed to be ineffective.

However, because of the complexity of oversight, management and decision-making processes within banks, it may be difficult to allocate individual responsibility for any failure to prevent or detect misconduct. Under these circumstances, the burden of enforcement sanctions in cases of misconduct may fall on the bank, its shareholders and other stakeholders, rather than on those individuals directly responsible for the failure. In order to strengthen the deterrent effect on individuals, some jurisdictions are planning to strengthen the focus on individual accountability within the prudential framework, and extend the powers of bank supervisors to address misconduct by individuals in the context of enforcement actions against firms.

In virtually all jurisdictions surveyed, bank supervisors have the existing powers and authority to require firms to establish effective frameworks for individual accountability for misconduct risk, which in turn would facilitate the identification of individual responsibility in enforcement actions. Use of such powers would facilitate additional focus by supervisors on addressing misconduct by individuals.

Action points on the role of incentives

- FSB to establish a working group to exchange good practices on the use of governance frameworks to address misconduct risks with a view to potentially developing a tool kit or guidelines to facilitate strengthening supervision in this area, taking into account

the work of the standard setting bodies. The FSB to review the findings of the working group ahead of the 2016 G20 Summit.

- FSB to follow up on its survey of bank regulators' enforcement powers in addressing misconduct by individuals by holding a workshop in 2016 Q1 to share national experiences on the role of bank regulators' enforcement powers in addressing misconduct by individuals, and on effective approaches to establishment of frameworks for individual accountability for misconduct risk. The workshop should include an opportunity for bank regulators to benefit from the long-standing experience on this subject of securities regulators, including through the work of IOSCO.
- CMCG to: (i) collect information and examine the use of compensation tools such as malus and clawbacks and the use of different instruments as an element of deferred compensation; and (ii) if appropriate, make recommendations on better practices. CMCG to report to the FSB ahead of the 2016 G20 Leaders' Summit.

II. International coordination on conduct in FICC markets

In recent years a host of scandals in FICC markets have revealed deficiencies in standards of behaviour in market practices. These deficiencies have in part reflected gaps in the regulatory regime, as well as the challenges of enforcing standards of conduct in markets that are opaque, dispersed and cross-border.

High standards of market conduct are essential to fair and efficient markets. Given the international nature of these markets, international coordination will help to ensure that reforms to improve conduct are effective, to reduce the scope for fragmentation of markets and regulatory arbitrage, and to address other gaps in standards of market conduct in a way that will support the effective and stable operation of global financial markets. A range of actions are being taken internationally to improve standards of conduct in FICC markets, including through financial market benchmarks reforms.

1. Standards of market practice

Work to address gaps in standards of conduct is in progress in a number of national jurisdictions. The UK's Fair and Effective Markets Review published in June its recommendations to improve practices in FICC markets.¹⁰ The European Securities Market Authority published in February its technical advice to supplement the Market Abuse Regulation issued by the European Council and European Parliament¹¹, including examples to clarify the indicators to evaluate market behaviours, including on trading platforms¹². Other

¹⁰ See <http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx> for details on the review.

¹¹ For Market Abuse Regulation, (EU) No. 596/2014, see <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0596>. For ESMA's technical advice on possible delegated acts concerning the MAR, see <http://www.esma.europa.eu/system/files/2015-224.pdf>.

¹² MiFID2 Directive 2014/65/EU and MiFIR, Regulation (EU) No. 600/2014

jurisdictions also have fora where market conduct is being discussed, for instance the Treasury Market Practices Group in the US.

Many reform initiatives have looked to industry to participate to shape and implement improvements. Reforms to interest rate benchmarks, for example, have involved close involvement of key market participants working with relevant authorities. In foreign exchange markets, central banks work closely with industry-based foreign exchange committees. Building on this constructive collaboration, authorities should work with industry to enhance existing guidance, reduce uncertainties over interpretation, and agree on ways in which compliance with standards might be more effectively encouraged or enforced.

The FSB has discussed what further steps at the international level should be considered to improve conduct in relation to the practices in these markets.

The IOSCO Board, at its annual meeting in June, had a wide-ranging discussion of market conduct workstreams including the UK Fair and Effective Markets Review and developments in other jurisdictions.¹³ The IOSCO Board acknowledged that high conduct standards are essential to promoting fair and efficient markets and considered what work IOSCO should undertake in order to further strengthen the current global framework to address misconduct by firms and individuals in professional markets. The IOSCO Board also underlined the importance of ensuring the integrity of financial benchmarks and discussed ways to progress IOSCO's work to date.

The IOSCO Board approved in October the establishment of a Task Force on Market Conduct, which aims to:

- Map IOSCO's work to date on standards of conduct for individuals and firms engaged in activities with 'professional' counterparties in financial markets.
- Undertake a survey of IOSCO members on the regulatory tools and approaches they have developed to promote proper conduct and accountability by market participants. This will include personal accountability mechanisms and remediation measures taken as a result of enforcement actions.
- Taking into account information collected in previous steps, discuss and develop a tool kit comprising measures to promote proper conduct by market participants, including individuals and firms. The Task Force aims to provide a final report by end-June 2016.

The BIS Governors in May agreed to set up a foreign exchange working group (FXWG) under the auspices of the BIS Markets Committee to take forward current initiatives of the various regional foreign exchange committees (FXCs) to strengthen code of conduct standards and principles in these markets.¹⁴ The main objectives of this work are to establish a single global Code of conduct standards and principles and to develop mechanisms to promote greater adherence to these standards and principles. The Code will cover all sections

¹³ See <https://www.iosco.org/news/pdf/IOSCONEWS384.pdf>

¹⁴ The membership of the FXWG covers major financial centres in both advanced economies and emerging markets. See <http://www.bis.org/about/factmktc/fxwg.htm?m=3%7C332%7C610>

of the foreign exchange market and have global application, with appropriate consideration to local circumstances.

To support the FXWG, a Markets Participants Group (MPG) has been established, drawing on participants from the sell side and buy side of the market as well as FX trading platforms. In addition, the FXWG and the MPG are working closely with the FXCs and reaching out to jurisdictions outside the Markets Committee.

Work is well underway. The FXWG held its first meeting in July, and a joint meeting with the MPG was held in early September. One workstream is drafting the new single global Code by harmonising common elements of the existing FX codes as well as new principles for those areas not adequately covered in existing codes, with input from the MPG. The other workstream is developing proposals to ensure adherence to the new single global Code. The target date for the finalisation of the Code, as well as the proposals to ensure greater adherence, is May 2017. Updates will be provided to the BIS Governors and the FSB on a regular basis. Progress towards the development of the Code will be shared publicly as the work takes place.

2. Financial benchmarks

A specific example where market conduct standards fell short in recent years has been in relation to interest rate and FX benchmarks. In response to the misconduct associated with these benchmarks, in July 2013 IOSCO published the Principles for Financial Benchmarks, and a set of recommended practices that should be implemented by benchmark administrators and submitters.¹⁵ The FSB subsequently published reform recommendations for major interest rate benchmarks in July 2014,¹⁶ and for FX benchmarks in September 2014¹⁷, to be implemented by authorities and market participants. IOSCO has undertaken reviews of major interest rate benchmarks (LIBOR, EURIBOR and TIBOR)¹⁸ and a key FX benchmark (WM Reuters 4pm London fix),¹⁹ as well as a review of a geographically broad sample of benchmarks across a wide range of asset classes (based on administrators' self-assessment against the IOSCO principles).²⁰

2.1 Interest rate benchmarks

The FSB's July 2014 report on interest rate benchmarks, prepared by the Official Sector Steering Group (OSSG), set out a work plan to ensure the recommendations of the report are implemented in a timely manner. The OSSG prepared an interim monitoring report on progress toward these recommendations that was published by the FSB in July 2015.²¹

¹⁵ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf>

¹⁶ http://www.financialstabilityboard.org/wp-content/uploads/r_140722.pdf

¹⁷ http://www.financialstabilityboard.org/wp-content/uploads/r_140930.pdf

¹⁸ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD444.pdf>

¹⁹ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD451.pdf>

²⁰ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD474.pdf>

²¹ <http://www.financialstabilityboard.org/2015/07/reforming-major-interest-rate-benchmarks-july-2015-progress-report/>.

Since July 2014, the administrators of the most widely used IBORs – EURIBOR, LIBOR and TIBOR – have made progress on these recommendations. Steps taken include reviews of respective benchmark methodologies and definitions, data collection exercises and feasibility studies, consideration of transitional and legal issues, and broad consultations with submitting banks, users and other stakeholders. Benchmark administrators and market participants from other jurisdictions, including Australia, Canada, Hong Kong, Mexico, Singapore and South Africa, have also taken steps towards reforming the existing rates in their own jurisdiction, given the importance of these rates to their domestic markets and their role as international financial centres.

Concrete progress has also been made in identifying potential risk-free rates, where these do not currently exist. In particular, detailed data collection exercises have been undertaken in key markets.

The OSSG will continue to monitor progress in implementing the FSB’s recommendations in the year ahead, and will prepare a final monitoring report for publication by the FSB in July 2016.

Complementing this work, IOSCO is undertaking a follow-up review of key interest rate benchmark administrators. IOSCO provided a status update of the review to the OSSG. A final report is expected to be published early in Q1 2016.

2.2 FX benchmarks

The FSB’s September 2014 report on FX benchmarks included a range of recommendations related to FX benchmarks and related market practices. In March 2015 the FSB Chair wrote to the various industry-based regional FX committees to ask these groups to report on market participants’ implementation of the FSB’s recommendations. These groups’ reports have been completed and a summary report on progress has been published in October 2015.²² The overall assessment of this report was that there has been good progress in implementing many of the recommendations; however, in some cases progress has been mixed. In particular, the report re-emphasises that the FSB recommendations are intended to apply to all FX benchmarks, not just the WM/Reuters 4pm London fix. A more complete implementation of the recommendations, particularly regarding other FX benchmarks, would increase the likelihood of maintaining and extending the improvement already seen. There is an expectation that the FSB recommendations will be implemented more broadly, though with appropriate consideration to the size and structure of the market. Regulators and FX market participants must remain focussed on achieving such an outcome.

As with interest rate benchmarks, IOSCO has agreed to undertake a follow-up review of the key FX benchmark administrator, which is expected to begin in Q1 2016.

²² <http://www.financialstabilityboard.org/wp-content/uploads/FX-Benchmarks-progress-report.pdf>

2.3 Additional IOSCO workstreams

In addition to its commitments under the FSB work plan, the IOSCO Board has approved proposals by the IOSCO Task Force on Financial Market Benchmarks to progress IOSCO's work to date on financial benchmarks. The Task Force will undertake consultation and information-gathering with benchmark administrators, with a view to identifying any relevant challenges and issues and offering further guidance, where necessary, to administrators on:

- the application of proportionality in implementing the Principles and its effects on how the Administrator can achieve full compliance with the Principles; and
- the information that should be contained in administrators' annual Statements of Compliance in respect of the Principles.

IOSCO also considered the need to provide guidance on the Principles to benchmark users and agreed that no work will be considered until guidance for administrators is completed.

Action points on international coordination on conduct in FICC markets

- FSB by July 2016 to publish a final monitoring report on progress in implementing recommendations to reform interest rate benchmarks.
- IOSCO in 2016 Q1 to publish its final report on its follow-up review of key interest rate benchmark administrators.
- IOSCO in 2016 Q1 to begin a follow-up review of major global FX benchmark providers.
- BIS Markets Committee by May 2017 to finalise the FX Code and the proposals to ensure greater market adherence than to existing codes.
- IOSCO by June 2016 to publish its report to further strengthen the current global framework to address misconduct by firms and individuals in professional markets.

III. Coordination in the application of conduct regulation and need for credible deterrence

Strong regulation and sanction regimes that hold individuals and entities accountable and deter misconduct promote public confidence and are key factors in the development of efficient markets and economies. Enforcement must be a credible deterrent to misconduct.

The IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU) provides global framework for cross-border enforcement and co-operation and is an important tool to ensure stronger global enforcement and coordination among market regulators. There are currently 105 signatories to the MMoU, and IOSCO continues to work with non-signatories who are seeking to gain the enforcement and cooperation powers that are prerequisites to signing the document.

IOSCO published in June its report on “Credible Deterrence in the Enforcement of Securities Regulation” that identifies key enforcement factors that may deter misconduct in international securities and investment markets.²³ The report identifies key elements in the prevention of misconduct and financial crime from a range of international regulatory authorities and encourages regulators operating in both emerging and developed markets to consider how they might integrate credible deterrence into new or existing enforcement strategies.

In particular, the report identifies seven key elements for credible deterrence:

1. *Legal certainty*: Consequences for misconduct must be certain and predictable;
2. *Detecting misconduct*: Regulators must be well connected and obtain the right information;
3. *Co-operation and collaboration*: Safe havens must be eliminated by working together;
4. *Investigation and prosecution of misconduct*: Enforcement must be bold and resolute;
5. *Sanctions*: Strong punishments must be given to wrongdoers so as to stop them profiting from misconduct;
6. *Public messaging*: Public understanding, transparency and caution must be promoted;
7. *Regulatory governance*: Good governance is necessary to deliver better enforcement.

As part of the FSB conduct workplan, the FSB is encouraging senior officials from prudential and conduct financial authorities, and other enforcement authorities as needed, to share information on their respective powers and approaches to the supervision and enforcement of conduct rules, and to discuss the issues they face in coordinating with each other.

Action points on coordination in the application of conduct regulation and need for credible deterrence

- Senior officials from prudential and conduct financial authorities on an ongoing basis to share information on their respective powers and approaches to the supervision and enforcement of conduct rules

²³ <https://www.iosco.org/news/pdf/IOSCONEWS383.pdf>

Annex I
Misconduct risk workplan action items and timetable

Action item	Date completed, or to be completed, by	Responsible Body
I. The role of incentives		
1. Compensation structures		
FSB to collect information and examine the case for strengthening disincentives to misconduct through compensation-related tools and if appropriate to make recommendations.	G20 Summit in 2016	FSB CMCG
2. Governance and culture		
FSB working group to report on national good practices on the use of governance frameworks to address misconduct risks	G20 Summit in 2016	FSB
3. Enforcement powers of banking regulators and supervisors		
FSB to hold a workshop on national experiences with bank regulators' (and possibly other regulators) enforcement powers in addressing misconduct by individuals	Q1 2016	FSB
II. International coordination on conduct in FICC markets		
1. Standards of market practice		
BIS Markets Committee to finalise the FX Code and the proposals to ensure greater adherence	May 2017	BIS Markets Committee
IOSCO to publish its report to further strengthen the current global framework to address misconduct by firms and individuals in professional markets.	By end-June 2016	IOSCO
2. Financial benchmarks		
FSB to monitor progress in implementing the work plan on interest rate benchmarks	Final monitoring report: July 2016	FSB OSSG

Action item	Date completed, or to be completed, by	Responsible Body
IOSCO to undertake follow-up review of key interest rate benchmark administrators	Final report to be published in early Q1 2016	IOSCO
IOSCO to undertake a follow-up review of major global FX benchmark providers	Review to commence in Q1 2016	IOSCO
III. Coordination in the application of conduct regulation		
Senior officials from prudential and conduct financial authorities to share information on their respective powers and approaches to the supervision and enforcement of conduct rules	Ongoing	FSB Members

Annex II

FSB Roundtable on the Effectiveness of Governance Frameworks to Address Conduct Risks

Key Outcomes and High-Level Summary

An FSB roundtable with industry was held in London on 2 September providing an opportunity for experts from FSB member organisations to engage with senior industry representatives (directors, chief risk officers, heads of compliance and conduct) and discuss their efforts to promote good governance frameworks and the processes and tools they use – extending beyond compensation schemes – to promote appropriate behaviours.

Three industry representatives shared their work on addressing conduct and culture. In particular on: i) the respective role of senior and middle management in driving cultural change; ii) on areas where further progress is needed to improve compliance, control and governance structures; iii) on how to embed a sound culture throughout the organisation, which must start with a common language on culture and expected behaviours clearly spelled out.

The discussion among roundtable participants centred on: (i) progress towards addressing misconduct risks; (ii) challenges that are hindering further progress; and (iii) ways the international community could provide impetus to industry efforts.

- (i) ***Progress towards strengthening conduct risk management.*** Participants noted that considerable work has been done in the official and private sectors to examine and address misconduct risks, including the G30 report on conduct and culture²⁴, the Basel Committee on Banking Supervision and Organisation for Economic Cooperation and Development revised guidance and principles on corporate governance, the FSB Principles for Sound Compensation Practices, and the UK Fair and Effective Markets Review. Taking note of this guidance as well as their own experience, firms have been developing ways (beyond compensation schemes) of addressing conduct risk and promoting appropriate behaviours. Firms described progress in implementing changes designed to: (i) integrate identification and assessment of conduct risk in business line decision-making and business target setting; (ii) implement the “three lines of defence framework”, clarifying roles and accountability for front line staff who “own” risk, managers who set and implement conduct standards and provide a framework for resolving difficult cases, and senior management and supervisory bodies who “set the tone at the top” and establish and enforce mechanisms for accountability; (iii) integrate behaviour and ethics considerations in staff hiring, professional development, compensation and promotion decisions; and (iv) support and strengthen the capacity of directors to identify and focus on conduct risk management and ethical business conduct as an integral part of their business oversight function.

²⁴ Group of Thirty, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform* (2015) at <http://group30.org/images/PDF/BankingConductandCulture.pdf>.

(ii) ***Challenges in implementing cultural and behavioural change in global firms.***

Participants noted that codes and standards of conduct have been in place across the industry for some time. The issue was not the articulation of codes or standards, but their effective implementation and enforcement across diverse business lines and across jurisdictions. Official sector and private sector representatives noted that effective implementation of conduct risk management involves fundamental changes in culture and behaviour across the industry, involving firms and market stakeholders. Such changes take time. Critical implementation challenges highlighted by participants include:

- *Integration in business decision-making.* The integration of behaviour and ethics considerations in business decisions (which could involve limiting or withdrawing from certain transactions or businesses) challenges the “prevailing consensus” defining success; other stakeholders, including a firm’s customers and shareholders, may need to be involved in supporting these changes. For instance, to signal industry-wide commitment to good conduct and ethical behaviour, the Dutch industry established an oath for bankers, similar to the Hippocratic Oath for physicians.
- *Consistency of messages and action.* The “tone at the top” is not always supported by consistent actions that demonstrate that conduct and ethical considerations visibly determine hiring, promotions, professional standing and success. This requires coordinated engagement of all parts of the organisation; ethics and behaviour considerations cannot therefore be segregated into compliance or human resources functions. Ensuring senior level individuals take responsibility for driving forward changes is important to success.
- *Cross-border and cross-cultural issues.* Supervisors, clients and stakeholders have different expectations and perspectives of the role of financial services providers. As such, approaches to conduct risk management as well as rules relating to permissible incentives regarding conduct differ across jurisdictions. These differences pose challenges for global firms seeking to establish consistent expectations across the institution.
- *Common taxonomy for conduct risk.* The integration of conduct risk in all aspects of a firm’s business, in a manner that is consistent across the industry, requires the development of a consistent set of definitions, methods of assessment and measurement of conduct risk. These risks vary across product lines and may vary with the organisational structure of businesses within firms.
- *Grey areas.* Actions that are not “illegal” but which, under particular circumstances, could be inconsistent with a firm’s values are sometimes difficult to address because they are often dependent on facts and circumstances. Those on the front lines are often called upon to exercise their discretion in fulfilling customer requests; these decisions are sometimes complex, and can vary across business lines. Under these circumstances, it is difficult to make *a priori* determinations on the best course of action or to

draw bright lines. Firms need to develop frameworks to address these questions in a consistent manner. Visible institutional leadership in resolving and sanctioning weak management of conduct risk will be important. Engaging business lines in cooperative approaches to identifying conduct risk such as “reporting in the public interest” may help overcome limitations of “whistleblowing” approaches, which risk implying putting employees and the institution on opposite sides. It was however noted that there was a significant amount of regulation and case law in existence which should help to give firms clarity on what constituted a breach of regulation or law.

- *Role of directors.* While board oversight of conduct risk is critical to the strengthening of conduct risk management, an appropriate balance should be established between the accountability of individual executives and the board, in particular NEDs. It was acknowledged that boards are facing increased pressure and that there may be a risk that this could potentially create disincentives for experienced and qualified experts to serve on them.

(iii) ***Ways the international community could support industry’s progress.*** There was general agreement that conduct risk and a perceived “ethical drift” in the financial services industry are issues that pose a risk to the integrity of financial markets, and merit the attention of supervisors, the industry and individual firms. In response to the Chair’s question, industry representatives provided a range of views on how the FSB could be helpful in supporting industry efforts currently underway. These include the following:

- *Developing best practices.* Several industry representatives see a need for the international community to develop best practices to support consistent treatment of “grey areas”. Given that supervisors and regulators see a range of practices across firms, they are best placed to develop such guidance. For instance, Japan provides examples of best practices based on on-site exams, and also publishes examples of bad practices.
- *Increasing individual accountability.* Several participants noted a lack of clarity on who is accountable, which is fundamental to understanding who gets paid for doing what and before taking enforcement actions. This requires effective supervision.
- *Enhancing supervision.* Supervisors need to enhance their skillset to effectively evaluate conduct and culture at firms, which requires a shift in mind-set from focusing on hard rules and regulations to thinking about ethics. There needs to be recognition that supervision is very different from enforcement, with the former requiring trust, transparency and a “safe space”. A few participants asked for guidance to help supervisors assess implementation of governance frameworks to address misconduct risks.
- *Consolidating existing codes of conduct.* Several participants opined that there are too many codes of conduct for a firm to adhere to within financial sectors and across jurisdictions. Given the global nature of firms, one set of high-level principles that are applicable cross-border and cross-sectors would

be meaningful; these could be complemented by sector-specific codes of conduct.

Following the roundtable with the financial industry, the participating experts from FSB member organisations discussed ways the international community could give further impetus to industry efforts underway, such as:

- ***Continuing the dialogue with industry.*** FSB participants agreed it was important to remain engaged with industry on their efforts to promote appropriate behaviours at their firms. Misconduct risk is challenging to address, particularly because fundamental changes in culture, consistent across diverse business lines and jurisdictions, require time and sustained effort. Further engagement with industry would encourage continued progress. The dialogue, however, should be extended to business line managers, reflecting the shared view that change must be delivered in the first instance from the ‘first line of defence’. In addition, it would be valuable to invite a wider range of stakeholders, such as shareholders and auditors, to participate in such a dialogue.
- ***Further exploring individual accountability and incentives.*** Much discussion focused on accountability, including the role of the board of directors, in particular non-executive directors, as well as executive and middle management. It would be valuable to have further discussions at an international level on topics such as: strengthening individual accountability; clarifying the roles and responsibilities of boards versus senior individuals in this area; and assessing the effectiveness of existing guidance on compensation. Several participants also suggested consideration of whether and how an amount of remuneration should be put at risk for a longer period in relation to conduct risks. At the same time, participants noted the need to explore other forms of incentives, such as links with human resources on career progression, as well as disincentives, such as enforcement sanctions for individual misconduct and the application of effective and deterrent sanctions regimes to reduce misconduct.
- ***Understanding supervisory tools.*** Guidance and principles on governance and culture are already in place but supervisory approaches and practices to address governance, culture and conduct risks vary across jurisdictions, with differences in the extent to which national authorities have embedded these risks within supervisory and examination programs and consider these as priority areas. Several participants spoke of the importance of strong enforcement for deterring misconduct. Supervision – alongside regulation – should play a powerful role and complement effective enforcement programs. Consideration should be given to further exchange of good practices and potentially developing a supervisory tool kit to facilitate strengthening supervision in this area. A few participants noted that such supervisory approaches should not be considered a substitute for strong enforcement programs.

Annex III

Key findings from the FSB questionnaire on banking regulators' enforcement powers against misconduct by individuals

The FSB conducted a stock taking exercise enforcement powers that banking regulators have available to address misconduct by individuals (such as fines or ability to require the dismissal of employees) on conduct grounds as part of their enforcement actions against firms. The questionnaire focused on the source and scope of regulatory authority in this regard; the standards of conduct which give rise to legally enforceable duties; the persons and functions covered by these standards; the availability of supervisory and preventative mechanisms; available remedies and sanctions; and mechanisms for information sharing and coordination among relevant domestic and international authorities.

I. Jurisdiction; Coverage

Jurisdiction; Source and Scope of Supervisory Authority In all FSB jurisdictions that have responded to the survey, the source of authority for bank regulators to address conduct risk and specifically misconduct by individuals derives primarily from two sources, prudential regulation and financial market conduct regulation.

Prudential Regulation. Prudential regulation relies on the principle of firms' and management's responsibility. One of the objectives of prudential supervision, therefore, is to ensure that the firm has the governance and control processes in place to ensure that issues are promptly discovered and addressed, and responsible individuals appropriately sanctioned by the firm. Across all jurisdictions, prudential regulation provides for, at a minimum, minimum professional and honourability ("fit and proper") standards for senior management and in some cases persons covering key functions, such as persons performing "control functions". Beyond these fit and proper requirements, jurisdictions use various approaches to empower bank supervisors to address misconduct by individuals:

(1) Jurisdictions may rely on the collective responsibility of the board and senior management to establish effective internal risk control and risk management frameworks and where the regulatory authority extends to the limited set of persons exercising specified control functions. In some cases, supervisory authority extends to specifying the oversight and management duties of senior management and control functions and may include the oversight of conduct risk. In some jurisdictions this scope extends more broadly to cover internal control and risk management, compliance and policy setting functions (for example, the US federal banking agencies have the concept of "Institution-Affiliated Parties") or through the powers of approval of persons exercising control functions, such as in the UK.

(2) Jurisdictions may define or interpret prudential mandates to specifically include the oversight of certain areas of conduct (beyond the general "fit and proper" criteria) relating to the business activities of banks, including for example transparency and fair treatment of customers or other conduct aspects (e.g. Italy, Singapore, Switzerland), or may refer more generally to a number of prudential standards set for both entities and individuals that provide the framework for prudential regulation of conduct risk and establish an industry benchmark for conduct risk management (Australia).

(3) Jurisdictions may exercise prudential mandates to impose licencing, certification and other qualification conditions on officers holding certain functions, to set minimum enforceable standards of conduct beyond the usual fit and proper requirements. The breach of any of the provisions of the codes might mean that the precondition for an individual's employment by regulated firms is no longer met, and de facto be a cause for disbarment of the individual.

Some jurisdictions (notably the UK following implementation of principles from its Fair and Effective Markets Report) are seeking to strengthen the responsibility of senior management for managing conduct risk, and are expanding the class of managers who fall within the scope of regulatory oversight.

Regulation related to Market Integrity and Market Conduct. In virtually all jurisdictions surveyed, the provision of financial services is regulated by an authority charged with the regulation of market practices and conduct. While market conduct rules are generally promulgated and specifically enforced by authorities other than bank regulators, banks and their employees or agents engaging in such activities are subject to these standards of conduct. Bank regulators in many jurisdictions have noted that monitoring a bank's compliance with law, including laws and regulation relating to conduct and market practices, falls within their prudential and supervisory functions. Bank regulators may therefore indirectly enforce adherence to conduct regulation promulgated by conduct authorities, by ensuring that banks have governance and management mechanisms in place to ensure compliance with applicable laws across all business lines. The failure of a bank to comply with the law or to have control and management functions in place to ensure compliance with applicable laws would trigger the use of regulatory enforcement powers. In jurisdictions where there is an integrated regulator (as in Singapore and Switzerland), the single regulator, in its regulation of banks, has broad powers to address misconduct, and to recognise and establish standards of conduct beyond the limited scope of prudential authorities.

Applicable Standards of Conduct and Types of Conduct Prohibited: The standards of conduct applicable to banks and to individuals who exercise control functions or act in various capacities on behalf of, or in the name of, banks can derive from several sources: bank regulation; conduct regulation applicable to banks and business conducted by banks promulgated and/or enforced by other agencies; standards having their source in mandated licensing or certification requirements; codes of conduct that are recognised or otherwise authorised by bank regulators; or generally applicable principles of law relating to fairness in commercial activities.

Codes of Conduct. Many jurisdictions encourage banks and other firms providing financial services to articulate and abide by codes of conduct specific to their business, where such functions are relevant to the public interest. These codes often apply existing legal standards to specific activities, and may set standards where the law is otherwise silent. The legal effect of such codes varies across jurisdictions. In some cases, particularly where these codes are approved or authorised by regulatory authorities, failure to adhere to such codes may be subject to legal redress (as in the case of Switzerland, where the industry codes recognised by the financial regulator, FINMA, establish a legal minimum standard of conduct).

Types of Conduct Prohibited. Jurisdictions report that the standards of conduct which form the basis for legally enforceable duties cover fundamental principles of fair market practices.

These include restrictions on third party transactions, self-dealing and conflicts of interest, price manipulation, trading on material non-public information, and misstatement and non-disclosure of material information.

II. Persons and Activities Covered; Duties

In addition to setting conduct standards through the implementation of “fit and proper” requirements for control persons, bank regulators can specify the oversight duties of such persons. Such duties can include implementation of mechanisms to ensure compliance with law, including laws relating to market conduct at the front lines. Depending on the circumstances, specific business roles such as compliance and audit may fall within the scope of “control functions” and therefore be subject to action by the bank regulator. Action against front-line employees generally falls outside the scope of the bank regulatory powers, and remains the responsibility of bank management. While direct regulatory authority does not extend beyond the specific class of persons exercising control functions, bank regulators could require the board and senior management to take action against individuals who fall outside the scope of regulatory authority. In addition, regulators in most jurisdictions may act against control persons for failure of oversight if appropriate controls are not in place.

III. Monitoring, Supervision and Prevention

Monitoring and Supervision. Powers of monitoring and access to information are critical to implement any regulatory responsibilities to conduct oversight. In all jurisdictions surveyed, supervisors have on-site inspection powers, access to books and records, and the power to call for information from bank officers and employees. If regulators become aware of conduct that may be illegal or contrary to the public interest, they would have the authority to refer the matter to management for corrective action and/or report the matter to other appropriate agencies. However, most jurisdictions do not currently have mechanisms in place for the review of conduct risk management frameworks as a part of their supervisory programs.

Prevention, self-reporting and corrective action. In the course of their supervisory function and dialogue with management and the board, bank regulators have the ability to require implementation of preventative systems and to encourage self-reporting by banks. Most jurisdictions have protections in place to encourage bank employees and others to report illegal behaviour (whistle-blowing). Information from self-reporting mechanisms, including whistle-blowing, can be used to encourage corrective action and, if necessary, for formal enforcement actions. The supervisory role allows the supervisor the opportunity to provide early warnings to encourage corrective actions and to refrain from using formal enforcement measures if corrective action is taken.

IV. Sanctions, Penalties, Remedies and Incentives

Firms’ and Individuals’ Responsibility; Allocation. Most bank regulators have broad powers to impose (i) monetary penalties and a range of other sanctions from warnings to limitations on business activities (including revocation or suspension of licenses) against banks and (ii), in appropriate cases, monetary penalties and other sanctions including suspension, dismissal

or debarment against individuals. If misconduct is due in part to the failure of adequate supervision or weak controls within a firm, in the absence of specific allocations of duties and responsibilities to individuals, the failure would be deemed to be a collective one, and sanctions would tend to be focused on the firm.

Balancing. Within the scope of administrative actions or civil actions initiated by the bank regulator, the regulators in most jurisdictions determine penalties taking into account all relevant circumstances, including cooperation and corrective action. In determining the penalty, supervisory authorities in most jurisdictions would exercise discretion and take into account the impact on the solvency of the firm, on the market and more broadly on financial stability. However, other than in administrative actions or civil actions brought by bank regulators, the ability of bank regulators to shape the remedy and sanctions may be limited, as these determinations are ultimately the responsibility of the court and may be prescribed in applicable legislation to ensure consistency of treatment. Flexibility may also be limited in specific cases where a particular sanction is prescribed by law for a specific violation. Moreover, some jurisdictions place limits on the extent to which a bank regulator may intervene in an action brought by customers against banks, for which courts or other judicial mechanisms would be responsible, so as to preserve the independence of the regulator.

Criminal Sanctions. Bank regulators in general do not have authority to bring criminal law actions, but may refer such actions to the appropriate authority. While criminal sanctions are provided in applicable laws for violations relating to prudential issues (such as conducting banking activities without a licence), bank regulators also monitor the bank’s compliance with law and, in most jurisdictions, regulators may refer evidence of misconduct for action by criminal authorities if warranted. The role of the bank regulator in preparing the criminal case varies by jurisdiction, with many jurisdictions placing limits on the extent to which regulatory supervisors may participate in the criminal action, after the initial referral.

V. Coordination and Information Sharing among Domestic Regulatory Agencies

Respondents generally confirmed the power of bank regulators to share information and coordinate enforcement with other domestic agencies, both informally and through MoUs. Several jurisdictions noted close coordination between agencies to support bank regulators in addressing misconduct of individuals, including through joint investigation and early sharing of information and coordination of civil and criminal proceedings (including Australia, Singapore and US).

VI. Cross-Border Enforcement

Most jurisdictions confirmed their regulators’ authority to share information with and cooperate on enforcement matters with other jurisdictions subject to compliance with domestic legal protections (and, in some cases, reciprocity). Many noted their participation in the IOSCO Multilateral Memorandum of Understanding concerning consultation and cooperation and the exchange of information. Respondents also noted that the home jurisdiction’s power to address conduct issues in foreign branches or subsidiaries of firms headquartered in the jurisdiction required coordination with host authorities and was

dependent on the legal status of the branch/subsidiary in the host jurisdiction. Most jurisdictions confirmed that the host regulator would have the power to address misconduct in the activities of local branches and subsidiaries of foreign firms, and would expect to share information with the home regulator; this power included the ability to address misconduct by individuals located in the host jurisdiction.