Strengthening Governance Frameworks to Mitigate Misconduct Risk:

A Toolkit for Firms and Supervisors

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Preface

Widespread misconduct in the financial sector on a broad scale creates mistrust, weakening the ability of markets to allocate capital to the real economy. This in turn may give rise to systemic risks, which is why addressing misconduct is part of the Financial Stability Board's (FSB) work programme.

Recent instances of misconduct have included collusion in the manipulation of wholesale markets and retail mis-selling schemes. Financial penalties are often extensive. Since the financial crisis of 2007–08, fines and legal costs for misconduct by global banks are estimated to have reached more than $320 billion.[1] However, as noted by Mark Carney, Chair of the FSB, in his July 2017 letter to G20 Leaders,

> Fines are essential to punish wrong doing and have an important deterrent effect, but it is insufficient and inefficient to rely solely on ex post penalties of institutions and their shareholders. The resources paid in fines, had they been retained as capital, could have supported up to $5 trillion in lending to households and businesses.[2]

Fines and sanctions act as deterrents to misconduct. Such fines have generally been imposed on firms rather than individuals, but preventative approaches that aim to influence the behaviour of individuals may also be needed to mitigate misconduct risk. Among these preventive approaches are improved corporate governance practices.

In May 2016 the FSB established a Working Group on Governance Frameworks (WGGF), chaired by Jeremy Rudin, Superintendent of Financial Institutions (Canada), to explore the use of firms' governance frameworks to mitigate misconduct risk with a view to potentially developing a toolkit for firms and supervisors, taking into account the work of the standard-setting bodies (SSBs).

It is for firms and authorities to determine how best to address conduct issues in their jurisdictions. Therefore, rather than creating an international standard or adopting a prescriptive approach, the FSB is offering this toolkit as a set of options based on the shared experience and diversity of perspective of FSB members in dealing with misconduct issues.

Mitigating misconduct risk requires a multifaceted approach. This toolkit forms one of the building blocks of the FSB's 2015 Workplan on Measures to Reduce Misconduct Risk, which includes:[3]

- Standards and codes of behaviour, such as the FX Global code,[4] and reforms to benchmark-setting practices;

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1 Boston Consulting Group, "Staying the course in banking," *Global Risk 2017*. The wider costs to the financial system and the economy from misconduct at financial institutions are harder to estimate.

2 FSB, *FSB Chair's letter to G20 Leaders – building a safer, simpler and fairer financial system*, July 2017, p 4.

3 FSB, *Measures to reduce misconduct risk: progress report,* November 2015.

4 Bank for International Settlements (BIS), *FX Global Code*, December 2017.

- Toolkit of measures related to wholesale market conduct, based on national approaches;[5]
- Guidance on compensation practices in addressing misconduct;[6] and
- Toolkit for firms and supervisors to strengthen governance frameworks by improving corporate culture, clarifying individual responsibility and accountability and preventing the movement of "bad apples" (employees with a history of misconduct) within or between firms.

The most recent update on progress under the overall Workplan on Measures to Reduce Misconduct Risk was delivered to the Hamburg G20 Summit in 2017 and is available on the FSB website.[7]

[5] International Organization of Securities Commissions (IOSCO), *IOSCO task force report on wholesale market conduct*, June 2017.

[6] FSB, *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices*, March 2018. The guidance supplements FSB, *Principles for Sound Compensation Practices*, April 2009, and FSB, *Implementation Standards for the FSB Principles for Sound Compensation Practices*, September 2009.

[7] FSB, *Reducing misconduct risks in the financial sector: progress report to G20 Leaders*, June 2017.

Executive summary

Misconduct[8] in some financial institutions has the potential to significantly harm consumers, undermine trust in financial institutions and markets and create systemic risks. As the Federal Reserve Bank of New York recently noted:

> The impact of employee misconduct extends beyond the individual and can impact the firm as a whole and the economy and financial markets more broadly. Employee misconduct can make a firm less resilient, for example, by diverting management attention, harming a firm's reputation in a way that impedes its business, driving change in the composition of the workforce, and depleting its capital. For the broader economy and financial markets, misconduct can inflict harm directly on consumers and employees. Over time, market participants may lose confidence in the financial sector as a whole and adversely impact its critical role in financial intermediation.[9]

Mitigating misconduct risk is an important issue for both firms and national authorities. While authorities can take steps to promote strong internal practices at firms, these do not replace the actions that firms should take to promote appropriate conduct within their organisations.

The FSB, in its workplan on measures to reduce misconduct in the financial sector, agreed to examine, among other things, the role of incentives in reducing misconduct in firms, and whether additional governance and compensation measures are needed to mitigate misconduct risk.[10] Compensation practices are a key driver of behaviour and conduct at firms, and the FSB's workplan therefore included a dedicated examination of the use of various compensation tools for addressing misconduct.[11]

Equally, because non-financial incentives play a significant role in driving behaviour, misconduct risk can also be mitigated through internal governance frameworks. Governance frameworks have an ex ante (preventive) focus, which is often made more effective when paired with the deterrent effect of ex post sanctions.

Phases of the workplan

The FSB's work on the use of governance frameworks to mitigate misconduct risk has taken place in two phases: Phase 1 – a stocktake of efforts by international bodies, national authorities, industry associations and firms. Phase 2 – development of a toolkit for use by firms and supervisors to strengthen the ability of governance frameworks to mitigate misconduct risk.

Phase 1: The stocktake

In May 2017, the FSB published the stocktake of efforts to strengthen governance frameworks to reduce misconduct risk, which included a two-pronged review covering both the literature on root

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8 For the purposes of this toolkit, misconduct can be generally understood as conduct that falls short of expected standards, including legal, professional, internal conduct and ethical standards.

9 Federal Reserve Bank of New York, *Misconduct risk, culture, and supervision*, December 2017, p 3.

10 FSB, November 2015.

11 FSB, March 2018.

causes of misconduct in the financial and non-financial sectors and the literature on scientific insights about the effectiveness of various approaches to mitigate the risks of such misconduct.[12]

In conducting this work, the FSB has understood "governance frameworks" to include the set of laws, regulations, policies, structures and processes used by firms and national authorities to reinforce corporate governance. Recognising the breadth of understanding and practices across FSB member jurisdictions, the FSB deliberately avoided an exhaustive definition of "framework", although provided a common definition for "governance" to guide its work:

> The range of methods and techniques by which a firm is directed and overseen by those who have ultimate responsibility for the affairs of the firm (e.g. directors, executive management). These could include, but are not limited to: corporate governance structures (i.e. boards[13] and board-level committees and management committees); risk governance framework; individual accountability; strategy setting, business planning and budgeting; internal reporting and management information; system of internal controls (risk management, compliance and audit); financial and non-financial incentives; people management (including recruitment, training and competence, performance management and staff promotions); and promulgation of corporate culture and values (e.g. "tone from the top", risk culture, escalation and whistle blowing mechanisms).[14]

This definition is deliberately broad, covering both structural and behavioural elements of corporate governance.

Out of this stocktake, 10 themes emerged as areas that merit further attention.[15] The FSB explored how each of these themes related to governance frameworks, the extent to which reforms related to these topics could lead to mitigation of misconduct risk and whether further international work should be conducted.

Phase 2: The toolkit

The FSB conducted further work in three of the 10 areas identified in Phase 1 that were considered particularly important for mitigating misconduct risk from a financial stability perspective: (i) cultural drivers of misconduct; (ii) individual responsibility[16] and accountability; and (iii) the "rolling bad apples" phenomenon, which refers to individuals who engage in misconduct but are able to obtain subsequent employment elsewhere without disclosing their earlier misconduct to the new employer.

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12 FSB, *Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks*, May 2017.

13 This document refers to a governance structure composed of a board of directors and senior management. However, it should be understood to include all governance structures and does not advocate any particular structure. It is acknowledged that some countries use a two-tier structure composed of the management board, which is the executive organ, and the supervisory board, which is responsible for supervising the management board. Other countries use a single-tiered structure in which the board of directors has a broader role and which discourages, limits, or prohibits executives from serving on the board. The toolkit presented here is relevant for all of these approaches. For two-tier board systems, the term "senior management" or "senior leadership" should be interpreted as members of the management board.

14 FSB, May 2017, p 32.

15 FSB, May 2017, pp 7-8.

16 For the purposes of this report, the FSB is using the term "responsibility" to refer to a defined set of activities or functions undertaken by one or more employees rather than a corporate job title, given that responsibilities associated with a particular job title may vary widely between firms and across jurisdictions.

The goal of this work has been to develop a toolkit that firms and national authorities can use to mitigate misconduct risk in these three areas.

Given the interplay between cultural drivers of misconduct, individual responsibility and accountability, and the "rolling bad apples" phenomenon, it is important to look at these aspects of governance frameworks together.

A firm's culture plays an important role in influencing the actions and decisions taken by employees within the firm and in shaping the firm's attitude toward its stakeholders, including supervisors and regulators. It also may allow or encourage misconduct by individuals, or large numbers of employees, particularly if instances of misconduct are overlooked. Insisting on clarity in individual responsibilities reflects the priority that the firm places on a culture of good conduct and the need for accountability. By contrast, a lack of clarity in individual responsibilities can make it difficult to hold individuals accountable for their actions and decisions, as well as for reasonably managing the actions and behaviours of those in their area of responsibilities. In some cases, individuals who are not held accountable for their misconduct at one firm surface at another firm (or another division of the same firm) and repeat their misbehaviour – the rolling bad apples phenomenon.

The toolkit has benefited from the results of related efforts undertaken by the FSB and other bodies:

- the FSB stocktake and its literature review covering root causes of misconduct and scientific findings on ways to mitigate it;
- the observations from a survey conducted by the Supervisors Roundtable for Governance Effectiveness;[17]
- a review of the SSBs' existing guidance and standards related to individual responsibility and accountability;[18]
- a survey of national authorities' approaches to setting expectations for individual responsibility and accountability;
- an examination of the rolling bad apples problem:
  - a review of relevant literature;
  - a review of public cases of the phenomenon and of national approaches to addressing it; and
  - a stocktake of the potential for using registries of financial services professionals and regulatory reference regimes as tools to mitigate the problem;
- discussions among FSB member authorities; and
- feedback from an industry roundtable that the FSB conducted with academics, lawyers and industry participants (e.g. directors, chief risk officers (CROs), business line leaders and heads of compliance).

[17] The Supervisors Roundtable for Governance Effectiveness is hosted by the Federal Reserve Bank of New York and is composed of supervisors from Australia, Canada, Hong Kong SAR, Japan, Singapore, Sweden, Switzerland, the United Kingdom, the United States and members of the European Central Bank Single Supervisory Mechanism (SSM).

[18] The guidance and standards are related to governance, accountability, and conduct (e.g. principles, guidance, recommendations, toolkits, range of practices) and have been issued by the FSB, the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), the IOSCO, the Organisation for Economic Co-operation and Development (OECD), and the Joint Forum (the Joint Forum – established in 1996 under the aegis of the BCBS, IAIS and IOSCO to deal with issues common to the banking, insurance and securities sectors, including the regulation of financial conglomerates – ceased operations in 2015).

The tools are summarised below and are elaborated in the body of the report.

The toolkit

To help give impetus to efforts underway, the FSB has developed a list of tools as options that firms and authorities can use, taking into account jurisdictions' legislative, judicial and regulatory frameworks. There is no one-size-fits-all approach; some tools may not be relevant for certain authorities and firms, and some jurisdictions or authorities may not have the authority to implement some of these tools. The toolkit provides some points of consideration and does not represent an end-point for mitigating misconduct risk.

While the onus is on firms to establish governance frameworks that take into account their business models as well as domestic legislative and regulatory regimes, authorities can play a role in addressing basic incentive problems (e.g. gaps between socially-desired outcomes and firms' private incentives) and assessing whether a firm's governance framework and processes are adequate and effective to support the sustained provision of financial services. As such, the toolkit is aimed at both firms and authorities.

The toolkit will evolve as industry and supervisors alike learn from their experiences. For example, while some elements of approaches developed by supervisors and firms in response to recent instances of misconduct are included in the toolkit, many of them have not been in place long enough to establish a clear record of success.

The tools do not constitute guidance and are not a recommendation for any particular approach. Nor are the tools meant to be taken as a package; firms and authorities may apply them separately or in combination to best conform to their business or supervisory approach and their legal and regulatory frameworks. They may also find that other tools are preferable. In sum, firms and authorities can decide whether and how to draw on this body of work to tackle the causes and consequences of misconduct.

Mitigating cultural drivers of misconduct

Firms

Tool 1: ***Senior leadership of the firm articulate desired cultural features that mitigate the risk of misconduct.*** A firm's senior leadership could articulate a clear cultural vision that will guide appropriate behaviour within the firm. To inform the cultural vision, leaders could adopt a risk-based approach that evaluates and prioritises the most significant cultural drivers of misconduct risk that may be inherent to their firm.

Tool 2: ***Identify significant cultural drivers of misconduct by reviewing a broad set of information and using multidisciplinary techniques.*** The senior leadership of the firm could strengthen its approach to mitigating misconduct risk by promoting the identification of significant cultural drivers of misconduct that are in conflict with the cultural vision articulated by the firm's leadership. The identification process could first involve collecting data and other information (from various sources and perspectives) that provide insight on behaviours that could lead to misconduct. Second, firms could apply multidisciplinary analytical techniques on the information gathered to obtain a more complete understanding of the drivers of these behaviours.

Tool 3: ***Act to shift behavioural norms to mitigate cultural drivers of misconduct.*** Senior leadership could take actions to shift attitudes and behaviours within the firm toward its cultural vision and to reinforce the governance frameworks designed to mitigate misconduct risk. Actions could be selected with reference to the most significant cultural drivers of misconduct identified by the firm (Tool 2) and based on the firm's operations. Such actions could include relevant informal and formal measures. Informal measures could include deliberate efforts by leaders to respond constructively to mistakes in order to create a safe environment for a candid dialogue and escalation of issues; more formal measures might include enhanced whistle blower protection, escalation procedures and effective compensation and related performance management mechanisms. Actions could also include monitoring the impact of interventions and making adjustments as necessary.

National authorities

Tool 4: ***Build a supervisory programme focused on culture to mitigate the risk of misconduct.*** National authorities could consider building a programme with a focus on supervising culture. Supervisory reviews of culture could be led by either firm-specific or subject-matter expert teams. Where an authority has governance or culture specialists, those specialists could work jointly with line supervisors to link observations related to culture with other supervisory issues at the firm.

Tool 5: ***Use a risk-based approach to prioritise for review the firms or groups of firms that display significant cultural drivers of misconduct.*** A risk-based approach to reviews could prioritise firms according to a comparative assessment of the cultural drivers of misconduct risk present within each firm. The depth of review could depend upon both the size and complexity of a firm or groups of firms under review, as well as the authority's own resources and the magnitude of misconduct.

Tool 6: ***Use a broad range of information and techniques to assess the cultural drivers of misconduct at firms.*** Qualitative and quantitative information that supervisors obtain from a firm could not only help supervisors understand how governance processes work, but could also provide insight into the behavioural norms and culture of the firm. The information could be shared through the firm's documentation, supervisory dialogue, specific meetings on the topic and/or meetings on other topics, as all supervisory interactions can provide supervisors with insight and information on a firm's culture.

Tool 7: ***Engage firms' leadership with respect to observations on culture and misconduct.*** Supervisors could engage in a range of methods to convey supervisory observations on behaviour and culture to the firms they supervise. A dialogue between a firm's leadership and supervisors could be useful to understand and bolster a firm's proposed actions to strengthen culture, where necessary, to mitigate misconduct risk. Engaging in a dialogue about culture could encourage firms to consider the issue more seriously.

Strengthening individual responsibility and accountability

Firms and/or national authorities[19]

Tool 8: ***Identify key responsibilities, including mitigation of the risk of misconduct, and assign them.*** Identifying key responsibilities and clearly assigning them to the holders of various positions within a firm promotes individual accountability and increases transparency both within a firm and to relevant stakeholders. The identification and assignment of key responsibilities may be achieved through legislative or regulatory requirements, firm-driven decisions on their preferred structure, or both.

Tool 9: ***Hold individuals accountable.*** Individuals could be held accountable through a combination of (i) legislative/regulatory provisions; (ii) a firm's internal processes, including employee contracts; (iii) supervisory action; and (iv) regulatory enforcement. Clearly assigning responsibilities reinforces individual accountability and allows authorities to identify the functions and business activities for which individuals are accountable.

Tool 10: ***Assess the suitability of individuals assigned key responsibilities.*** Firms and/or national authorities could undertake assessments of the suitability of individuals (integrity and professional competency, including qualifications and experience) who have been assigned key responsibilities. Such assessments could take place at the time those individuals first assume their responsibilities and periodically thereafter.

National authorities

Tool 11: ***Develop and monitor a responsibility and accountability framework.*** National authorities could assess the implementation of a framework for responsibility and accountability that includes, inter alia, (i) the identification of key responsibilities for individuals in the firm, (ii) allocation of those responsibilities to specific individuals; and/or (iii) holding individuals accountable for the responsibilities to which they have been assigned.

Tool 12: ***Coordinate with other authorities.*** Supervisory techniques that aim to strengthen individual accountability through clearly assigned responsibilities could be deployed by more than one authority in the same jurisdiction. Approaches applied by one authority may have consequences for approaches that other authorities are considering. As such, national authorities could engage and coordinate with those authorities to understand their approaches to individual accountability.

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19 Tools 8, 9 and 10 are directed to firms and/or national authorities because they may be achieved through governmental action (legislative, regulatory, supervisory or enforcement) or firm-driven decisions or some combination of the two. How they are implemented depends on the specificities of the jurisdiction itself.

Addressing the rolling bad apples phenomenon

Firms

Tool 13: ***Communicate conduct expectations early and consistently in recruitment and hiring processes***. Firms have many opportunities during the recruiting and hiring processes to address potential employee conduct issues. Communicating clear, consistent messages about conduct expectations could deter some bad apples from pursuing employment at a firm that emphasises both high integrity and high performance. Silence as to expected employee conduct could signal that the issue is less important to the firm.

Tool 14: ***Enhance interviewing techniques.*** In addition to assessing the technical competency, experience and qualifications of candidates, the recruitment process could consider their behavioural competency and conduct history as well as their potential for adhering to the firm's values. This broadened review could be accomplished by asking particular questions or even by conducting a separate interview focused entirely on behavioural and conduct matters. Training in interviewing techniques to assess behavioural characteristics and spot "red flags" could add value to the interview process.

Tool 15: ***Leverage multiple sources of available information before hiring.*** Firms could search both publicly available and proprietary data sources for information about candidates. Current employees could have personal knowledge of a candidate's conduct at a previous employer. Previous employers are another possible source of information, though the extent to which firms are allowed, required or willing to share such conduct information could differ. Such information could require subsequent verification, depending on the number and credibility of the sources.

Tool 16: ***Reassess employee conduct regularly.*** Firms could update or renew background checks on regular schedules; for example, after three months or a year of employment or at career milestones, including promotions or lateral moves within a firm. In some jurisdictions, institutions have to (re)assess the fitness and propriety of employees in functions deemed capable of causing significant harm to the firm or its customers.

Tool 17: ***Conduct "exit reviews".*** Without prejudice to applicable legal requirements, firms could implement "exit reviews" and maintain appropriate records on former employees for their own potential future benefit as well as for prospective employers.

National authorities

Tool 18: ***Supervise firms' practices for screening prospective employees and monitoring current employees.*** An assessment of firms' employment and disciplinary policies and practices could be embedded in the supervisory process. Supervisors could also require institutions to regularly reassess and revalidate the conduct or suitability of employees or a subset of them deemed to pose the greatest risk to the firm or its customers (see Tool 16).

Tool 19: ***Promote compliance with legal or regulatory requirements regarding conduct-related information about applicable employees, where these exist.*** Authorities could provide methods for firms to exchange meaningful information on employees. This could include promoting consistent and more comprehensive information in databases of financial services professionals, where they exist.

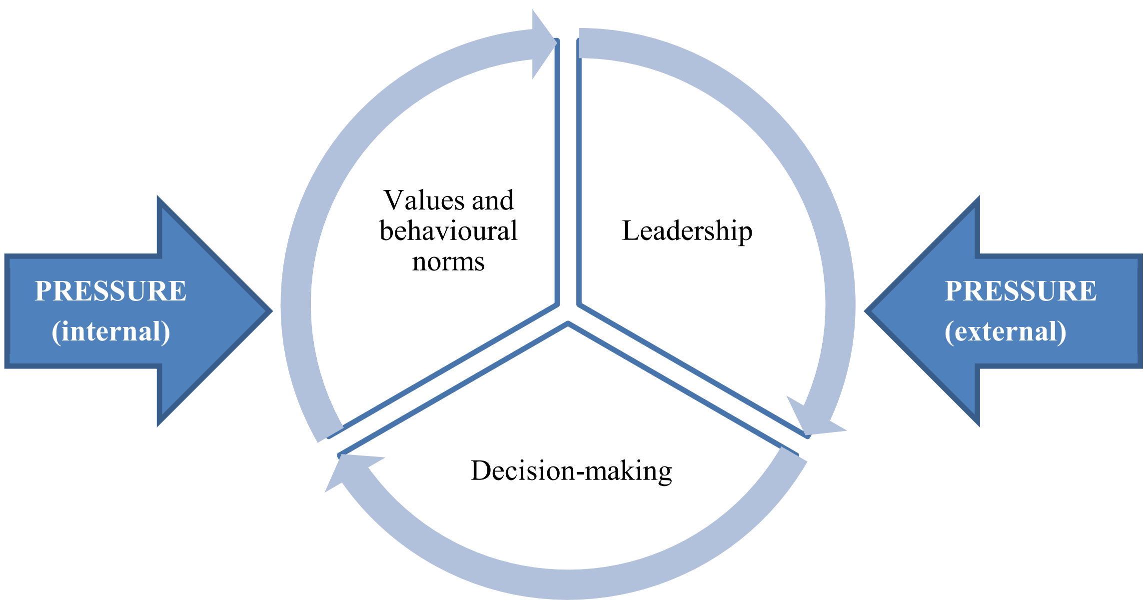
1. Mitigating cultural drivers of misconduct: Tools 1–7

A key observation drawn from the FSB stocktake in Phase 1 was how the relationship between governance frameworks, culture and conduct mutually influence one another in both positive and negative ways. A culture that values appropriate conduct can reduce incidents of misconduct, including by supporting and reinforcing governance frameworks. Conversely, a culture that tolerates or rewards misconduct or drives misconduct underground can undermine the effectiveness of those frameworks and harm firms, consumers and markets. Thus, understanding the elements of culture that can influence governance frameworks is important because they have a bearing on the likelihood that misconduct will occur. These influential elements of culture are as follows:

- The ***leadership*** of a firm, which sets the organisation's direction and the tone from the top and thus, through role modelling, influences the behaviour of staff;
- The ***decision-making*** process, including how decisions are made, challenged and communicated; and
- The ***values and behavioural norms*** of the firm, which collectively reflect and support the firm's purpose and its activities.

In addition to each of these elements, a firm's culture can be subject to ***pressures*** that contribute to the occurrence of misconduct (Figure 1). Pressure can be generated by either external forces (e.g. market conditions) or internal forces (e.g. deteriorating capital/liquidity positions, significant debt or an overly ambitious growth strategy). For instance, external pressures, such as a challenging business environment, may increase the temptation of employees in a firm that sets unrealistic or inappropriate goals (e.g. simultaneously striving for profit, growth and efficiency) to overlook established policies and procedures.

Figure 1: Elements of culture



A number of key drivers influence each of these elements of culture (Table 1). While not exhaustive, the lists in Table 1 show key cultural drivers that can undermine the effectiveness of governance frameworks and result in misconduct.

Table 1: Key cultural drivers of misconduct

Leadership	Decision-making	Values and behavioural norms
• Lack of accountability for misconduct • Lack of attention, skills and knowledge regarding misconduct risk • Domineering leadership style • Mismatch between leaders' words and actions (e.g. not leading by example) • "Tone from the middle" inconsistent with the tone from the top • Mindset/ambition that does not take account of all relevant stakeholders, including customers, markets and society • Failure to resolve staff engagement issues • Lack of will to cooperate or to share information	• Failure to resolve competing priorities • Lack of challenge and debate • Confusion regarding strategy or risk appetite • Weak connections between leadership levels • Poor communication • Decision-making dominated by the business lines • Lack of diversity and inclusion, resulting in "groupthink"	• Normalisation of misconduct • Lack of psychological safety within the firm • Reluctance to accept bad news • Limited adverse consequences for misconduct • Ineffective identification of, and response to, errors • Lack of transparency upwards

1.1 Interplay between cultural drivers of misconduct and governance frameworks

The interplay among cultural drivers of misconduct (i.e. the existence of a number of drivers within one firm) can increase the likelihood and impact of misconduct. For example, a domineering leadership style can influence whether employees feel sufficient psychological safety to freely express themselves without fear of negative consequences.

Governance frameworks themselves have an influence on culture, and vice versa. For example, a governance framework influences the way the business operates, including its systems, controls and risk management processes. When these governance frameworks are poorly designed or ineffectively implemented, they can contribute to the risk of misconduct. A number of governance framework mechanisms could negatively affect culture and potentially lead to misconduct. Among them are the following:

- ineffective reporting;
- misalignment of incentives and stated goals;
- rigid hierarchies;
- complex organisational structure;
- poor escalation mechanisms;

- insufficient stature of internal control functions;
- weak human resources practices (e.g. hiring, performance management, compensation, termination);[20] and
- inadequate management of risks (e.g. credit, liquidity, market and operational risks) and internal controls.[21]

Therefore, no single cultural driver of misconduct should be viewed in isolation from other drivers, from governance frameworks or from the context in which the firm operates. Nor should any particular driver be viewed as more likely than another to result in misconduct. Using the foregoing example, a domineering leadership style will not always result in misconduct; it may be exactly what a particular business needs to survive at a certain point in time, such as in a crisis, when quick and decisive action is necessary.

A scenario (drawn from broad supervisory experience – it does not represent an actual event) illustrates the interplay between cultural drivers of misconduct and governance mechanisms (Box 1).

Box 1: Illustration of the interplay between cultural drivers of misconduct and governance mechanisms

Taking advantage of favourable macroeconomic conditions, a firm achieved a long period of rapid growth. During this time, it executed a series of mergers and acquisitions that increased the complexity of its structure and culture.

A financial-sector crisis generated internal pressures to minimise costs and maximise short-term profits in its trading portfolio as the firm was becoming unstable due to growing complexity, increased levels of risk and mounting losses. In this environment, employees were encouraged to maximise short-term profits without fully taking into account potential downside risks. Moreover, employees were afraid to make mistakes or admit to errors, since undue pressure to generate positive results meant that errors were not tolerated. These internal pressures also meant that improper behaviours were not punished. Senior leaders took the view that success could not be achieved without compromising on ethics. Apart from small groups of employees (teams within teams), there was a noticeable lack of trust in the organisation. Front line staff and control areas did not collaborate to address difficult problems because they were suspicious of one another and did not respect each other's work. In particular, risk and control staff were seen as "policemen" by the business lines and simply a hurdle to risk-takers' ability to push against regulatory boundaries – a behaviour that was encouraged by the firm-wide focus on maximising short-term profits.

In the months following the crisis, many of the senior leaders who constituted the firm's global leadership resigned before the extent of the losses were fully realised; later, the middle managers who knew about the trading infrastructure also left due to the toxic environment. Less-experienced employees were asked to manage the trading portfolio without adequate expertise or knowledge of whom to consult.

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[20] Work on compensation and broader human resources practices are being conducted by the FSB Compensation Monitoring Contact Group.

[21] While this report focuses on misconduct risk, prudential supervisors consider "conduct risk" as a subset of "operational risk" (see, for example, BCBS, *Principles for the Sound Management of Operational Risk*, June 2011; and the European System Risk Board, *Report on misconduct risk in the banking sector*, June 2015, pp 4 and 17). From a prudential supervision point of view, firms are primarily profit-oriented and therefore by nature have to take risks. In the "grey zone" where no breach of law occurs or the current case law allows the presumption that the behaviour is permitted, firms are allowed to take risks but are responsible for managing these risks appropriately. This management of risk does not necessarily mean the avoidance of conduct risk.

The scenario in Box 1 illustrates that misconduct can arise from the interaction of the three dimensions of culture in Table 1 – leadership, decision-making, and values and behavioural norms – and governance mechanisms. The main contributing cultural drivers of misconduct and governance mechanisms in the scenario are as follows:

Leadership

- ***Mindset/ambition did not take account of all relevant stakeholders, including customers, markets and society.*** Leadership's attention was focused on maximising short-term profits, and it adopted the view that success could not be achieved without compromising ethics.
- ***Lack of will to cooperate or to share information.*** Dialogue and robust challenge between risk-controllers and risk-takers were strained because the two groups did not respect each other's work. In addition, risk-controllers were required to act as "police", while risk-takers were encouraged to push against regulatory boundaries. This led to weakened risk management throughout the firm.

Decision-making

- ***Poor communication.*** The complexity of the organisation meant that, after the leadership team resigned from the firm, employees did not know whom to consult to manage the trading portfolio.
- ***Decision-making dominated by the business lines.*** The firm aimed to maximise short-term profits and minimise costs without taking into account the long-term operational and risk dimensions of its business activities.

Values and behavioural norms

- ***Normalisation of misconduct***. There were no consequences for increasing risk positions beyond regulatory limits.
- ***Lack of psychological safety within the firm***. Internal pressures to maximise profits in the short-term meant that mistakes were not tolerated.
- ***Reluctance to accept bad news***. Because errors were not tolerated in the organisation, employees concealed their mistakes.

Governance mechanisms

- ***Complex organisational structure***. After a series of acquisitions, staff and business lines were not consolidated, which left the firm with an overly complex organisational structure and confusion concerning the responsibilities and authority of those in some key roles. This, in turn, resulted in a lack of understanding of the overall trading infrastructure after the departure of the leadership team and middle managers.

1.2 The role of cultural drivers of misconduct

The emergence of widespread misconduct in an organisation can be described in several ways. One key way is by examining the cultural driver "the normalisation of misconduct" noted above, which can be defined as a progressive acceptance of incrementally unsound decisions or acts by an expanding group of people that diverge from the stated expectation.[22] Research on the normalisation of misconduct in organisations shows three mutually reinforcing processes that underlie normalisation:[23]

1. *Institutionalisation*: An initial act, decision or incident of poor conduct becomes embedded in an organisation and thereby becomes routine.
2. *Rationalisation*: Strategies allow individuals and others around them to view their acts of poor conduct as justified.
3. *Socialisation*: Newcomers are induced to view misconduct as permissible, if not desirable.

The process of normalisation begins with an initial act of divergence from a formal rule or ethical expectation. The process is underpinned and enabled by the presence of certain social norms, which play a key role throughout all stages of the normalisation of misconduct.

Social norms are the unwritten rules and informal understandings that tell people what to do in different situations.[24] They arise in different ways. Sometimes they are introduced to existing groups by a new member, and they become a group norm if seen as functional and effective; sometimes they arise when a group is formed or when it encounters a new situation.[25] Social norms are therefore both dynamic and the result of social learning.

Although social norms are not usually formally documented, for example in policies, research indicates that they have a powerful influence on individuals' behaviour.[26] This is because individuals look at the behaviour of others to determine the right thing to do in a particular situation.[27] In other words, "to determine what is correct is to find out what other people think is correct".[28] Research also indicates that behaviour can be affected more by informal social norms than by formal rules and policies designed to reduce it.[29] This highlights a key reason why it is important and useful to look beyond the effectiveness of governance frameworks to examine other cultural drivers of misconduct to ensure that they are fulfilling the purpose for which they have been designed. The process of normalisation of misconduct is further elaborated in Annex A.

1.3 Toolkit for managing cultural risk factors through governance frameworks

A range of options are available to firms seeking to identify and influence cultural risk factors. To help with this process, firms' senior leadership and supervisors can consider drawing upon the

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23 B Ashforth and V Anand, "The normalisation of corruption in organisations", *Research in Organisational Behavior*, vol 25, 2003, pp 1–52.

24 H Young, "The evolution of social norms", *Economics*, vol 7, no 1, 2015, pp 359–87.

25 E Schein, *Organisational culture and leadership*, vol 2, Wiley, 2010.

26 N Goldstein, R Cialdini and V Griskevicius, "A room with a viewpoint: using social norms to motivate environmental conservation in hotels", *Journal of Consumer Research*, vol 35, no 3, 2008, pp 472–82.

27 C Moore and F Gino, "Ethically adrift: how others pull our moral compass from true North, and how we can fix it", *Research in Organisational Behavior*, vol 33, 2013, pp 53–77.

28 R Cialdini, *Influence: the psychology of persuasion*, William Morrow, 1984, p 116.

29 R Hollinger and J Clark, *Theft by employees*, Lexington Books, 1983.

following tools in their efforts to manage misconduct risk through enhanced governance frameworks and mechanisms.

The tools in this area are aimed to assist firms and supervisors as follows:

- the senior leaders of firms in their efforts to *identify* (Tools 1 and 2) and *mitigate* (Tool 3) cultural drivers of misconduct; and
- supervisors (Tools 4–7) in techniques for assessing firms' management of cultural drivers of misconduct.

1.3.1 Tools to assist firms in their identification of cultural drivers of misconduct

Firms should have a clear understanding of the cultural drivers within their organisation. This will ensure that time and resources are targeted at the most significant challenges to their desired culture.

Tool 1: Senior leadership of the firm articulate desired cultural features that mitigate the risk of misconduct

A firm's senior leadership could articulate a clear cultural vision that will guide appropriate behaviour within the firm. To inform the cultural vision, leaders could adopt a risk-based approach that evaluates and prioritises the most significant cultural drivers of misconduct risk that may be inherent to their firm.

The senior leadership of a firm is responsible for determining and managing the firm's culture. To identify any actions necessary to minimise the risk of misconduct, senior leaders first could articulate the desired cultural features for their organisation. This is an important preparatory step in identifying the current cultural features of the firm or in designing a set of actions to mitigate any cultural features that are driving misconduct.

As no two firms are the same, each firm will take its own approach to developing and articulating its desired cultural features, but the following may be useful steps to consider:

- *Leadership team discussion, decision-making and behaviour*. Leaders' attitude to misconduct and the ways in which they act, make decisions and communicate set the tone and drive behaviour throughout an organisation. Leadership teams could spend time reflecting on the desired cultural features they have articulated and determine the key behaviours and attitudes they wish to see from – and be exhibited by – themselves, their peers and colleagues, as well as the organisational outcomes they intend their behaviours to support.
- *Review and align existing behavioural policies*. A firm's culture is driven by the behaviour of individuals. Therefore, behavioural policies could be aligned not only to one another, but also to the senior leaders' vision of the desired cultural features that drive appropriate behaviour within the firm. Possible areas for review include values, strategy, mission, codes of conduct, behavioural standards used for staff performance management and leadership guidelines.
- *Staff engagement and feedback*. Defining the desired cultural features of a firm is often the role of its leaders, but engagement with staff throughout the process can ensure that critical issues at all levels of the firm are considered. Engagement could take place via workshops, surveys or interviews. Engaging staff at all levels in discussion about the firm's desired cultural features is an important (but by no means the only) step towards embedding them.

Tool 2: Identify significant cultural drivers of misconduct by reviewing a broad set of information and using multidisciplinary techniques

The senior leadership of the firm could strengthen its approach to mitigating misconduct risk by promoting the identification of significant cultural drivers of misconduct that are in conflict with the cultural vision articulated by the firm's leadership. The identification process could first involve collecting data and other information (from various sources and perspectives) that provide insight on behaviours that could lead to misconduct. Second, firms could apply multidisciplinary analytical techniques on the information gathered to obtain a more complete understanding of the drivers of these behaviours.

An inherent difficulty in identifying culture is that shared values and beliefs may not be formally stated or clearly observable.[30] However, scientific methods exist to extrapolate the existence of culture and, perhaps more importantly, to systematically observe its impact on human behaviour.

Social science methodologies for identifying cultural risk factors and conducting root cause analyses include both deductive[31] and inductive approaches. Deductive approaches share similarities with the auditing concept of negative assurance, i.e. a statement or representation that a fact is believed to be accurate since there is no evidence to the contrary. Deductive approaches focus on a specific scope of enquiry (i.e. "we have a hypothesis that there is a culture of fear which drives staff to conceal their mistakes") and can be undertaken with more targeted data (i.e. conducting a survey focused on issues related to fear, trust and confidence in discussing mistakes). However, such a targeted approach may overlook key characteristics that have not been defined in the original hypothesis and lead to several research errors.

Inductive methods begin with a broad scope of enquiry to see what emerges. A starting point for this methodology is establishing clear definitions of the various dimensions which characterise the topic of culture; for example, tone from the top, risk capability, openness and challenge, accountability and risk governance. Each dimension is then explored systematically and analysed to arrive at a set of themes that adequately reflect the data set. This approach provides a good opportunity to obtain a clear representation of a firm's unique characteristics, but it requires collecting a broader set of data and perhaps more sophisticated analytic techniques. It also makes benchmarking across and within firms more difficult.

Whether the analysis is deductive or inductive, its purpose is to identify cultural drivers that heighten the risk of misconduct, and it requires the collection of data (while being mindful of data protection rules). Qualitative data can offer a richness of understanding of the behaviour of individuals that can be very difficult to capture adequately via quantitative metrics, and such data also provide an entry

[30] According to Edgar Schein, a professor at the Massachusetts Institute of Technology Sloan School of Management, organisations do not adopt a culture in a single day; instead it is formed over time as employees go through various changes, adapt to the external environment and solve problems. They gain from their past experiences and start practicing it every day, which forms the culture of the workplace.

[31] Deductive methods test a priori hypotheses by seeking evidence that a certain set of behaviours or drivers exist which may heighten the risk of misconduct. In the absence of such evidence, the analyst may determine that these behaviours or drivers do not exist, and therefore the culture is sufficiently robust in avoiding the risk of heightened misconduct.

point to understanding firms' governance mechanisms. Quantitative data contribute a means of consistency, relativity, materiality and reliable evaluation of change over time.

Qualitative sources of data include the following:

- minutes of management, board and committee meetings;
- management presentations to the board;
- summaries of interviews with staff;
- free-text (open-ended) comments in staff surveys;
- social media posts by employees and customers;
- transcripts of leadership communications;
- transcripts or voice recordings of customer interactions;
- transcripts of employee exit interviews;
- reports from key functions, such as internal audit, risk, compliance and human resources; and
- independent or self-assessments of the board.

Similarly, some firms collect many types of quantitative data, including the following:[32]

- statistics and root cause analysis of any themes or trends on staff engagement, turnover, employee relations incidents, code of conduct breaches, diversity and inclusion;
- participation rates in risk and compliance training;
- reports on breaches in risk limits;
- whistle blower statistics;
- number and types of issues escalated to the senior management;
- information on performance management and variable compensation, including details on any adjustments to compensation;
- risk assessments from supervisory authorities;
- audit and risk ratings and the time taken to resolve control issues; and
- participation rates at management meetings.

This quantitative information could be complemented with efforts to collect data specifically to aid in assessing culture, such as surveys, structured observations, in-person or virtual focus groups, email and social media mining, social network analysis and notes from individual interviews (while being mindful of data protection rules). For instance, conducting interviews with individuals and/or small groups (e.g. using the "Five Whys" technique[33]) or systematically reviewing the formal environment (e.g. formal processes, structures, policies) and the informal environment (e.g. corporate 'stories', leadership behaviour, shared language) could help to identify the cultural drivers of misconduct.

[32] It should be noted that these sources could be used to determine conduct risk as part of operational risk exposures in the banking and insurance sectors.

[33] O Serrat, *The Five Whys Technique*. Asian Development Bank, February 2009. The Five Whys is a simple question-asking technique that explores the cause-and-effect relationships underlying problems.

A few indicators for some of the common cultural drivers of misconduct listed in Table 1 are as follows:

- *Tone from the middle inconsistent with the tone from the top*. To determine how leadership is driving behaviour, the kinds of explicit cues that leaders are sending (the “talk”) could be observed alongside the implicit cues that they are modelling with their behaviour (the “walk”), to determine which of these seem to be having more of an impact on the behaviour of staff at different levels. Leaders could consider how their actions, decision-making and communications (tone from the top) are driving behaviour within the firm.
- *Confusion regarding strategy or risk appetite*. To determine whether leaders’ expectations for employees’ performance are realistic and achievable, the goals could be reviewed in light of the realities of the market, the capabilities of the staff and the time and resources available. How delivery of these goals is incentivised – both financially and non-financially – and how these goals cascade into all layers of the organisation could also be explored.
- *Lack of psychological safety within the firm*. Certain observable conditions can erode a feeling of psychological safety within the organisation. These include quick punishment of mistakes, viewing questions as a show of weakness and ostracising team members who have dissenting opinions.

1.3.2 Tools to assist firms in their mitigation of cultural drivers of misconduct

Once the cultural drivers of misconduct have been identified, firms could determine how to mitigate these drivers, what tools they can use, in which direction they want the behaviours within the firm to go and over what time period. Firms could also consider how their governance frameworks can be used to ensure that the cultural drivers of misconduct are not undermining the governance processes in place, and they could reflect on what can be learnt from past incidents of misconduct.

Tool 3: Act to shift behavioural norms to mitigate cultural drivers of misconduct

Senior leadership could take actions to shift attitudes and behaviours within the firm toward its cultural vision and to reinforce the governance frameworks designed to mitigate misconduct risk. Actions could be selected with reference to the most significant cultural drivers of misconduct identified by the firm (Tool 2) and based on the firm’s operations. Such actions could include relevant informal and formal measures. Informal measures could include deliberate efforts by leaders to respond constructively to mistakes in order to create a safe environment for a candid dialogue and escalation of issues; more formal measures might include enhanced whistle blower protection, escalation procedures and effective compensation and related performance management mechanisms. Actions could also include monitoring the impact of interventions and making adjustments as necessary.

Key dimensions to consider when trying to shift behavioural norms could include the following:

- *Leadership behaviour*. Organisational change can be reinforced and modelled by leaders. This “lead by example” approach may involve leaders reflecting on their own behaviour, individually and as a team, the visibility of their behaviours to the rest of the organisation and the changes required to better support the desired cultural features of the firm. For example, individual leaders could promote positive learning behaviours and open dialogue (instead of displaying anger or defensiveness) when issues are raised to them and offer each other real-time feedback to support this continuous process of learning and adjustment. Other leadership behaviour may simply consist of deliberate actions to help support organisational change – for example, increased attention to referencing the firm's values and expectations in day-to-day discussions with staff. Finally, leadership could support the firm's desired culture by making and encouraging decisions that reflect an appropriate balance among risks, rewards and various stakeholders' interests.

- *Staff engagement*. Dialogue between staff and leaders, based upon mutual respect is important. Individuals often require some benefit to shift away from habit, and deliberate engagement between staff and leaders can be an important vehicle for making these benefits clear. Deliberate engagement can also clarify expectations and ensure that feedback and questions are escalated upwards. Such engagement involves more than just downward communication or the release of a policy; it entails a candid and active dialogue between all levels and layers within the organisation. Strategic issues, potential incidents that were identified and addressed before they actually occurred and visible errors can serve as natural triggers for such a dialogue. The same holds true for key management indicators (e.g. illness rates, staff turnover, staff surveys). Such management indicators are the beginning of the dialogue, not the substitute for it.
- *Capability building.* Cultural change within an organisation can include both individual and collective behavioural change. At an individual level, firms could consider whether the behavioural changes they are asking of staff may require additional skills or knowledge. At an organisational level, firms could consider whether cultural challenges have developed due to a gap in strategic or operational capability that requires additional resourcing, investment or focus. For example, an ineffective breach-tracking system not only hampers transparency but also signals a lack of commitment by leaders to diligently monitor breaches.
- *Mutually reinforcing informal and formal governance mechanisms.* Firms could consider aligning formal policies and procedures with desired behaviours. If problematic cultural features have developed, formal mechanisms – originally designed to support certain organisational aims – may actually be undermining them and thus increasing the level of misconduct risk. For example, inappropriately structured compensation arrangements can incentivise individuals to take imprudent risks that are inconsistent with the long-term value creation and time horizon of a firm's desired risk profile.[34] Hence, the impact of formal policy/procedure changes may be monitored and adjusted carefully.
- *Lasting cultural change.* A continuous approach that allows for formal and informal governance mechanisms to be mutually reinforcing will sustain cultural change. Individual behavioural change is influenced by a desire to change, the ability to change and observing change in others (especially leaders); senior leadership sets an appropriate tone from the top by supporting formal policy changes, leading by example and peer role modelling.

[34] FSB, March 2018, p 1.

1.3.3 Tools to assist supervisors in assessing firms' management of cultural drivers of misconduct

Supervisory programmes for reviewing cultural drivers of misconduct can support supervisory goals in a number of ways:

- contributing to supervisory understanding of firms' risks, informing ratings and overall assessments and feeding into internal benchmarking reports;
- building institutional expertise through supervisory reviews of cultural drivers of misconduct and helping to build a consistent approach to supervisory engagement on issues related to misconduct risk;
- providing signals for potential undesirable increases in a firm's risk more broadly, as culture can be seen as a leading indicator in the support or undermining of effective risk management; and
- helping supervisors to determine the level of supervisory review required for a firm.

Engaging in a dialogue about culture may encourage firms to consider the issue more seriously.

Tools 4–7 draw on a survey of supervisory authorities' approaches to governance effectiveness, behaviour and culture that was conducted by the Supervisors Roundtable for Governance Effectiveness, with additional input from FSB members that are not members of the Roundtable. Additional observations from the survey can be found in Annex B.

Tool 4: Build a supervisory programme focused on culture to mitigate the risk of misconduct

National authorities could consider building a programme with a focus on supervising culture. Supervisory reviews of culture could be led by either firm-specific or subject-matter expert teams. Where an authority has governance or culture specialists, those specialists could work jointly with line supervisors to link observations related to culture with other supervisory issues at the firm.

National authorities are using a range of practices to monitor behaviour and culture at firms. The approach taken depends on an individual authority's mandate and objectives, and no single approach has been identified as the most effective. However, before building a programme to monitor culture, authorities might consider certain questions to help define the programme's broad outline:

- How might a focus on behaviour and culture support the authority's supervisory objective?
- Where would the programme fit within the supervisory framework?
- Would any observations or outcomes affect supervisory assessments or ratings?
- What internal and external challenges or obstacles would need to be overcome in developing the programme/approach?
- What skills and resources are needed to produce high-quality, credible results?
- What is the authority's risk tolerance for experimenting with a new approach – can it allow some margin for error?
- What will success look like in the short term and over a longer period?

The formalisation of dedicated supervisory reviews could improve supervisors' insights into a firm's culture in general as well as into a range of other topics. For instance, such reviews could enable supervisory teams to "connect the dots" and see that identified behavioural issues have been root causes of a number of deficiencies, breaches and risks.

While a formalised structure can be beneficial, supervisors do not necessarily need to conduct a formal review to assess the culture of a firm. Instead, observations drawn from seemingly disparate supervisory activities and engagements can be combined to make the assessment.

National authorities employ a wide range of approaches when structuring their programmes for culture. For example, they may establish a specific unit dedicated to governance or culture, or they may designate an established task force or team to support line supervisors in their culture assessments. To provide consistency and opportunities for benchmarking, firm-specific supervisory teams that lead governance and culture reviews could be supported, overseen, advised and/or challenged by a central group with subject-matter expertise. In some cases this central group could directly oversee the firm-specific work; in other cases, advisors could be made available to support and train the firm-specific teams. Authorities could also complement their supervisory teams with specialists in organisational behaviour or psychology, including external experts, who could bring helpful perspective and additional resources.

The approach that national authorities take in developing their frameworks for supervising behaviour and culture may vary according to their desired level of formality. They may find that some of the following strategies will fit their desired approach:

- Look for behavioural patterns and the cultural drivers affecting those behaviours at various levels within the organisation.
- Conduct reviews at those firms with the highest behaviour- and culture-related risk rather than across all institutions (see Tool 5).
- To help supervisors identify patterns, themes or trends, make reviews more holistic so that judgments are not formed in isolation but benefit from previous recommendations and observations at the firms under review.
- Gather data on behavioural norms across a number of sources, including surveys, interviews, reviews of formal mechanisms, in-situ observations and outcomes analyses (see Tool 6).
- Introduce investigations of a handful of key decisions by reviewing the associated documents, discussing the decision-making process with those involved and focusing on specific examples, such as how breaches of risk appetite guidelines were managed.
- Ask front-line supervisory teams to note observations relevant to culture as part of regular supervisory reviews and assessments.
- Introduce peer-group meetings to obtain comparative perspectives and support benchmarking.
- Introduce workshops for supervisors to accelerate their acquisition of common language and knowledge regarding behaviour and organisational culture.
- Develop supervision guides so that consistent recommendations are made for similar observations across institutions.
- Complement supervisory teams with "senior advisors" and centralised, dedicated behaviour and culture resources such as organisational or behavioural psychologists.

Tool 5: Use a risk-based approach to prioritise for review the firms or groups of firms that display significant cultural drivers of misconduct

A risk-based approach to reviews could prioritise firms according to a comparative assessment of the cultural drivers of misconduct risk present within each firm. The depth of review could depend upon both the size and complexity of a firm or groups of firms under review, as well as the authority's own resources and the magnitude of misconduct.

Every supervisory activity can be an opportunity to observe behaviours that could result in misconduct. For instance, supervisors may receive troubling information about the behaviours of senior executives, detect unmanaged conflict at the board level or note an unexpected or unexplained change in strategy. Each of these observations could suggest the presence of particular cultural drivers of misconduct at a firm. Indeed, the list of cultural drivers of misconduct risk described in Table 1 could provide a useful resource for supervisors in identifying which firms might merit a deeper review.

A supervisory team can identify the need for a culture review in various ways, including through ongoing supervision, the annual supervisory planning process or instances of actual misconduct. The review might also be prompted by a change in priorities at the supervisory authority.

The depth of review could depend upon both the size and type of firm under review as well as on the authority's own resources. For instance, the length of the review could range from a few days for some smaller or less complex institutions to more than a year for a thematic review across multiple large institutions.

Tool 6: Use a broad range of information and techniques to assess the cultural drivers of misconduct at firms

Qualitative and quantitative information that supervisors obtain from a firm could not only help supervisors understand how governance processes work, but could also provide insight into the behavioural norms and culture of the firm. The information could be shared through the firm's documentation, supervisory dialogue, specific meetings on the topic and/or meetings on other topics, as all supervisory interactions can provide supervisors with insight and information on a firm's culture.

Reviewing a wide range of quantitative and qualitative documentation can give insights into the cultural drivers of misconduct risk. Document reviews could be part of a dedicated review of culture, or they could be part of another supervisory exercise to apply a culture lens to the review. Much of the relevant documentation includes regularly produced information that supervisors already receive, such as meeting minutes, management presentations to the board and risk appetite reports, while other documents may not have been reviewed by supervisors in the past (e.g. training participation rates or free-text comments in employee surveys). The discussion of Tool 2 contains an extensive list of the documents that firms can consider in their own culture reviews; these could prove equally useful to supervisors.

In some jurisdictions, meetings are a central part of regular, ongoing supervision. Depending upon the approach that a supervisor has chosen, authorities could gain insight into potential cultural drivers of misconduct by conducting culture-specific meetings with a supervised firm or by analysing existing interactions. Engagements that could be incorporated into supervisory assessments of firms' cultural drivers of misconduct include the following:

- interviews/meetings with board members, most often including the chair, the chief executive officer (CEO), the chairs of the audit and risk committees and chairs of other key committees;
- interviews/meetings with the full board, with the agenda being set by the supervisor;
- observations of board meetings;
- interviews/meetings with senior management, including key function/infrastructure executives;
- observations of other internal (management level) meetings;
- focus groups with individuals below management level; and
- interviews/meetings with internal and external auditors.

Tool 7: Engage firms' leadership with respect to observations on culture and misconduct

Supervisors could engage in a range of methods to convey supervisory observations on behaviour and culture to the firms they supervise. A dialogue between a firm's leadership and supervisors could be useful to understand and bolster a firm's proposed actions to strengthen culture, where necessary, to mitigate misconduct risk. Engaging in a dialogue about culture could encourage firms to consider the issue more seriously.

Irrespective of the formality or extent of an authority's programme for the supervision of culture and behaviour, supervisors tend to have observations about these topics through the normal course of supervision. Because their unique perspective can be helpful to a firm that is looking to understand its own culture, supervisors could consider holding up a "mirror" to the firm by sharing such observations with the boards and senior management of the firm. The form that a supervisory message takes could range from simple reporting of observations to more formal supervisory "findings." This will likely depend upon the topic and level of formality of the review as well as on the level of maturity or formality of an authority's programme.

Following the communication of observations, supervisors could request that firms provide written remediation plans to address identified cultural drivers of misconduct within a particular timeframe and to give regular verbal and written updates on key milestones achieved against those plans. Supervisors could monitor progress via focused follow-up assessments or through the regular course of supervision. If observed problems are not addressed and misconduct occurs as a result, supervisors have a range of tools they could employ:

- influencing firm action through moral suasion;
- imposing administrative enforcement measures, sanctions or business improvement orders;
- imposing disciplinary measures or warnings;
- restricting business activities, adding a capital surcharge, requiring independent audits or downgrading supervisory ratings; and
- taking enforcement measures against individuals, prompting renewed fit-and-proper reviews or requiring changes to management or the board.

2. Strengthening individual responsibility and accountability: Tools 8–12

In recent years, fines have been widely used to sanction firms for instances of misconduct.[35] A consequence of the growth in fines and settlements is heightened interest by both firms and authorities in addressing misconduct, especially by holding individuals accountable for their actions. Accountability[36] can be reinforced by clearly identifying key responsibilities and assigning them to individuals. Such an approach could also support cultural change at firms – for instance, by dispelling notions that fines are the cost of doing business. To help ensure that individuals appreciate and understand the responsibilities to which they have been assigned, an expectation that individuals will adhere to policies that define acceptable and unacceptable behaviours can be embedded in annual performance plans and reviews.

Through their supervisory programmes, national authorities can review the effectiveness of such firm-led approaches – evaluating the possibility that ineffective arrangements might not address misconduct risk. Authorities may use a number of supervisory techniques to promote appropriate standards with respect to conduct, systems and internal controls besides imposing fines or other sanctions on firms. The choice of tools will depend on the legislative arrangements in each jurisdiction that may promote or constrain particular approaches.

2.1 Overview of existing international guidance and standards related to individual responsibility and accountability

The efforts of firms and national authorities to strengthen individual accountability are supported by a broad range of policy documents issued by the FSB and SSBs in the areas of governance, accountability and conduct. Annex C provides a list of the relevant international documents and the principles related to identifying and defining roles, allocating responsibilities and holding individuals accountable. These documents offer guidance on the following topics:

- the collective responsibilities of boards whose members are seen as ultimately responsible for the conduct of the firm;
- the importance of clarity with respect to an individual's role within the firm and function and the responsibilities that have been assigned to that role;
- the responsibilities and requisites of some specific roles, including the chairman of the board, CEO, CRO, head of internal audit and the main board-level committees (e.g. risk committee and audit committee). These responsibilities include decision-making as well as implementing and monitoring the activities of the firm;
- the importance of risk management and internal controls, the development of codes of conduct and ethical behaviour; and

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35 See footnote 1.

36 "Accountability" occurs where an individual can be held to account for "outcomes" in the areas for which s/he has responsibility. For the purpose of this paper, accountability may take a variety of forms, and the term is not used prescriptively to imply any particular accountability mechanism. At the same time, an employee cannot be described as individually accountable if he or she never faces consequences for misconduct.

- the composition (and suitability of members) of the board and its committees, including the role of independent, non-executive and executive directors; and the delineation of responsibilities associated with executive and non-executive roles.

Given that firms are responsible for holding employees accountable for their behaviour, most of the international policies reviewed are addressed to firms. However, several policies issued by the FSB and SSBs highlight an important role for authorities; as a precondition, authorities should have the powers and resources to evaluate the corporate governance of a firm, including on a group-wide basis. For example, there are some international policies for supervisors to establish guidance or rules requiring firms to have robust corporate governance policies and practices and to expect their boards to establish organisational structures that promote accountability, transparency and a clear allocation of responsibilities.[37] Most authorities have a range of tools to require improvements in this area, including, for example, the ability to compel changes in the composition of the firm's board or senior management.

2.2 Approaches to strengthening individual responsibility and accountability

The FSB surveyed member jurisdictions concerning measures to strengthen individual responsibility and accountability (a detailed summary of the results is presented in Annex D). Such measures included one or more of the following elements:

1. **Identification of key responsibilities:** Key functions/responsibilities are identified and described.[38] Depending on the size and activities of the firm, key roles may also be identified and described.[39] The description of these functions and roles may be brief and cover only their core characteristics or responsibilities, taking into account the firm's business model, structure, risk profile and key deliverables. Such processes fall within the responsibilities of the board. However, depending on the size, complexity or significance of the firm, authorities are generally empowered by law to establish expectations for firms to establish certain functions (e.g. a risk management function), roles and/or certain sub-structures within the board (e.g. audit, risk and compensation committees are required for systemically important banks).

2. **Allocation of responsibilities:**[40] Key responsibilities are assigned to individuals undertaking a relevant role or activity, often taking account of a firm's business model, risk profile and firm-specific key projects or deliverables. Clearly allocating responsibilities to individuals helps set out the nature and/or scope of an individual's specific responsibilities beyond a basic definition of the role.

3. **Individual accountability:** The individuals performing the functions/responsibilities assigned to these roles are held accountable for their actions. Similarly, management is responsible for

[37] BCBS, *Corporate governance principles for banks*, July 2015.

[38] For example, BCBS, July 2015, paragraph 105 notes, "The independent risk management function … is responsible for overseeing risk-taking activities across the enterprise and should have authority within the organisation to do so."

[39] For example, BCBS, July 2015, paragraph 108 notes, "Large, complex and internationally active banks, and other banks, based on their risk profile and local governance requirements, should have a senior manager (CRO or equivalent) with overall responsibility for the bank's risk management function."

[40] The term "responsibility" is used broadly in this paper, recognising that it may have one or more meanings in the context of a specific legal or regulatory framework. The term is not intended to imply that any particular form of liability attaches to an individual undertaking a role or function.

delegating duties to staff and for establishing a management structure that promotes accountability and transparency throughout the firm. Accountability can be achieved through a combination of (i) legislative/regulatory provisions; (ii) a firm's internal processes, including employee contracts; (iii) supervisory action; and (iv) regulatory enforcement. The weight or balance among these approaches to achieving accountability will vary by jurisdiction, with some being led more by legislation and others driven by supervision or enforcement.

Respondents were asked to discuss how they incorporate strengthened individual responsibility and accountability into their supervisory structure and to reflect on the benefits and the challenges of doing so.

In discussing supervisory approaches to individual responsibility and accountability, this report takes into account the variety of regimes and practices employed by FSB members.

2.2.1 Incorporation in the supervisory structure

Some of the high-level observations from the survey are as follows:

- Some jurisdictions link roles and responsibilities to reinforce accountability within their regulatory system and to mitigate misconduct risk. This approach includes expecting individuals to be fully involved in the activities of their institutions and ensuring that accountability and lines of authority are clearly delineated.
- A few jurisdictions are broadening their frameworks to link roles, responsibilities and accountability to senior individuals for the key aspects of a firm's business and operations. These include Hong Kong's Manager-In-Charge Regime, the United Kingdom's Senior Manager & Certification Regime, and Australia's recently established Banking Executive Accountability Regime.[41] Meanwhile, Singapore is studying possible measures to augment its existing framework to strengthen individual accountability.[42]
- In several jurisdictions the responsibility regime of firms and the concepts of "individual accountability"[43] and "delegation of responsibilities" are set in civil codes, corporate law or other pieces of basic legislation (e.g. labour legislation). In addition, basic laws are complemented by sectoral legislation that broadens the responsibility regime beyond members of the board to encompass individuals performing certain key functions; supervisory authorities may also be empowered to impose administrative sanctions on those individuals if they cause serious damage to the firm with their actions or inactions (i.e. if they who fail to comply with their duties, including a failure to supervise subordinates).

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41 Australia's regime is intended to strengthen the accountability obligations of banks, their directors and their senior executives and to impose more severe consequences for violating these obligations. To support the Banking Executive Accountability Regime, the Australian Prudential Regulation Authority will receive new and strengthened powers. In particular, it will be empowered to impose substantial fines on banks, more easily disqualify accountable persons, and ensure that banks' remuneration policies result in financial consequences for individuals.

42 In addition, although not part of the FSB's survey on individual responsibility and accountability, the Central Bank of Malaysia recently issued a discussion paper on the issue, *Responsibility Mapping Discussion Paper*, February 2018.

43 For example, stemming from the regulation of the "mandate" contract.

2.2.2 *Benefits and challenges*

A number of jurisdictions have found it difficult to identify or measure how the use of tools related to individual responsibility and accountability have changed behaviour and reduced misconduct in significant firms. In some jurisdictions, effects are hard to measure because regulations have only recently been introduced. Making such an assessment was considered challenging, in part because individual behaviour is also affected by other factors, including efforts to strengthen internal controls, compensation practices and employee training programmes. Better information could assist in interpreting trends. For example, in Germany, a register of employees and complaints has made it possible to trace misconduct to the responsible sales manager.[44]

Nonetheless, behavioural changes within firms have been observed (e.g. in South Africa, United Kingdom) or are expected (e.g. in Hong Kong), including in terms of restructuring reporting lines. In general, jurisdictions expected that accountability mechanisms would ultimately drive better ex ante decisions and provide better incentives for appropriate conduct.

Moreover, where introduced, linking roles and responsibilities with accountability of individuals has enhanced the competency of individuals and – particularly within larger firms, resulted in better documented and more transparent internal roles. This has proved useful to both firms and authorities. A number of respondents noted that linking roles, responsibilities and accountability of individuals allows for a more immediate and efficient identification of responsible executives for key business issues. That, in turn, facilitates an open dialogue and meaningful interaction with supervisors as well as more effective enforcement actions.

Respondents reported that linking roles and responsibilities with accountability was more likely to gain traction if they (i) promoted individual accountability and "deep dives" by authorities into governance issues; (ii) provided greater clarity (including for authorities) as to the responsibilities associated with a role, thereby promoting better governance within the firm; (iii) delivered improved and more granular specification of roles and responsibilities for key individuals; and (iv) increased awareness by firms and authorities.

2.3 Tools for firms and national authorities to strengthen individual responsibility and accountability

These tools recognise that collective decisions of the board and senior management draw on contributions from a range of individuals with distinct responsibilities throughout the organisation. Individual accountability clarifies and strengthens the responsibility of individuals with respect to their specific contributions to collective decisions. At the same time, jurisdictions may, as a matter of law, hold board members accountable for the management of the firm, recognising that they have an obligation to supervise their colleagues and are not able to abrogate key responsibilities even if particular tasks are delegated.

[44] According to German securities law, investment services enterprises must ensure that all their employees who inform clients about financial instruments, structured deposits, investment services or ancillary services as well as their portfolio managers, sales representatives and compliance officers must meet minimum requirements regarding their expertise and reliability. Moreover, certain employees (sales representatives, compliance officers and those who provide investment advice) must be included in the non-public database maintained by the Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority or BaFin), along with further information relevant from a supervisory perspective (e.g. the number of complaints).

Some legislative frameworks impose accountability when duties or responsibilities are delegated to individuals. These tools offer additional ways in which regulators can strengthen – or even set, where this obligation does not exist in legislation – individual responsibility and accountability.

2.3.1 Tools to assist firms and/or national authorities in identifying key responsibilities

Tool 8: Identify key responsibilities, including mitigation of the risk of misconduct, and assign them
Identifying key responsibilities and clearly assigning them to the holders of various positions within a firm promotes individual accountability and increases transparency both within a firm and to relevant stakeholders. The identification and assignment of key responsibilities may be achieved through legislative or regulatory requirements, firm-driven decisions on their preferred structure, or both.

A structured approach to identifying the "key responsibilities" within the firm and assigning them to specific individuals could help to avoid opaque and duplicative decision-making procedures that make it difficult to determine where the responsibility for taking key business decisions actually rests. Key responsibilities could include managing major functions (e.g. risk, compliance, internal audit), running core business lines and chairing decision-making committees that report to senior management or the board. As firms vary greatly in their size, structure and business model, the nature of these key responsibilities will also vary across firms.

A short description of the significant functions or a statement of the activities for which each senior manager is responsible could be used to devise a "responsibilities map" showing how key responsibilities are allocated across the firm.

In identifying key responsibilities, firms and/or authorities could consider the following issues:

- the level of granularity in which assigned responsibilities and reporting lines are outlined;
- the extent to which internal statements cover institutional detail relating to functions and tasks, and expectations on how these should be performed, including the maintenance of conduct standards;
- the extent to which responsibilities and duties can be delegated to employees at lower levels, and, depending on the legislative framework in place, the extent to which they continue to reside with the most senior individual who has been assigned that responsibility by the board;
- the extent to which the approach to responsibilities is integrated with the performance and remuneration policies and practices as well as disciplinary processes of the firm; and
- the need to address (i) shared responsibilities and collective decision-making, including, for example, business lines or functions with co-heads; (ii) the management of projects and activities that require close collaboration between different functions; (iii) the application of matrix management; (iv) the relationship between the responsibilities of senior executives at the legal entity level and those at group level; and (v) the role of committees in the decision-making process.

Assigning or delegating the identified key responsibilities to individuals can promote accountability and transparency throughout the firm. This could give employees greater clarity as to their objectives, including their responsibility for following conduct standards, and could reduce the scope for mismatched expectations between firms and employees.

Depending on the size and activities of the firm, key roles may also be identified and described. A number of individual roles could be relevant to mitigating misconduct risk. Although no standard nomenclature applies to the heads of business lines or the local operations of cross-border firms, the following list of roles could be considered:

Board positions:

- chair of the board; and
- chairs of relevant board committees (e.g. risk committee, audit committee).

Management and control functions

- chief executive officer;
- chief financial officer;
- heads of business lines;
- head of local operations of a foreign firm;
- chief operating officer;
- chief technology officer;
- chief risk officer;
- head of compliance; and
- head of internal audit.

National laws or regulations may impose some requirements regarding the identification and allocation of responsibilities or the standards against which senior individuals are assessed when performing their duties. For example:

- *One or more specific functions or responsibilities should exist* (e.g. a risk function, a compliance function, an internal audit function) and might be vested in particular individuals (e.g. firms should have a head of risk or head of compliance). A number of jurisdictions require some institutions to have at least a risk committee or an individual who is designated as the head of risk.

  In the US, for example, financial firms subject to section 165(h) of the Dodd-Frank Act are required to have a risk committee that is responsible for the oversight of the enterprise-wide risk management practices and that includes at least one member with experience in identifying, assessing and managing risk exposures of large, complex firms. A US example of a role directed at addressing misconduct is the requirement in the Investment Company Act of 1940 and the Investment Advisers Act of 1940 for investment advisers and investment companies to designate a chief compliance officer (CCO) with sufficient responsibility and authority to develop and enforce compliance policies and procedures.

  In the European Union, the Capital Requirements Directive IV requires that banks and investment firms that are deemed "significant" appoint a senior manager with distinct responsibility for the risk management function (Article 76) and that these institutions establish a risk committee (Article 76), a nominations committee (Article 88) and a remuneration committee (Article 95). Article 41 of Directive 2006/43/EC requires that each public-interest entity have an audit committee.

- *Firms identify to a national authority the allocation of key responsibilities to individuals.* See, for example, the UK's Senior Manager & Certification Regime, Hong Kong's Manager-In-Charge regime and Australia's Banking Executive Accountability Regime. Such approaches can be used to ensure that there are no significant gaps or unassigned responsibilities across the set of core tasks that exist within firms. More generally, many supervisors assess the suitability – including experience and competencies – of members of the board and senior managers against their delegated functions (see Tool 10). Such processes can allow supervisors to see the specific functions delegated to individuals holding senior roles.

- *Individuals are subject to professional standards of competence and conduct in the discharge of their duties*. These standards could cover the "failure to supervise liability"[45] that is intended, in part, to guard against managers evading responsibility on grounds that their subordinates were responsible and that they were not aware of the misconduct that occurred. For example, the US Securities and Exchange Commission (SEC) has the authority to charge and sanction an individual for failing to reasonably supervise a subordinate who has violated federal securities laws. Under Italian civil and administrative law, the CONSOB can draw on principles such as "culpa in eligendo" (bad choice of employees) and "culpa in vigilando" (failure to properly supervise employees) to sanction managers.

  Authorities can take different approaches as to who constitutes a "supervisor" and what type of supervision is "reasonable." However, authorities often have an expectation that these individuals, consistent with their obligation to reasonably supervise, could establish and maintain a compliance system designed to help ensure that subordinates are acting in compliance with relevant laws. In some instances, laws may also provide an affirmative defence against such liability for failure to supervise where reasonable procedures have been adopted and effectively implemented.

Firms and/or national authorities could also consider the following issues:

- whether particular responsibilities or functions are of significance to the policy objectives;
- the proportionate application of any approach, taking into account the size, complexity, activities and structure of a firm;
- the legal authority needed to support a preferred approach, recognising that particular approaches to the assignment of responsibilities and their performance may already be established by national legislation; and
- whether to specify one or more functions or responsibilities as significant, or set expectations about their performance.

[45] Also referred to in some legislative frameworks as "culpa in vigilando", which implies that an individual is responsible for the actions of another individual over whom the former has a special duty of vigilance or oversight.

Tool 9: Hold individuals accountable

Individuals could be held accountable through a combination of (i) legislative/regulatory provisions; (ii) a firm's internal processes, including employee contracts; (iii) supervisory action; and (iv) regulatory enforcement. Clearly assigning responsibilities reinforces individual accountability and allows authorities to identify the functions and business activities for which individuals are accountable.

Clarifying the responsibilities assigned to individuals can reinforce individual accountability and contribute to improved behaviour on the part of individual employees. Clearly assigned responsibilities enable the firm to more easily hold employees accountable for possible misconduct. By the same token, greater clarity concerning their responsibilities may enable employees to demonstrate that their actions were reasonable, given the tasks that they were assigned.

With this background in mind, firms and/or authorities could introduce some combination of the following measures to hold individuals accountable, depending upon jurisdictional specificities:

- *Legislative/regulatory provisions*. In some jurisdictions, accountability obligations are set in basic legislation, such as civil codes. In such cases, the obligations may then become part of the general responsibility and liability regime applicable to members of the board and senior managers. A delegation of responsibilities by the board to an individual – generally a senior manager – or to a specific supporting committee is a formal act that often needs to be decided by the board. In some cases those decisions may need to be made public.
- *Firms' internal processes and employee contracts*. Even if employees at lower levels are not generally subject to responsibility regimes, firms could consider clarifying their accountability obligations within their labour contracts, where relevant, as well as their functions and responsibilities. This clarity may facilitate internal disciplinary processes in the event of misconduct.
- *Supervisory action*. Supervision of firms' governance, internal organisation and, where relevant, accountability mechanisms is an important tool to foster improved conduct. Authorities could consider adopting supervisory programmes aimed at setting clear expectations at firms, especially where accountability is not already set in legislation. Authorities could also consider using supervision as their principal means of assessing how firms address accountability issues or in conjunction with specific approaches directed to ensuring particular outcomes in the area of individual accountability (see Tool 11). In either case, authorities can draw on existing principles and guidance on internal governance and supervision by the SSBs and the FSB.[46]
- *Regulatory enforcement*. Firms could be held accountable for the failure of certain staff to undertake their duties effectively. Some jurisdictions see having tools that extend beyond corporate penalties (e.g. to individuals) as a way to increase the incentives for individuals to improve their oversight of the firm and their areas of responsibility.

[46] Relevant documents include BCBS, *Corporate governance principles for banks*, July 2015; BCBS, *Core principles for effective banking supervision*, September 2012, Principle 14; IAIS Insurance Core Principle 7.1.2; and FSB, *Principles for an Effective Risk Appetite Framework*, November 2013.

Tool 10: Assess the suitability of individuals assigned key responsibilities

Firms and/or national authorities could undertake assessments of the suitability of individuals (integrity and professional competency, including qualifications and experience) who have been assigned key responsibilities. Such assessments could take place at the time those individuals first assume their responsibilities and periodically thereafter.

The process of identifying key functions and assigning responsibilities to individuals can provide greater clarity and support effective decision-making and accountability. It also allows firms and, as appropriate, authorities to weigh more carefully the professional attributes and competencies that are required by function holders. The likelihood that an individual will promote high standards of conduct and act with integrity could form an integral part of such an assessment.

A requirement that firms assess the suitability of individuals to perform certain board level or senior management roles is a key element in the approaches taken by several jurisdictions. This can be undertaken at appointment and also on an ongoing basis. In addition, if firms have a clearer sense of the responsibilities of their senior staff, they could better frame their approach to recruitment and job references.

Although the onus is largely on firms to conduct thorough suitability assessments, authorities in some jurisdictions can review the firm's suitability assessment or object to a senior appointment.

2.3.2 Tools to assist national authorities

Tool 11: Develop and monitor a responsibility and accountability framework

National authorities could assess the implementation of a framework for responsibility and accountability that includes, inter alia, (i) the identification of key responsibilities for individuals in the firm, (ii) allocation of those responsibilities to specific individuals; and/or (iii) holding individuals accountable for the responsibilities to which they have been assigned.

As noted in the discussions of Tools 8, 9 and 10, national authorities can develop a framework to identify responsibilities for individuals and hold those individuals accountable for the responsibilities to which they have been assigned. Some jurisdictions have existing statutory or regulatory authority to require responsibility and accountability frameworks for individuals occupying senior positions in firms. In those jurisdictions where accountability is not already set in legislation, authorities could use supervision as their principal means to assess how firms address accountability issues, or they could use supervision in conjunction with specific approaches directed at ensuring particular outcomes in the area of individual accountability.

National authorities could set clear supervisory expectations for firms to establish responsibility and accountability frameworks or they could provide specific direction to a firm regarding the development and implementation of a responsibility and accountability framework. Supervisory programmes are also an effective means of monitoring a firm's responsibility and accountability frameworks. Monitoring programmes could focus on internal governance and the control environment at firms to identify activities that lead to misconduct. Monitoring programmes could also give authorities flexible tools to examine misconduct issues in the context of a firm's overall risk profile and thereby determine the effectiveness of the firm's responsibility and accountability framework. Other tools could include documenting responsibilities (e.g. through a responsibility map) to help authorities monitor the effectiveness of a firm's governance and identify the individual responsible for a given activity. To ensure ongoing understanding of responsibilities, supervisors could review how firms monitor and embed adherence to codes of conduct and other related policies in annual performance plans and reviews. National authorities could supplement these tools by drawing on existing principles and guidance on internal governance and supervision issued by the SSBs and the FSB.[47]

Tool 12: Coordinate with other authorities

Supervisory techniques that aim to strengthen individual accountability through clearly assigned responsibilities could be deployed by more than one authority in the same jurisdiction. Approaches applied by one authority may have consequences for approaches that other authorities are considering. As such, national authorities could engage and coordinate with those authorities to understand their approaches to individual accountability.

National authorities that aim to strengthen individual accountability through more clearly defined responsibilities assigned to certain roles could consider whether this may have implications for, or be affected by, approaches deployed by others.

The extent to which this calls for inter-agency dialogue will depend on, for example, each authority's legal mandate. Coordination is likely to be particularly important in situations where each authority (such as a conduct regulator and a prudential regulator) applies a broad-based approach to individual accountability to the same set of firms. This could call for an exchange of views on the design and operational requirements of this approach at an early date.

Similarly, in the context of a cross-border group, national authorities could consider the potential linkages between their approach to individual responsibility and accountability and those of authorities in other jurisdictions, including due regard for existing legislative frameworks.

Group structures may be relevant in at least two contexts. First, a function-holder at a regulated entity may report to a senior officer at group level with similar functional responsibilities (e.g. a local entity CRO reporting to a group CRO) as well as to a senior executive (e.g. the CEO) within the regulated firm.[48] Understanding how matrix management arrangements operate within firms or groups provides regulators with important information. It may, however, have added significance if both home and host authorities set requirements for the same or similar functions and as the number of authorities doing so widens. This could be an additional factor supporting the use of responsibility maps that outline the allocation of responsibilities within a firm or group.

Second, senior individuals from an overseas parent company may sometimes sit on the board of a regulated entity as non-executive directors. Given their role within the group, such non-executive directors could exercise greater control than usual. In such circumstances, the authority responsible

[47] See footnote 46.

[48] The same issue may can apply in the case of a firm with a domestically headquartered group.

for the local regulated entity could seek clarification of the responsibilities assigned to such individuals.

3. Addressing the "rolling bad apples" phenomenon: Tools 13–19

Another aspect of strengthening individual accountability relates to the problem of individuals who engage in misconduct but are able to obtain subsequent employment elsewhere without disclosing their earlier misconduct to the new employer (so-called rolling bad apples). The result is that employees are mobile, but their conduct records are not, and a valuable deterrent against misconduct – risk to future employment – is thus lost.[49]

The term "rolling bad apples" may also apply to individuals who engage in misconduct, change roles within the same firm, and continue engaging in misconduct in their new function. The terms "bad apple" and "misconduct" cover clear-cut breaches of statutory or regulatory requirements. But they may also include conduct that, while not formally illegal, may contravene the policies, norms or values of the industry or individual firms or the expectations of national authorities.

There is some risk that an over-emphasis on bad apples may distract from collective norms or other environmental factors that influence conduct. As described in Section 1, on the cultural drivers of misconduct, misconduct may be a result of the culture of the firm in which a person works. In other words, the problem might be the apple "barrels", not the apples,[50] and it might be easier for organisations to blame individual bad apples than to consider potential cultural or structural causes of misconduct. These causes may include, but are not limited to, misaligned incentives and a lax internal control environment.[51] Addressing misconduct by taking account of all relevant factors – including effective governance, systems and controls and other areas highlighted in this report – is more likely to be effective than an approach that focuses solely on bad apples.

Similarly, the preceding section on responsibility and accountability is relevant to the underlying issues discussed in this section. It might be easier for an employer to consider bad apples as incurable recidivists than to accept responsibility for poor hiring decisions, an inadequate tone from the top, or poor management oversight.

There are also fundamental issues of fairness at stake in the phrase "rolling bad apples". Branding someone a "bad apple" carries the risk of an unjust stigma. A person could be permanently characterised as irredeemably "bad" due to a single prior failing – which, as described elsewhere in this report, may have had contributing factors other than an individual moral failing. Some serious

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[49] See HM Treasury, Bank of England and Financial Conduct Authority, *Fair and Effective Markets Review: Final Report*, June 2016, p 62: "Respondents to the Review's consultation and market outreach expressed particularly strong views about the need for further action to be taken to prevent the 'recycling' of individuals with poor conduct records between firms: the 'rolling bad apples' problem."

[50] William C. Dudley, "Enhancing financial stability by improving culture in the financial services industry", remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry, 20 October 2014.

[51] There are, of course, limits to the "bad barrels" argument. Blaming internal controls for one's own misconduct is undeniably disfavoured. A noteworthy example concerns Seymour R Thaler, once a state senator in New York, who sued the Second New Haven Bank for negligence while serving a sentence for selling stolen bonds to that institution. Thaler argued that the bank failed to screen the bonds he gave to a teller. Had it done so, the bank would have recognised the contraband and Thaler would not have been convicted. See Thaler v. Second New Haven Bank, Civ. No. B-713, slip op. at 1 (D. Conn. Apr. 10, 1974). Thaler's case contributed to the development of the word chutzpah as a "legal term of art." See Motorola Corp. v. Uzan, 561 F.3d 123, 128 n.5 (2d Cir. 2009) (José A. Cabranes, J.) (collecting cases).

misconduct may warrant a lifelong stigma. Other missteps may call for a more nuanced understanding. Firms may want to take into account all relevant circumstances, including any extenuating and mitigating circumstances and any remediating or rehabilitative action, including subsequent good conduct. For example, misconduct early in a career, in a position that may carry lower expectations of maturity, may be less relevant than misconduct committed in a more senior role. Apart from the experience of the offender at the time, the staleness of the offense may also mitigate its relevance to future performance. These are decisions for employers to make, although they highlight a few of the concerns with the term "rolling bad apples."

Even if one questions whether rolling bad apples threaten financial stability, the phenomenon is important for several reasons. Individuals may feel less deterred from committing serious transgressions if they believe their conduct records will remain secret when they seek reemployment. Efforts by individual firms to prevent and address misconduct may be weakened by collective inaction. Moreover, recurring misconduct is especially vexing to both the industry and the official sector because of a sense that something should have been done sooner.

One of the goals of the tools in this section is to give hiring managers options to consider when carrying out their responsibilities. Firms cannot control the employment information they receive, but they can control their hiring and employment processes. Mindful that firms often lack all the information relevant to employment decisions, the tools presented here are designed to help firms identify bad apples regardless of their previous employment (which may be at a non-financial firm or at a financial firm based in another jurisdiction). Although avoiding bad apples is primarily the responsibility of firms, Tools 18 and 19 address national authorities (see Annex E for a range of authorities' approaches to the bad apples problem). These tools underscore the common interest of employers and national authorities in deterring misconduct and acknowledge measures taken by some authorities to facilitate action by firms.

The FSB examined the nature and scope of the rolling bad apples phenomenon. It reviewed relevant literature, examined how national authorities address the issue, studied public cases of rolling bad apples, conducted a stocktake of databases/registries of financial services professionals and regulatory reference regimes, and held discussions with FSB member authorities and representatives from the industry. The following discussion draws on this body of work.

3.1 Nature and scope of the "rolling bad apples" phenomenon

The rolling bad apples phenomenon is linked to, and may partially be caused by, a reluctance among industry competitors, and even departments within the same firm, to share information about the conduct of employees. For instance, many firms limit what they disclose to third parties about former employees due to legal risks arising from data protection, defamation, employment rights or privacy law.

But even when information about a potential employee's past misconduct is available to employers, empirical evidence shows that some firms still hire bad apples. According to a 2016 study of labour mobility among registered representatives of broker-dealers in the US with a record of misconduct (the "Study"), the number of registered representatives of broker-dealers (referred to as "financial advisors" in the Study) from 2005 to 2015 represented approximately 10% of employment in the finance and insurance sectors. The Study relied on a publicly available database – "BrokerCheck" – which is maintained by the Financial Industry Regulatory Authority, Inc. (FINRA) as an investor protection measure and in accordance with the US securities laws.

The Study observed that 7% of registered representatives employed at broker-dealers had a public record of discipline, including discipline for misconduct and/or fraud, and that approximately one-third of the 7% were repeat offenders.[52] Employees with previous offenses were five times more likely to engage in new misconduct than the average employee. The Study also found that of the broker-dealer registered representatives fired for misconduct, 44% were reemployed in similar roles within a year. Two patterns in the rehiring of employees with tainted records were discerned. First, firms that hired them had higher rates of earlier misconduct than other firms ("down-market movement"). Second, the new employers tended to be smaller than former employers.[53] The Study was based exclusively on the number of records and not the severity of the misconduct.[54]

The Australian Securities Industry Commission (ASIC) also looked for evidence of the problem among financial advisers.[55] ASIC reviewed how effectively Australia's largest banking and financial services institutions oversee their financial advisers. The goal was to assist the industry in raising its standards and reduce the risk that customers would receive non-compliant advice in the future. ASIC found the following weaknesses in firms' processes for checking the background of prospective employees and the references they provided:[56]

- The processes often failed to identify which advisers had a history of non-compliant conduct.
- In some cases, former colleagues were not appropriately independent and would not have had access to the compliance records of their licenced adviser.
- Recruiting officers rarely received effective responses to a request for an adviser's previous audit reports.
- Limited effectiveness of background- and reference-checking processes could sometimes be attributed to a former employer's reluctance to provide relevant information to a prospective employer.
- Even where the prospective employer did receive information that raised potential concerns about the adviser's past non-compliant conduct, the prospective employer in some instances failed to make appropriate further enquiries and hired the adviser.

The FSB asked industry representatives to discuss why an employer would hire an employee with more than one public record of misconduct. They suggested the following reasons:

- Firms may not have checked all available sources. Or if they did, relevant information did not reach key decision-makers. Employee screening at some firms may simply be less rigorous

52 M Egan, G Matvos, and A Seru, "The market for financial adviser misconduct," Working Paper 22050, National Bureau of Economic Research, February 2016.

53 Down-market movement and concentrations of bad apples in smaller firms were also observed in an investigative report by Reuters. See B Lesser and E Dilts, "Wall Street's self-regulator blocks public scrutiny of firms with tainted brokers", 12 June 2017.

54 Some observers have questioned the Study's methods or have criticised attempts to extrapolate from the narrow results to reach broader conclusions about misconduct in the financial services industry. See, e.g. Securities Industry and Financial Markets Association (SIFMA), "Flawed report overstates advisor misconduct", 10 March 2016, which argued that "misconduct" is an overly broad term and may include product failures unrelated to a financial adviser's poor advice or service. Researchers on the staff of the US Securities and Exchange Commission have posited that reports of misconduct may be correlated with the complexity or opacity of the product being sold. See M Kozora, "Security recommendations and the liabilities of broker-dealers," working paper, US Securities and Exchange Commission, 1 May 2016.

55 ASIC, *Financial advice: review of how large institutions oversee their advisers*, March 2017.

56 ASIC, March 2017.

than at others – especially as an employee moves down-market to smaller firms or firms that are themselves more prone to misconduct.

- Some of the skills required for financial services employment are in short supply, so firms may face pressure to hire quickly before a technically proficient candidate finds other employment. They may therefore fail to conduct rigorous due diligence or simply overlook or ignore the results.
- Internal policies may also contribute to a rush to hire. Positions left vacant for too long may be deemed non-essential and eliminated. Compensation rules may create incentives to hire only at times when employees would be eligible for variable pay.
- In some instances, firms may have reviewed the record and determined that the misconduct was immaterial. These firms may take the view that some forms of misconduct should not necessarily preclude future employment. In other instances, exculpatory or mitigating circumstances or subsequent corrective actions came to light during the recruitment process.
- Some firms might not hold managers accountable for hiring employees with known records of misconduct. Internal processes may only require that a hiring manager check for available information, such as references, and not necessarily take the information into consideration. Control functions may not be empowered to question the substance of a decision, as opposed to the process for reaching a decision.
- There may be a time lag between a hiring decision (done in many cases while an applicant is employed at another firm) and the availability of information about misconduct on public databases such as BrokerCheck (presumably after a departure from the former firm). Internal systems may not account for conduct information received after an offer of employment is made.
- Some firms may have concluded that, with the right management and controls, they can mitigate the risk of reoccurrence.
- More generally, pressure that might arise from market conditions or an ambitious business strategy may lead firms to give priority to profit and growth at the expense of risk management and ethics.
- "Like attracts like." Some firms may have lower expectations of good conduct, which may attract employees willing to take risks that would be deemed inappropriate by other firms or by the industry generally.

The FSB also considered the experience of industries outside the financial sector, such as the US aviation industry, with rolling bad apples (see Annex F). The existence of rolling bad apples beyond the financial sector means that opportunities exist for learning from other industries.

3.2 Constraints on information sharing

Greater information sharing might be beneficial even if it does not always reduce the incidence of rolling bad apples. For one thing, greater information sharing may remove the availability of "plausible deniability" for firms and their hiring managers. Information sharing may also make it easier for regulatory authorities to track the movement of individuals with a history of misconduct or to see their convergence at particular firms, which might present heightened risks to those firms' safety and soundness. At a minimum, greater information sharing enables firms to make more informed choices, even if their risk tolerances vary.

The final report of the UK's Fair and Effective Markets Review (FEMR), which led to the implementation of the regulatory references requirement in the UK,[57] summarised two reasons commonly cited for keeping vital information confidential. First, banks may face "risks of legal challenge from employees who feel they have been unfairly described." Indeed, in many jurisdictions legislation and/or case law require firms to exercise due skill and care when preparing job references. References should be true, accurate, fair and based on documented fact. Second, there was an "increasing tendency to reach 'compromise' or 'settlement' agreements as part of negotiated exits with employees, under which firms agree to limit the scope of information released in references."[58] These two reasons are referred to in the following discussion as "legal" and "customary" hurdles, respectively.

3.2.1 Legal hurdles

Civil lawsuits by former employees appear to be the principal legal risk to firms that choose to share information about prior misconduct. The consequences of these lawsuits can be serious. Even if a lawsuit is resolved in favour of the employer on the merits, the resource impact of litigation may be sufficient to deter information sharing.

Several causes of action are available to employees, depending on the jurisdiction. Under US law, for example, one cause of action is defamation – that is, an injury to reputation based on untrue statements. Employees in some jurisdictions may also sue for reputational harm based on the public disclosure of *true* facts that were of a private nature. Employees may also sue for economic (as opposed to purely reputational) harm. Such harm may include loss of employment opportunity (interference with prospective economic advantage), negligent misrepresentation or tortious interference with contract.

An employer's assessment of legal risk may also take into account collateral consequences from a lawsuit by a former employee. Pleadings in employment lawsuits often contain "dirty laundry" – scandalous allegations that, while not proven factually, can cause injury to individual or corporate reputation. Once information is made public in a lawsuit, any expectation of privacy for that information is lost.

Legal risk may also arise out of industry collaboration. In discussions with industry and official-sector representatives, in-house and outside counsel raised concerns about anti-trust liability for any attempt to agree on standard practices for information sharing, especially in the absence of a specific legal and regulatory framework on exchange of such information. This concern has precedents. The technology sector provides a cautionary tale. A 2010 US Department of Justice lawsuit alleged civil violations of anti-trust law by several prominent technology companies (including Google and Apple) for agreeing not to recruit employees directly from one another – what might be called a "rolling *good*

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[57] Some jurisdictions require firms to exchange prescribed information on employee misconduct via mandatory employment references (commonly referred to as regulatory references), or provide that information to a central database administered by a supervisory authority or self-regulatory body. Annex G describes information-sharing regimes in several jurisdictions.

[58] HM Treasury, Bank of England and Financial Conduct Authority, June 2016, pp 62–63.

apples" problem.[59] The alleged violations denied employees the benefit of market competition for their services. Firms may be concerned about anti-trust law scrutiny of their collaboration over information sharing, especially in the absence of a specific legal and regulatory framework on the exchange of such information.

Some jurisdictions recognise a qualified privilege – and, in at least one jurisdiction, an absolute privilege – for reporting certain employment information.[60] For example, in the European Union (EU), under Article 23 of the recently adopted General Data Protection Regulation (GDPR), member states can introduce exemptions from several of the GDPR's obligations under certain conditions: they must respect the essence of fundamental rights and freedoms, and they must be necessary and proportionate to safeguard "other important public interests of the EU or member state, in particular economic or financial interests including monetary, budgetary and taxation, public health and social security"; and be required for the "prevention, investigation, detection and prosecution of breaches of ethics for regulated professions." If they adhere to these conditions, the derogations may shield firms from some of the legal risks that may result from exchanging information on employees' conduct. Regardless of legal safeguards, employers remain exposed to litigation risk if the accuracy or fairness of the information they provide is challenged.[61]

Different jurisdictions may offer greater or lesser protection for clearly identified opinions in references, as opposed to purported facts. For example, a statement that an employee was "unprofessional" may be considered an opinion, while a statement that an employee "procrastinated" or was "dishonest" may not.[62] Or, consider a statement that, "The employee no longer works for us and that might say enough"; at least one court was convinced that this type of statement was an actionable statement of fact, not of opinion.[63]

A related question is whether employee notification or consent can mitigate most legal risk that firms face. For instance, a recent consultation on Employee Screening by the Central Bank of Malaysia includes the following provision:

> [I]n processing an application for employment, a financial institution must obtain a written consent from the individual which authorises an inquiry into, and disclosures of information pertaining to, his/her previous employment(s). This written consent must cover the requesting financial institution and all former employers within the scope of this policy document.[64]

Similarly, UK regulatory requirements acknowledge that "fairness may normally require a firm to have given an employee an opportunity to comment on information in a reference ('right to comment')." It is, however, for firms to decide whether a right to comment is appropriate taking into account the individual circumstances of each case. Giving individuals a right to comment on

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59 US Department of Justice, "*Justice Department requires six high tech companies to stop entering into anticompetitive employee solicitation agreements*", news release, 24 September 2010.

60 See *Rosenberg v. MetLife, Inc.*, 8 N.Y.3d 359 (2007). The court held that under New York law, registered broker-dealers may not sue their employers for defamation based on false reports to FINRA's database.

61 European Commission, *Regulation (EU) 2016/679 of the European Parliament and of the Council*, 27 April 2016.

62 M Finkin, *Privacy in employment law,* Bureau of National Affairs, 2003, pp 297–98.

63 M Finkin, p 298, citing *Signal Construction Corp. v. Stanbury*, 586 A.2d 1204 (D.C. App. 1991).

64 Central Bank of Malaysia, *Employee screening: exposure draft,* 12 October 2017, p 3.

allegations capable of inclusion in a regulatory reference does not equate to giving them a right to edit or veto the contents of a reference.

In jurisdictions that mandate information sharing, failing to conduct timely or adequate background checks on employees can expose a firm to enforcement action, financial penalties and reputational damage. For instance, FINRA recently settled an action against an institution for allegedly failing to conduct timely or adequate background checks on approximately 8,600, or 95%, of its non-registered associated persons from January 2009 through May 2017.[65] This case underscores the role that official sector organisations can play in both providing a facilitative framework for institutions to address the issue of rolling bad apples and taking appropriate action when regulatory standards are not adhered to.

In light of these hurdles, there has been some support for creating a legal safe harbour for reporting misconduct in financial services – either to a central database or directly to other firms. In 2014, William C. Dudley, President of the Federal Reserve Bank of New York, proposed one such solution.[66] A new banker misconduct database would rely on two new statutory duties: First, firms must report certain types of misconduct (and must *not* report other types). Second, firms must check the database when a conditional offer of employment is made and before an employee begins work (and must *not* otherwise consult the database). The duty to report would be strengthened considerably by offering civil immunity to firms from any claim for money damages based on a report to the database. In other words, while former employees may seek to correct erroneous reports, they may not sue for monetary damages arising from, say, injury to their reputations in connection with the filing of reports in the database. Employees would also have the right to prompt notice of any report made about them, and their rights under existing workplace antidiscrimination and whistle blower protection laws would not be affected. Internal control functions within firms would also play an important gatekeeping function. Finally, as a backstop, banking supervisors could monitor the database to provide further assurance of accurate reporting. Calls for a safe harbour, however, only underscore the strength of the hurdles created by existing laws.

3.2.2 Customary hurdles

Apart from legal risks, some hurdles to information sharing may arise from a perception of local industry norms – "the way things are done." Financial sector firms may also question what is to be gained by sharing references beyond the legal minima. Why should one employer in a competitive marketplace take a risk that no other employer is willing to take – especially when the only reward will be to a competitor who does not hire a bad apple? Sharing information may yield systemic benefits, which every employer will reap, but those benefits might be more remote and less immediate than the risks of a lawsuit.

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65 FINRA, "FINRA fines J.P. Morgan Securities, LLC $1.25 million for failing to appropriately fingerprint or screen its employees", news release, 21 November 2017.

66 W Dudley, "Enhancing financial stability by improving culture in the financial services industry," remarks at the Federal Reserve Bank of New York, "Workshop on reforming culture and behavior in the financial services industry", 20 October 2014. See also M Held, "Reforming culture and conduct in the financial services industry: how can lawyers help?", remarks at Yale Law School Center for the Study of Corporate Law, Marvin A. Chirelstein Colloquium on Contemporary Issues in Law and Business, 8 March 2017.

Discussions with participants from different sectors of the financial services industry revealed that there is some variation in the types of information that firms consider sharing. For example, some firms will refer subsequent employers to information that is in the public domain, such as criminal or civil enforcement actions.[67]

Local customs may shape the information that is reported even when information sharing is mandated. As noted above, the UK Fair and Effective Markets Review observed that firms were increasingly reaching agreements with departing employees that limited the scope of information to be revealed in references.[68] Similarly, in the US, negotiation over the terms of a departure is customary in some parts of the financial services industry even if the disclosure of misconduct is required. Except in cases of an employee's voluntary departure or death, FINRA requires that departures by licensed employees be explained on an official form known as the U5, and much of the U5 information is separately made available through BrokerCheck, FINRA's public database. Attorneys for employers and employees frequently negotiate the terms of what will be disclosed on the U5.[69] As a result, information about conduct made available to future employers may not actually inform a reader about why the employer and employee parted ways.

Some of the reluctance to share information may derive from a concern that a mistake in reporting a former employee's conduct could severely hurt morale among current employees. Firms may be eager to prevent an impression of retaliation. This concern may be symptomatic of mistrust between employees and employers, but it may nonetheless contribute to a custom of being conservative with information sharing.

Finally, some industry norms may themselves create legal risk. In some jurisdictions, for example, mutual non-disparagement provisions have become a standard feature of separation agreements, even though those provisions are not required by data protection laws. An example of an employer's obligation follows:

> Employer agrees that it will not disparage Employee in any manner harmful to the Employee's reputation, provided that Employer shall not be precluded from confirming to others Employee's separation from Employer.[70]

Some contracts may also set conditions on any future employment references. Departure from these conditions, including any inaccurate statements, may lead to a lawsuit alleging a breach of contract. This legal risk may include circumstances where "inaccuracy" may be the result of a material omission of good conduct rather than an affirmative misstatement about misconduct.

3.3 Unofficial channels for information sharing among firms

Reflecting both legal risk and industry customs, written policies at many financial firms prohibit offering references for current or former employees. These firms will generally, upon request,

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67 Group of Thirty, Banking conduct and culture: a call for sustained and comprehensive reform, July 2015, p 53, notes that some firms "have accepted the higher legal or financial risks that accompany disclosing this information, and this report encourages more of that attitude."

68 In response, the PRA and FCA introduced a requirement preventing firms from entering into any arrangements or agreements with any person that limit their ability to disclose information under the UK's regulatory reference requirements.

69 The process of negotiating the information entered on the U5 is described in *New England Sec. Corp. v. Stone*, No. 15575/11, 2011 N.Y. Misc. LEXIS 6082, at *3-5 (N.Y. Sup. Ct. Kings County, 12 December 2011).

70 Thomson Reuters, *Corporate counsel's guide to employment contracts*, 2017, pp 15–16.

confirm only basic employment information: dates of employment, title and perhaps salary. Exceptional circumstances may warrant a departure from that policy but only with approval from the firm's highest management level.

During informal consultations, however, many industry participants noted that employees sometimes pass along information *without* permission from their employer. One example involves an employee at a prospective firm contacting an acquaintance who may be a current or former colleague of a job applicant. Learning information in this way may violate an employer's policy or even the laws of the jurisdiction. Although the frequency of this unofficial sharing or the magnitude of its impact cannot be measured, it is clear that firms *sometimes* learn something about job candidates that would be prohibited under policies or laws that limit information sharing. It is also clear that many in the industry view these informal channels as an ordinary and sometimes useful method of gathering conduct-related information.

Besides being potentially wrongful because it violates an employee's duty to an employer, or perhaps even local law, information shared through backchannels may also be incomplete or otherwise inaccurate. There is, after all, no guarantee that the person sharing information has all of the relevant facts, *especially* in disciplinary matters, which are often handled confidentially.

Alternatively, firms may ask current employees for information on a job applicant. For example, some firms will check their employee database to see if current employees were classmates or colleagues of a prospective employee. If so, such employees can be valuable sources of information, but the same liabilities discussed above in the case of direct employee contact also exist in this instance: the information may be incomplete or subject to confidentiality duties owed to a former employer. Thus, informal sharing of information is risky for both firms and employees.

Other types of information sharing are more subtle, complying with the letter, if not the spirit, of information sharing restrictions. For example, in oral confirmations of previous employment, the simple statement that "Yes, so-and-so used to work here" may be spoken in tones conveying the vocal equivalent of a raised eyebrow or an eye roll.

In discussions with industry participants, the use of unofficial channels for information sharing is mentioned frequently, which suggests a market need for information that is not being met through official or formal channels. Nonetheless, it is improper to ask individuals to possibly violate laws or policies in an attempt to gather information about possible misconduct.

3.4 Tools for addressing the "rolling bad apples" phenomenon

The order in which the tools are presented below reflects the typical stages of the employment cycle: the hiring process, the ongoing assessment and monitoring of current employees and exit procedures. The tools carry two important provisos. First, past misconduct may not always indicate a certainty or even a likelihood of misconduct in the future. After all, to some extent, employee conduct depends on the culture and structure of the employer. Moreover, human beings make mistakes and hopefully learn from them. Second, the availability of these tools will depend on applicable law. Firms will want to consider, among other things, data privacy requirements and employment rights.

3.4.1 Tools to assist firms in improving hiring practices

Tool 13: Communicate conduct expectations early and consistently in recruitment and hiring processes

Firms have many opportunities during the recruiting and hiring processes to address potential employee conduct issues. Communicating clear, consistent messages about conduct expectations could deter some bad apples from pursuing employment at a firm that emphasises both high integrity and high performance. Silence as to expected employee conduct could signal that the issue is less important to the firm.

Written materials – posted on a website or distributed in hard copy – are an opportunity to address conduct concerns at the earliest stage of the employment cycle. Discussions with prospective employees can emphasise the expectations set forth in written materials. This is true for interactions with a firm's human resources staff, but it is especially true for discussions between prospective employees and their future peers and managers.

Tool 14: Enhance interviewing techniques

In addition to assessing the technical competency, experience and qualifications of candidates, the recruitment process could consider their behavioural competency and conduct history as well as their potential for adhering to the firm´s values. This broadened review could be accomplished by asking particular questions or even by conducting a separate interview focused entirely on behavioural and conduct matters. Training in interviewing techniques to assess behavioural characteristics and spot "red flags" could add value to the interview process.

A firm's consistent message about expectations of good conduct may help deter bad apples from seeking employment there. Current employees involved in recruiting and hiring might be trained to raise expectations regarding conduct during their communications with prospective employees.

Training in behavioural interviewing techniques may also add value. For example, presenting job applicants with ethical dilemmas and observing their methods for responding to them could, to a trained observer, provide insight into behavioural tendencies. Similarly, employees might be trained to ask a consistent set of questions about past conduct during interviews. In addition, including individuals from control functions in the interview process may send a signal to candidates about the importance the firm places on its controls. Members of control functions could also provide an employer with an alternative view on the suitability of a candidate for a position.

Keeping current on developments in employment law may help firms to better understand the risk of requesting or sharing information. If possible within those constraints, direct questions to prospective employees about their record of conduct may yield important information (see Tool 15) as well as contribute to an overall signalling about the importance of good conduct. Firms could ask the candidates to declare that, to the best of their knowledge:

- they have never been involved in relevant administrative, civil, criminal or regulatory proceedings (including disqualification as a director or officer or bankruptcy or other solvency issues); and
- the information they have provided on their past conduct and fitness is accurate and complete.

More generally, personnel involved in the hiring process can be trained to spot "red flags" that may appear on written applications or in spoken communications. Red flags may include gaps in employment histories or multiple employers in short periods of time. Part of this training might emphasise that red flags should be examined contextually. For example, a gap in employment history during an economic recession or multiple employers in a sector known for high turnover do not necessarily indicate a history of misconduct.

Tool 15: Leverage multiple sources of available information before hiring

Firms could search both publicly available and proprietary data sources for information about candidates. Current employees could have personal knowledge of a candidate's conduct at a previous employer. Previous employers are another possible source of information, though the extent to which firms are allowed, required or willing to share such conduct information could differ. Such information could require subsequent verification, depending on the number and credibility of the sources.

Rules on data protection may require firms to obtain a candidate's consent before making enquiries of former employers. Explaining the process for checking past conduct signals to a prospective employee the importance that a firm places on good conduct. In addition, an objection from a job candidate (or the unreasonable withholding of consent in jurisdictions where consent is required) may signal a potential conduct issue.

Options available to firms that consider using open source searches include the following:

- general internet search engines (e.g. Google);
- public databases (e.g. WorldCheck);
- social media (e.g. Facebook, LinkedIn);
- news feeds (e.g. LEXIS); and
- public regulatory databases (e.g. BrokerCheck).

Examples of relevant non-public databases are as follows:

- criminal record checks (but some jurisdictions may restrict the use of criminal background checks for certain positions);
- payment collection registers;
- industry or employer databases (e.g. Early Warning Service's Internal Fraud Prevention System); and
- professional associations, some of which operate private registers accessible by regulated prospective employers.

If a job candidate has previously worked for the firm or a corporate affiliate, the firm could check available internal records for any information on past conduct. This may seem like an obvious step, but it may not always be easy. For example, information technology (IT) challenges may arise from integrating record systems of merged corporate entities. Identifying the IT challenges and building work-arounds could help facilitate the exchange of information within a firm. However, legal considerations may be relevant if records have come into a firm's possession through a corporate merger or through an international affiliate.

3.4.2 Tools to assist firms in ongoing monitoring of employees and exit procedures

Tool 16: Reassess employee conduct regularly

Firms could update or renew background checks on regular schedules; for example, after three months or a year of employment or at career milestones, including promotions or lateral moves within a firm. In some jurisdictions, institutions have to (re)assess the fitness and propriety of employees in functions deemed capable of causing significant harm to the firm or its customers.

Together with the other tools proposed in this report, regular reviews of conduct can help send a consistent message about the firm's expectations for good behaviour.

Tool 17: Conduct "exit reviews"

Without prejudice to applicable legal requirements, firms could implement "exit reviews" and maintain appropriate records on former employees for their own potential future benefit as well as for prospective employers.

Asking behavioural questions, using the same techniques discussed in Tool 14, may help firms gain insights into the conduct of departing employees. In addition, thorough exit interviews can contribute to accurate regulatory filings.

3.4.3 Tools to assist national authorities in their oversight of firms' employment practices

Tool 18: Supervise firms' practices for screening prospective employees and monitoring current employees

An assessment of firms' employment and disciplinary policies and practices could be embedded in the supervisory process. Supervisors could also require institutions to regularly reassess and revalidate the conduct or suitability of employees or a subset of them deemed to pose the greatest risk to the firm or its customers (see Tool 16).

Supervisory assessments of firms' employment policies, practices, performance assessment and disciplinary processes may help identify and disseminate best practice, strengthen governance frameworks and prevent or mitigate misconduct. These supervisory assessments can be part of, or combined with, other periodic, in-depth or thematic reviews of related areas such as conduct risk, culture or governance.

National authorities can also require institutions to periodically re-assess and certify the conduct and suitability of employees – for instance, as part of performance appraisals or compensation decisions.
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Tool 19: Promote compliance with legal or regulatory requirements regarding conduct-related information about applicable employees, where these exist

Authorities could provide methods for firms to exchange meaningful information on employees. This could include promoting consistent and more comprehensive information in databases of financial services professionals, where they exist.

Some jurisdictions have adopted legal measures to encourage and help firms address the problem of rolling bad apples. These measures require firms to submit information on current or former employees to national authorities or to exchange it among themselves. The information can include the individual's conduct history.

These measures aim to facilitate a meaningful exchange of information on employees' conduct (as noted in Tool 15) by providing a layer of protection against the legal risks associated with it.

The availability of these facilitative legal measures inevitably depends on the legal framework in each jurisdiction. Accordingly, they may not be possible to implement in certain jurisdictions.

Annex A: The process of normalising misconduct

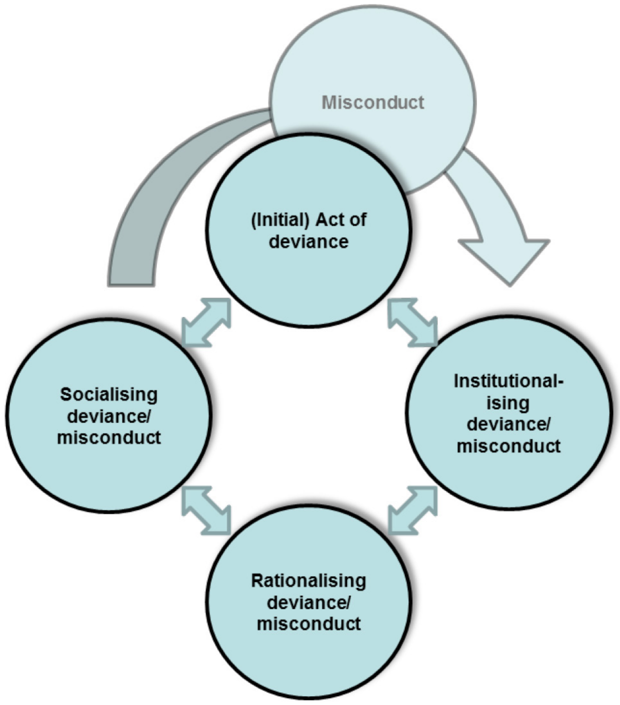
Behaviours that underpin the normalisation of misconduct

(Initial) act of deviance or misconduct
- Dominant, intense and opportunistic style of leadership
- Setting unrealistic goals

Institutionalising deviance/misconduct
- Obedience to authority
- Reluctance to accept bad news
- Misaligned incentives
- Diffusion of responsibility
- Doing what is legal versus what is right
- Routinisation of unsound practices
- Lack of accountability for misconduct
- Lack of psychological safety
- Existence of subgroups/subcultures

Rationalising deviance/misconduct
- Leadership
- Lack of challenge
- Lack of diversity and inclusion (e.g. creation of groupthink)

Socialising into deviance/misconduct
- Socially approved way of doing things (social norms)
- Social categorisation ("us" versus "them")
- Rewarding misconduct (status, self-esteem)
- Social pressures to conform
- Smaller acts of non-compliance culminate into larger acts



- *(Initial) Act of deviance or misconduct*: This could be through a dominant leadership that sets unrealistic goals. Leadership is also important because obedience to authority is a deep-seated psychological response that only a minority of individuals naturally resist.[71]
- *Institutionalising deviance/misconduct:* Leaders serve as role models that can formally and informally authorise poor conduct. Leaders who fail to see the connection between their actions and outcomes or do not accept accountability for their actions are more likely to institutionalise poor behaviours.[72]
- *Rationalising deviance/misconduct*: In order to justify poor conduct, individuals distort their understanding of their own behaviour. This rationalisation process can be facilitated by other processes, e.g. self-verification. Research indicates that people are motivated to seek out other people, opinions, and evidence that validate their existing view of themselves.[73] Group loyalty within teams in firms, or across firms in specific areas of business/activity can also facilitate rationalisation of poor conduct. Group members may abandon global or universal norms in favour of 'local' ones in order to belong, be liked, and avoid exclusion.[74]

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71 C Moore and F Gino, pp 53-77.

72 J.J. Kish-Gephart, D.A. Harrison, and K.L. Treviño. (2010). Bad apples, bad cases, and bad barrels: meta-analytic evidence about sources of unethical decisions at work. Journal of Applied Psychology, 1, 1-31.

73 C Moore and F Gino, pp 53-77.

74 Ibid.

- *Socialising into deviance/misconduct*: Research indicates that this process involves communicating to newcomers the values, beliefs and skills that they will need to fulfil their roles and function effectively within the group context.[75] Newcomers will be rewarded for changing their attitude towards the inappropriate behaviour. They are initially induced to engage in small acts that seem relatively harmless and they rationalise these small acts in order to alleviate the discomfort caused.[76] As the process repeats, the poor conduct is more likely to evolve into misconduct on a larger scale.

The model distinguishes between an initial act of poor conduct and broader misconduct to acknowledge a vital difference in severity and sequence. The initial act, which is often relatively small and isolated, and perhaps not even considered "misconduct" when viewed on its own, jumpstarts the normalisation process. However, as the act is normalised, it can become more frequent and/or serious, eventually resulting in a severity of non-compliance which warrants the label of misconduct.

The distinction between the initial act of poor conduct and broader misconduct is important for two reasons. First, it means that the initial act may be small, and therefore difficult to identify and prevent. Second, it means that the process of normalisation *precedes* significant acts of misconduct. Therefore, whilst mitigating measures aimed at combatting individual initial acts of poor conduct may prove difficult, efforts aimed at disrupting the later process of normalisation could be more successful in preventing future misconduct.

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75 B Ashforth and V Anand, 2003.

76 Ibid.

Annex B: Supervisory approaches and practices to supervising culture

This annex summarises responses to a survey conducted by the Supervisors Roundtable for Governance Effectiveness, hosted by the Federal Reserve Bank of New York, which was then supplemented with additional input from FSB members that were not part of the initial survey. Most of the programmes described below were created between 2010 and 2015. In many cases they were created in response to the financial crisis or the series of misconduct incidents that came to light in the years that followed the crisis. Indeed, several respondents highlighted a perception that governance and culture have still not been sufficiently addressed since the crisis.

Most of the participating authorities have found that their reviews of governance, behaviour, and culture have also contributed to improvements to industry knowledge and practice. For instance, supervisors have released information papers, supervisory statements and brochures describing what their efforts have taught them thus far about governance, behaviour, and culture and describing their priorities going forward. Several authorities have also revised their corporate governance guidelines or are considering doing so as a result of their work in this area. Supervisors actively participate in relevant conferences and have used public speaking engagements to share the knowledge they have gained and to clarify expectations. One supervisor shared the results of a governance and risk appetite review and another published a book describing the authority's methodology for assessing culture and behaviours.

Industry engagement is an important component of most supervisory authorities' programmes, and industry feedback on the efforts described above has largely been positive, though in some cases responses were initially sceptical. Supervised firms regularly seek clarification of expectations from authorities on these new areas of focus. This has been most noticeable with respect to industry's interest in understanding supervisors' expectations regarding the role of the board and senior management.

1. Objectives and scope of supervisory focus

All responding authorities link their governance, behaviour, and culture programmes to their authority's mandate, specifically to goals relating to financial stability, including safety and soundness, reduced systemic risk, and/or efficient markets. Some respondents also indicated that their governance and culture objectives are tied to their authority's efforts to restore trust in the financial industry.

The object of respondents' focus on governance effectiveness, behaviour, and culture depends upon that supervisor's span of authority; however, in the aggregate, responses covered all types of financial institutions, including banks, insurers, pension funds, trust agencies, broker-dealers, exchanges, clearing houses, and central counterparties, though most respondents focus their governance, behaviour, and culture programmes on the largest and most systemically important institutions in their jurisdiction.

There is consensus among respondents that the board and senior management play a key role in governance effectiveness, behaviour, and culture. All surveyed authorities focus at the level of the board, and nearly all also focus on senior management. Focusing on heads of specific functions (e.g. the heads of risk management, compliance, internal audit, and the chief financial officer) or extending more deeply into the organisation, including reviews of behaviours in specific business areas, is less common.

2. Organisational structure

Authorities employ a wide range of approaches in structuring their programmes for governance effectiveness, behaviour, and culture. Some have set up specific divisions/sections dedicated to governance or culture. Others do not have a formal division, but have established a task-force/project team that supports banking supervisors in their governance or culture assessments. Authorities use both "off-site" and "on-site" supervisors for the performance of governance assessments.

Almost all participating authorities have adopted fairly broad approaches that cover a wide range of topics, from board/senior management effectiveness to risk culture, behaviours, culture, compensation, and risk governance. Some authorities also include the supervision of operational risk and information technology risk in their governance assessment programmes.

Supervisory reviews of governance effectiveness, behaviour, and culture are led by either firm-specific or subject matter expert teams. In nearly all cases where an authority has governance or culture specialists, those staff work jointly with line supervisors in order to link observations related to governance effectiveness, behaviour, and culture with other supervisory issues at the institution. Where the dedicated, firm-specific supervisory teams lead governance and culture reviews, they are often supported, overseen, advised, and/or challenged by a central group. In some cases this central group directly oversees the firm-specific work, while in others, advisers are made available to support and train the firm-specific teams. In all cases, the central group provides consistency and opportunities for benchmarking.

Supervisory authorities utilise staff with a wide range of experience and backgrounds, including, but not limited to: economics, accounting, financial analysis, and project management, as well as expertise on more specific topics such as incentive compensation or corporate governance standards. In at least two cases, staff members have experience in organisational psychology. Where they exist, the governance divisions are in most cases composed of 8-10 individuals, who are sometimes not dedicated to this work full time.

Governance and culture are often referred to as among supervisory authorities' top priorities. Survey respondents want to enhance their focus and expertise in this area, to improve consistency and to identify sound practices over time.

3. Methodology and approach

Supervisors employ a variety of methodologies and approaches in assessing governance, behaviour, and culture, and the depth of review depends upon both the size and type of firm under review, as well as the authority's own resources.

Historically, supervisors have not had dedicated programmes that consider culture and the more behavioural aspects of governance effectiveness. Line supervisors have always had insights into the operating culture of the firms they supervise, and have often been able to recognise how particular behaviours might lead to positive – or negative – outcomes for the firm. However, supervisors historically did not have an analytical framework for making formal assessments of the behavioural and cultural elements of governance effectiveness.

In recent years, a number of authorities have refined their frameworks for assessing governance effectiveness to allow for more consistent and deliberate assessments, and several other authorities have developed and defined frameworks for assessing culture more directly.

There are different views across supervisory authorities with respect to the use of external experts. Where external experts are used, they are most often brought in on discrete projects to make up for internal resource limitations, or are consulted for the diversity of perspective they can offer. One authority hired outside organisational psychologists to help develop its methodology, while another hired an outside governance consultant to help map international governance expectations and perform a local gap analysis. Several respondents indicated that they have sought input or advice from outside experts to gain views on certain areas of focus, for instance on empowerment of non-executive directors or on risk culture. One authority established a standing "Corporate Governance Advisory Committee," comprised of external stakeholders, which provides ongoing input and advice.

The above examples notwithstanding, most participants agreed that the primary "outside" input used in building supervisory programmes for governance effectiveness, behaviour and culture has been received through interactions with other supervisory and regulatory authorities.

4. Supervisory observations and output

Supervisors provided a range of examples of observations that have come out of their reviews of governance effectiveness and culture. Some issues that were identified include:

- Board and senior management lack a collective vision of the change in culture that is desired;
- Board does not connect desired cultural change to the reason it is needed (e.g. link to strategy);
- Behavioural patterns and aspects of a firm's culture present a risk to the soundness and integrity of the institution;
- Executive management was found to lack risk focus when significant deficiencies were detected across business lines;
- Unclear delegation of responsibilities;
- Deficient implementation of policies and processes;
- Lack of board attention to risk or control function reporting;
- Concerns about the composition of the board or management bodies, for instance with respect to independence or collective abilities or experience;
- Non-financial risks are not given sufficient consideration, including within the risk appetite framework;
- There is insufficient debate among the board or among the C-Suite (e.g. CEO, CRO, COO);
- There is an insufficient "check" on the CEO from independent directors; and
- Non-financial goals – including the risk appetite – are not appropriately cascaded or understood within the businesses.

Annex C: Summary of existing principles and guidance aimed at strengthening individual responsibility and accountability

Principles, Standards and Guidance	Principles or recommendations related to:		
	Identification of roles	**Allocation of responsibilities**	**Individual accountability**
BCBS Corporate Governance Principles for Banks	Principle 3. Sets out the role of the chair of the board and key board committee specifically setting out expectations for the audit committee, risk committee and compensation committees including expectations that they are chaired by independent non-executive directors.	Principle 1: "The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, governance framework and corporate culture." The principle elaborates on the responsibilities of the board noting that it is responsible for providing oversight of senior management. It also states that "a risk governance framework should include well defined organisational responsibilities for risk management, typically referred to as the three lines of defence."	Principle 4. "The organisation and procedure and decision-making of senior management should be clear and transparent…This includes clarity on the role, authority and responsibility of the various positions within senior management, including that of the CEO… Senior management is responsible for delegating duties to staff and should establish a management structure that promotes accountability and transparency throughout the bank."
FSB Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture"	The FSB thematic review on risk governance defines executive director, non-executive director and independent director in terms of board roles that do or do not have 'management responsibilities within the firm'.		Sets out indicators of accountability including that the CEO, senior management and employees throughout the organisation are held accountable for their actions.
FSB Thematic Review of Corporate Governance	Sets out sound practices for the role of the board and its committees and the risk management function. This includes the risk committee, audit committee role of the CRO.		

Principles, Standards and Guidance	Principles or recommendations related to:		
	Identification of roles	**Allocation of responsibilities**	**Individual accountability**
IAIS Insurance Core Principles (ICPs)		ICP 7.1. Covers appropriate allocation of oversight and management responsibilities. "The supervisor requires the insurer's Board to: • ensure that the roles and responsibilities allocated to the Board, Senior Management and Key Persons in Control Functions are clearly defined so as to promote an appropriate separation of the oversight function from the management responsibilities; and • provide oversight of the Senior Management." ICP 8 sets out expectations on persons leading control functions including that they should "be led by a person of appropriate level of authority" and the head should "not have operational business line responsibilities" (ICP 8.3.8). It also sets out expectations for board committees and granular expectations for control functions including the compliance and actuarial functions alongside risk and internal audit. The authority and responsibilities of each control function should be set out in writing and made part of, or referred to in, the governance documentation of the insurer (ICP 8.3.7).	
IOSCO Objectives and Principles of Securities Regulation		IOSCO Principle 16 relating to "issuers", states there should be full, accurate and timely disclosure of financial results risk, and other information which is material to investors' decisions. Principle 23 states "other entities that offer investors analytical or evaluative services" should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them. Principle 31 states "market intermediaries" should be required to establish an internal function that delivers compliance with standards for internal organisation and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.	Principle 10 states that the Regulator should have comprehensive inspection, investigation and surveillance powers. Principle 11 states that the Regulator should have comprehensive enforcement powers. Principle 12 states the regulatory system should have an effective, credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. IOSCO Principle 17 states Holders of securities in a company should be treated in a fair and equitable manner.

Principles, Standards and Guidance	Principles or recommendations related to:		
	Identification of roles	**Allocation of responsibilities**	**Individual accountability**
IOSCO Task Force Report on Wholesale Market Conduct		Sets out regulatory approaches and tools that are relevant to address market conduct by traders and other professionals engaging in trading with, advising or providing other investment services to professional counterparties in wholesale markets and managers who are responsible for supervising such professionals. It sets out particular categories of conduct expectations of participants in wholesale markets, including firms (both the buy and the sell side) and individuals that are considered more sophisticated than the typical retail investor, which have been derived from previous IOSCO work.	
Joint Forum Principles for the supervision of financial conglomerates		Implementation criteria of Joint Forum Principle 10 on corporate governance of the financial conglomerate states that the ultimate responsibility for the sound and prudent management of a financial conglomerate rests with the Board of the head of the financial conglomerate. Explanatory comments note that the corporate governance framework should address where appropriate … fiduciary responsibilities of the board of directors and senior management of the head company and material subsidiaries…	
OECD Principles of Corporate governance	Highlights the distinct role of non-executives and recommend that 'boards should consider assigning a sufficient number of non-executive board members' and aspects of the roles, including in relation to safeguarding the interests of market participants, independent judgment and in management of potential conflicts of interest.	Principle 6. Focuses on the responsibilities and key functions of the board as a collective. "The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders."	

Annex D: Summary of survey of national authorities' approaches to strengthening individual accountability

The FSB surveyed its member jurisdictions to gather further information concerning national authorities' experiences in implementing individual responsibility and accountability frameworks (including issues that may arise in group structures). The survey provided insights into the outcomes authorities seek to achieve from increasing individual responsibility and accountability and the possible routes to achieving those objectives, and the potential benefits and challenges associated with various approaches.

1. Identifying roles and responsibilities

Many jurisdictions indicated that they have formal statutory authority as it relates to designating responsibilities for senior individuals and holding individuals accountable. The UK has an explicit statutory and regulatory authority for establishing a list of key senior manager roles and promoting individual accountability through responsibility mapping. Meanwhile, Singapore is currently studying possible measures to augment their existing framework through linking roles and responsibilities to accountability. Supervisory and regulatory expectations are in place with respect to roles and responsibilities in several jurisdictions, largely pertaining to the roles and responsibility of the board and senior management. However, several jurisdictions also extend deeper into the senior management layer within the firms, such as the heads of the control functions, the heads of the businesses, or staff levels.

Some jurisdictions allow for some form of dual responsibility for key functions; however this is usually dependent upon the size and complexity of the firm and/or limited to some control function positions (i.e. not including internal audit). Meanwhile, other jurisdictions do not allow for dual responsibility primarily due to concerns over conflicts of interests.

Examples of supervisory and regulatory approaches to allocating responsibilities

European Union (EU)

The AIFMD (Directive 2011/61/EU), UCITS (Directive 2009/65/EC) and MiFID 2 (Directive 20014/65/EU) establish requirements applicable to significant securities market intermediaries operating in the EU, namely managers of alternative investment funds / UCITS, market operators and investment firms/banks providing investment services. Within this regulatory framework, responsibility mapping is achieved through a combination of means, such as internal organisation requirements, supervision and enforcement.

Internal organisation

EU laws require firms to allocate functions and responsibilities in a clear and documented manner and establish, implement and maintain adequate internal control mechanisms and effective internal reporting at all relevant levels.

Particularly, when allocating functions internally, firms shall ensure that the individuals exercising executive functions or effectively conducting the business (so called senior managers) are responsible for the firm's compliance with its obligations and for the day-to-day management of the entity, including for the implementation and periodic review of the various internal policies and strategies of the firm.

MiFID 2 explicitly sets forth that:

- senior managers are accountable to the management body;
- the allocation of significant functions among senior managers shall clearly establish who is responsible for – overseeing and maintaining the firm's organisational requirements. Records of the allocation of significant functions shall be kept up-to-date; and
- members of the management body shall have adequate access to information and documents which are needed to oversee and monitor management decision-making.

In terms of internal controls, the aforementioned Directives provide that firms shall establish permanent compliance, risk management and audit functions according to a set of specified principles ensuring that responsibilities are performed properly and independently. Firms are required to appoint a compliance officer responsible for the compliance function and for reporting on a frequent basis, and at least annually, to senior managers.

Supervision

The allocation of functions and responsibilities within the firm is supervised at national level by competent authorities. According to EU Directives such authorities must be granted with an identified comprehensive set of minimum supervisory, investigatory and remedial powers that may be exercised both towards firms and individuals, as may be appropriate.

National competent authorities are under the duty to cooperate among themselves and with the European Securities and Markets Authority (ESMA), including by exchanging information, taking statements and carrying out on-site visits for any supervisory and investigatory purposes.

ESMA is responsible to foster convergence of supervisory practices by, among others, issuing Q&As, Opinions and Guidelines (see for instance the ESMA Guidelines on certain aspects of the MiFID compliance function requirements and the ESMA/EBA Guidelines on the Assessment of the Suitability of the Members of Management Body and Key Function Holders) and performs peer reviews.

Hong Kong SAR

On 16 December 2016, the Hong Kong's Securities and Futures Commission (SFC) issued a circular[77] to introduce the Manager-In-Charge (MIC) regime,[78] which is applicable to all licensed corporations, including broker-dealers, investment advisers, corporate finance advisers, asset managers and credit rating agencies. This regime came into effect on 18 April 2017.

The MIC regime provides more guidance on who should be regarded as the senior management of a licensed corporation. The SFC also identifies eight core functions (Core Functions)[79] which are instrumental to the operations of licensed corporations. Licensed corporations are expected to designate fit and proper individuals to be MIC of each of these functions. Those who have overall management oversight of the licensed corporations and those in charge of key business line functions

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77 Securities and Futures Commission, *Circular to licensed corporations regarding measures for augmenting the accountability of senior management*, Hong Kong, 16 December 2016.

78 As the MIC regime is consistent with the existing regulatory framework, it was not considered necessary to amend any legislation or impose additional liability on licensed corporations or their senior management.

79 Eight core functions comprise (i) overall management oversight, (ii) key business line, (iii) operational control and review, (iv) risk management, (v) finance and accounting, (vi) information technology, (vii) compliance and (viii) anti-money laundering and counterterrorist financing.

are also expected to seek the SFC's approval as responsible officers.[80] All licensed corporations are also required to submit their up-to-date management structure information and organisational charts to the SFC.

It is noteworthy that a senior manager of a licensed corporation including a MIC is subject to the SFC's disciplinary powers if he/she is, or was at any time, guilty of misconduct or is considered not fit and proper. The SFC expects that the MIC regime will drive better ex-ante decisions and proper business behaviour of licensed corporations, starting from the top management and then cascading down throughout the organisation.

For the banking sector, authorized institutions are required to notify the Hong Kong Monetary Authority (HKMA) of the appointment of managers and subsequent changes associated with such appointments. A "manager" is defined in the Banking Ordinance as any individual (other than a director or chief executive) appointed to be principally responsible, either alone or with others, for the conduct of any one or more of the business or affairs specified in the Fourteenth Schedule to the Ordinance[81].

The United Kingdom

The UK Senior Managers and Certification Regime (SM&CR) was introduced with the intention of strengthening individual accountability and corporate governance in UK-based regulated firms. The Senior Managers part of the regime (SMR) requires a clear allocation of responsibilities to the most senior individuals in firms and enhances the UK regulators' powers of approval, supervision and enforcement.

The SMR was introduced for banks and other deposit taking institutions in 2016, alongside a parallel regime for insurers (the Senior Insurance Managers Regime (SIMR)). It will be rolled out to the great majority of regulated firms, including asset managers and securities traders, over the next few years.

It focuses on the most senior individuals in firms, the key members of the board and the top layer of senior management and the heads of key control functions – internal audit, compliance and risk management.

The SMR also covers Group Entity Senior Managers, namely those individuals perhaps based in a group or parent company who exercise direct and significant influence over the way a firm carries out its regulated activities in the UK.

Individuals performing one or more functions covered by the regime must have a Statement of Responsibility, outlining their specific responsibilities. Together, such statements of responsibility must cover all the business activities and management functions of the firm (the "no gaps" principle). Additionally, each firm must produce a Responsibilities Map that summarises the responsibilities of all senior managers and documents the firm's governance arrangements.

Two additional components to the UK accountability regime complement the SMR: (i) the Certification Regime, which is concerned with the fitness and propriety of other individuals who are in a position to do significant harm to the firm or its customers (Certified employees); and (ii) Conduct rules, which set basic standards for all staff, other than those in purely ancillary roles. (See the figure below for a stylised representation.)

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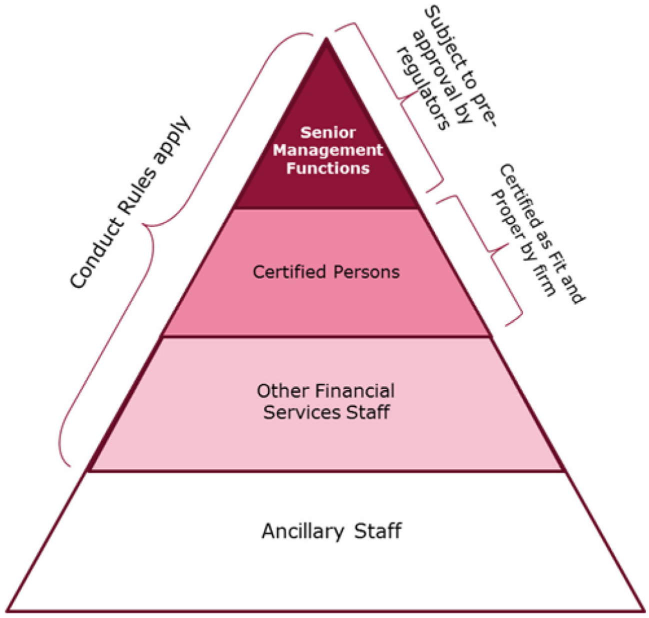
80 Section 126 of the Securities and Futures Ordinance.

81 The specified business or affairs are: (i) the carrying on of retail banking, private banking, corporate banking, international banking, institutional banking, treasury or any other business which is material to the authorized institution; (ii) the maintenance of accounts or accounting systems; (iii) the maintenance of systems of controls, including those systems intended to manage the risks of the authorized institutions (iv) the maintenance of systems of control to protect the authorized institution against involvement in money laundering; (v) the development, operation and maintenance of computer systems; (vi) the conduct of internal audits or inspections of the authorized institution's affairs or business; and (vii) the function of ensuring compliance with laws, regulations or guidelines that are applicable to the authorized institution.

Stylised representation of the UK SM&CR



2. Suitability assessments

Almost all jurisdictions surveyed indicated that other governance tools are used to support efforts to strengthen individual accountability, including the composition of the board (e.g. independent members, limits on non-executive members), incentives, internal auditors and compliance officers, corporate governance codes, and fit and proper assessments. The most frequent fit and proper assessments are for board and senior management positions of the regulated entity and the parent company. Several jurisdictions also include the heads of the control functions (e.g. risk management, compliance, finance, internal audit, chief actuary), the manager in charge and business heads where they have fit and proper assessments. For example, the European Central Bank (jointly with the relevant national authorities of the SSM) conducts fitness and propriety assessments of the members of the management body against five criteria: experience; reputation; conflicts of interest and independence of mind; time commitment; and collective suitability.

In the Hong Kong banking sector, the appointment of directors, chief executives (including alternate chief executives) and executive officers[82] requires regulatory approval and is subject to the HKMA's scrutiny through fit and proper assessments. The HKMA has powers to withdraw consent from a director, chief executive or executive officer who is guilty of misconduct or ceases to meet the fit and proper requirements, or to impose other disciplinary sanctions as appropriate. In addition, authorized institutions are required to maintain adequate systems of control to ensure the fitness and propriety of their managers. Similarly, all appointments of controllers, directors, key persons in control functions as well as the appointed actuaries of authorised insurers in Hong Kong are required to seek

[82] The term "executive officer" has the meaning set out in section 2 of the Banking Ordinance. Essentially, an executive officer is an individual appointed by a registered institution to directly supervise the conduct of one or more regulated activities under the Securities and Futures Ordinance.

the Insurance Authority's approval under the Insurance Ordinance. These persons must satisfy the fit and proper requirements set out in the Guideline on "Fit and Proper" Criteria.

In the US, financial firms subject to section 165 (h) of the Dodd Frank Act and Regulation YY are required to have a risk committee including at least one member with experience in identifying, assessing and managing risk exposures of large, complex firms and are responsible for the oversight of risk management policies. In addition, the regulations implementing the Dodd Frank Act require that certain firms subject to the rule to have one independent director that chairs the risk committee of the board. For certain larger firms, the risk committee of the board is required to be an independent committee of the board that is devoted to risk management oversight.

3. Enforcement

As described in the main text of the report, a few jurisdictions use enforcement as a tool to strengthen individual accountability. Other approaches beyond those discussed in the main text, include strengthening individual responsibility and accountability include attestations, i.e. reports from CEOs, compliance functions, and independent accounting firms or an employee and complaints register. In the UK, banks must notify the regulators of any disciplinary actions related to individuals subject to the conduct rules.

In the US, the Federal Reserve's Framework for Risk-Focused Supervision of Large Complex Institutions states that management is expected to be fully involved in the activities of their institutions and possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated.

Examples of supervisory and regulatory approaches to enforcement

European Union

Without prejudice to criminal sanctions, Member States in the EU are required to introduce appropriate administrative measures and penalties against the persons responsible for the breach of a regulatory provision. Such measures shall be effective, proportionate and dissuasive.

UCITS V and MiFID 2 Directives have introduced a harmonised enforcement framework, providing for common requirements on the type of administrative sanctions available to competent authorities, their application, including minimum amount for the pecuniary penalties, and publication.

Individual accountability is fostered, among others, by providing that administrative measures and sanctions are applied to the firm and to the natural person(s) held responsible within the firm, according to national law.

Among such measures, UCITS V and MiFID 2 require that competent authorities are empowered to apply a temporary or, for repeated serious infringements, a permanent ban against a member of the management body of the firm or against any other natural person who is held responsible, from exercising management functions in such firms.

Hong Kong SAR

Under the Banking Ordinance, the directors, chief executives (including alternate chief executives) and managers of authorized institutions may be liable and commit an offence for certain contraventions. For example, managers may be held criminally liable for a contravention of the Banking Ordinance to the extent that the contravention was caused or contributed to by a manager's own acts or omissions or the acts or omissions of a person under a manager's control. Executive officers may be disciplined for misconduct or ceasing to be fit and proper under relevant provisions of the Banking Ordinance and the Securities and Futures Ordinance.

Singapore

The Monetary Authority of Singapore has powers under the Banking Act, Insurance Act, Securities and Futures Act, and Financial Advisers Act to take a range of supervisory or enforcement actions against directors and executive officers, including for failure to take reasonable steps to secure a financial institution's compliance with applicable laws.

Spain

Further to the general companies' legislation, which sets the board members' joint[83] liability for the harm they cause to the firm both for their "actions" and for their "omissions", the legal framework concerning credit institutions foresees that, besides credit institutions, their executives and directors can also be held liable for committing administrative infringements. Thus, according to the standing legal framework for credit institutions[84] and the current distribution of powers set thereof between the ECB and the national authorities, Bank of Spain may impose penalties (both on the credit institutions and their directors and executives) for "very serious", "serious" or "minor" infringements of regulatory and disciplinary rules. These sanctions can be pecuniary, non-pecuniary (e.g. suspension from office), and may be accompanied by accessory measures (e.g. requirements that the infringer cease such conduct; public reprimands). Penalties and public reprimands for very serious infringements shall be published in the "Official State Gazette", and penalties for serious infringements may also be published in said Gazette. Likewise, penalties and reprimands for very serious and serious infringements shall be published on the Bank of Spain website (as a general rule, with disclosure of the identity of the sanctioned institutions or individuals, unless certain requirements provided by the law are met; in this latter case the publication on the website may take place without disclosing said identity).

4. Group context

Most respondents emphasised that they applied their supervisory powers on a consolidated or sub-consolidated basis when there is a group established with multiple entities in their jurisdiction. Many responses emphasised the importance of ensuring effective and coherent governance arrangements and enterprise wide risk management across subsidiaries and parent entities in financial conglomerates. Memoranda of Understanding (MoU's) were cited by some jurisdictions as a means to help coordinate and collaborate their respective approaches to the same firms or entities in their respective jurisdictions. This is especially true in situations where two or more supervisory authorities in the same jurisdiction have authority for roles, responsibilities and individual accountability. Other jurisdictions noted that they have both formal and informal mechanisms in place to facilitate the sharing of certain information.

No respondents indicated that supervisory tools based on roles, responsibilities and individual accountability were applied in a different manner for locally incorporated firms with an overseas parent compared to domestic institutions. The US for example, requires domestic banks and foreign banking operations above a certain threshold to have a CRO. The accountability regimes in the UK

83 The "solidarity" character of liability of members of the board means that each member is obligated to compensate for the totality of quantities or acts claimed, even though the other directors are also liable.

84 In particular, EU Regulation 1024/2013 of the Council, 15 October 2013; and EU Regulation 468/2014 of the ECB, 16 April 2014. The Spanish "Banking Solvency Act" (*Ley 10/2014, de 26 de junio, de ordenación, supervision y solvencia de entidades de crédito)* implements the EU-relevant prudential banking framework into the Spanish banking legal system.

and Hong Kong apply on a regulated entity basis to regulated firms. However, both approaches make provisions for individuals who are employees in a group context being brought into the scope of the regimes if they have the relevant authorities relating to the regulated entity.

There was slightly more variation in the approaches taken for branches incorporated in another jurisdiction. Some responses indicated the same or similar treatment for branches compared to subsidiaries. Others indicated in their responses the need for the identification of at least one individual responsible for directing the business of the branch. In European jurisdictions, branches of EEA-incorporated firms operate under the rules of the jurisdiction of the head office with some exceptions such as anti-money laundering.

Annex E: National authorities' approaches to addressing "bad apples"

1. Fitness and propriety assessments

The scope of fitness and propriety regimes tends to be confined to firms' board members, senior executives, head of internal control functions and individuals in predetermined risk-taking or customer-facing roles. Consequently, whilst fitness and propriety assessments can help clarify the roles, responsibilities and accountability of key decision-makers and certain employees, their scope will not typically reach all potential "rolling bad apples".

In some jurisdictions, in addition to assessing the fitness and propriety of directors and senior managers, supervisory authorities must consent to the appointment or continuing employment of individuals regardless of seniority in specific circumstances, such as bankruptcy or a prior conviction for certain crimes. For instance, in the United States, Section 19 of the Federal Deposit Insurance Act prohibits individuals convicted of a criminal offense involving dishonesty, breach of trust, money laundering, or drugs from participating in the affairs of an insured depository institution without a Federal banking regulator's previous written consent. Similarly, in Hong Kong, Section 73 of the Banking Ordinance bars employment at authorized institutions without the consent of the HKMA if a person is bankrupt, has been convicted of a crime of dishonesty, or was previously a director, chief executive or manager in an insolvent authorized institution.

A case study of Mexico

Mexico has regulatory requirements for fitness and propriety of the Banking Senior Management. To be the General Director, or any of the manager's two levels below the General Director, a banker must have good credit and a good professional reputation. The latter means, at a minimum, *not* having any of the following impediments on one's record:

- An outstanding legal dispute with the institution;
- Criminal offences; banned for commerce activities or banned to perform as public server or within the Mexican financial system;
- Personal bankruptcy/insolvency;
- Concurrent employment with a supervisor or regulator with jurisdiction over the bank; or
- Membership on the board of another bank or financial group's holding to which another bank belongs.

In the process of authorisation of a prospective commercial bank, the Comisión Nacional Bancaria y de Valores (CNBV) reviews potential senior managers and members of the board, along with the documentation that endorses the fulfilment of the fitness and propriety legal requirements. Possible members of the board and senior management must also sign a letter in which they declare under oath that they reside in Mexico, have sufficient experience in executive positions, understand the rights and duties inherent to the position, and satisfy all other relevant legal criteria. The CNBV has legal powers to verify the information in fitness and propriety submission with other authorities. An individual who provides false information could be subject to criminal sanctions. The CNBV may not grant the authorisation to operate as a bank if possible senior management or members of the boards do not fulfil the legal requirements.

Once a bank is operating, it has the obligation to verify that senior managers and members of the board fulfil the legal requirements. Under CNBV rules, a designated internal comptroller or equivalent function will be responsible for, among others, setting the policies/mechanisms to verify/update, at least once a year; monitoring the managers' ethical and professional performance; and keeping the board and shareholders updated in case of any exceptions in the process. Results of internal reviews must be shared with the CNBV annually.

The new appointments must be reported to the CNBV within five days, indicating compliance with regulatory fitness and propriety requirements. In the event an individual resigns or is removed by the firm, the firm must inform the CNBV of the reasons for resignation or removal within five days. The law grants powers to the CNBV to proceed to the suspension of relevant functions, removal from relevant position, or ban within the Mexican financial system of senior managers and members of the board who do not comply with the requirements.

In addition to banks, this regime applies to other financial institutions such as financial holding companies, brokerage houses, stock exchanges, derivatives exchanges, credit rating firms, settlement and clearing firms, credit unions, mutual funds operation and distribution firms, valuation firms, credit firms.

Therefore, to tackle the "bad apples" within the financial system, the CNBV aims to curb serial misconduct through a combination of mandatory background checks, ongoing assessment of fitness and propriety, and the regulatory power to suspend, remove or ban individuals under certain circumstances.

2. Regulatory references

Of the various regulatory approaches examined in this section, the UK's individual accountability regime was explored in greatest detail. A component of this regime is a mandatory reference – called a "regulatory reference."

A case study of the United Kingdom

The use of employment references when hiring candidates is common across industries and jurisdictions. However, as highlighted in the UK's Fair and Effective Markets Review (FEMR), the usefulness of employment references as a means of gathering anything beyond basic factual information on candidates, such as confirmation that they were employed by a given institution during a specific period of time, has decreased over time. This is due to a combination of legal risk aversion and industry practice.

The genesis of the current regulatory referencing requirements in the UK may be found in the FEMR report, which recommended that the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA):

> …mandate a form setting out in detail the minimum information that firms should include in regulatory references, to ensure that there is a decisive break from past referencing practices, and to improve firms' ability to investigate an individual's past conduct effectively. Such a form would build on the information requirements already proposed under the [UK Senior Managers and Certification Regime (SM&CR)], helping to promote a uniform approach. Firms will not be able to use non-disclosure agreements with departing employees to limit

disclosure of information required in such regulatory reference forms by the new SM&CR rules.[85]

The UK's regulatory reference requirements entered into force on 7 March 2017. They currently apply to all firms jointly regulated by the PRA and FCA (known as 'dual regulated firms', e.g. banks and insurers) and are expected to apply to all regulated financial services firms in the UK once the SM&CR is extended.

Dual-regulated firms are required to request regulatory references from all current and former employers (including overseas firms and non-financial companies) in the previous six years when conducting due diligence on candidates seeking to perform a:

- Senior Management Function (SMF) or Senior Insurance Management Function (SIMF) i.e. a functions subject to a fit and proper assessment and approval by the PRA and/or FCA;
- Role subject to the Certification Regime (as explained in the section on 'mandatory pre-employment screening');
- Non-executive directorship; and/or
- A Key Function Holder (KFH) role in an insurance firm (as defined in the Solvency II Directive) not otherwise covered by the above bullets.

If a dual-regulated firm receives a request for a regulatory reference from another dual-regulated firm, it must provide it using the mandatory template prescribed by the PRA/FCA. Overseas and non-financial firms are not subject to these requirements.

The information to be included in the regulatory reference template includes:

- Details of any internal disciplinary action by the firm against the individual due to breaches of the PRA/FCA Conduct Rules in the previous six years. For these purposes, internal disciplinary action means "a formal written warning, suspension or dismissal of the person, and/or reduction or recovery of any of the person's remuneration [as a result of misconduct]." (FCA PS16/22 § 2.7.) Suspensions imposed pending the results of an internal investigation are not considered disciplinary action for these purposes. These internal disciplinary actions would also have been previously reported to the PRA/FCA as required by section 64C of the Financial Services and Markets Act 2000 (FSMA);
- Any other information relevant to the hiring firm's assessment of the candidate's fitness and propriety by the prospective employer, which may include:
  - Details of misconduct going back longer than six years if sufficiently serious;
  - Details of situations where the individual left before a formal finding of misconduct (subject to other legal obligations on the firm);
  - Additional information on incidents disclosed elsewhere on the form such as mitigating circumstances, subsequent good conduct or remediation action etc.

Although regulatory references are a regulatory requirement for dual-regulated firms, their mandatory nature does not exempt these firms from their legal obligations under areas such as contract, data protection, defamation, employment human rights or tort law.

[85] HM Treasury, Bank of England and Financial Conduct Authority, June 2015, p 63.

The PRA's and FCA's guidance have emphasised that the requirements relating to the provision of regulatory references should be compatible with firms' wider legal obligations. For instance:

- Regulatory references should be based on facts, rather than suspicions or unproven allegations; and
- Giving employees an opportunity to comment on information in regulatory references can help ensure their fairness and consistency with the firms' wider legal obligations. A right to comment is not, however, a right to edit or to veto information. Moreover, it is for firms to decide whether and how to afford this opportunity. There is no obligation to do so under PRA/FCA rules.

A right to comment can mitigate a potential disadvantage of bank-to-bank references, as compared with reports made to a centralised misconduct database. In the bank-to-bank model, references for the same employee could vary from enquiry to enquiry. There is no requirement that the same facts and circumstances about a misconduct event be reported to every prospective employer. Banks may adopt practices of providing more information to preferred firms and less to others. This is not only a disadvantage to prospective employers, who are unsure whether the playing field is level. It also places employees at a disadvantage. They do not know what will be said about them from one enquiry to another. By contrast, a central database offers protection for employees to know what is reported about them (and, if mistaken, seek redress). A right to comment would, at least, give an employee notice of what will be said about them.

PRA-regulated firms are required to update a regulatory reference if, within a period of six years from the end of an employment relationship, they discover new information that would have caused them to provide a different reference. The updated reference needs to be sent only to the individual's current employer. Separate notification to the PRA/FCA is also likely to be required

A case study of Malaysia

In October 2017, the Central Bank of Malaysia published an exposure draft on Employee Screening.[86]

The draft sets out expectations on employee screening procedures of financial institutions and seeks to promote an ethical workforce within the financial sector. The recruitment process represents a key opportunity for financial institutions to identify the individuals that are aligned with the institution's desired corporate culture and values. To this end, the draft sets out requirements in two areas:

- mandatory sharing of employment references between financial institutions; and
- employee declarations of past criminal offences.

The proposals relating to the mandatory sharing of employment references are similar to the UK's requirements and, if adopted, will include obligations to request, provide and, in certain circumstances update such references.

Like regulatory references in the UK, the mandatory references proposed in the draft will need to include specific disclosures on candidates' prior conduct and disciplinary history as well as any information otherwise relevant for assessing of their honesty or integrity.

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86 Central Bank of Malaysia, *Employee screening: exposure draft,* 12 October 2017.

The proposals do, however, differ from the UK's existing requirements in the following areas of coverage:

- *Apply to all financial institutions*. The UK's regulatory reference requirements currently apply to banks and insurers, although there are proposals to extend them to all UK regulated financial institutions.
- *Cover all employees*. In contrast, the UK's requirements only apply to individuals performing SMFs, employees subject to the Certification Regime, non-executive directors (NEDs) and (in the case of insurance firms) KFHs as defined in Solvency II.
- *Cover the previous seven years' employment*. The UK's requirements cover only the previous six years' employment, except in cases of serious misconduct, for which there is no time limit.

The draft also contains additional requirements for firms looking to hire individuals who have been either previously employed as dealers or brokers or will be employed in those roles. In these cases, the financial institution will need to ask the Financial Markets Association of Malaysia whether the individual has been involved in any case of financial market misconduct.

3. Mandatory pre-employment screening

In addition to, or independent of any fitness and propriety assessments which supervisory authorities may carry out on directors and senior management, in a number of jurisdictions institutions are legally required to carry out mandatory, rigorous due diligence checks on certain employees prior to appointment and/or periodically thereafter.

For instance, in the UK, banks are subject to a Certification Regime whereby they must assess and certify the fitness and propriety of employees deemed capable by the PRA or FCA of causing significant harm to a firm or its customers. The assessment and certification of these employees' fitness and propriety must take place prior to appointment and annually thereafter. Employees subject to the Certification Regime are defined in the Certification part of the PRA Rulebook and in SYSC 5.2 of the FCA and include the following employees or activities:

- material risk-takers under the Capital Requirements Directive IV compensation rules;
- algorithmic trading;
- benchmark submission and administration;
- client Asset Sourcebook (CASS) oversight;
- customer dealing;
- functions requiring qualifications;
- managers of certification employees;
- proprietary traders; and
- significant management.

The PRA and FCA are proposing to extend the Certification Regime to all financial services firms regulated under FSMA over the coming years.

In some jurisdictions, pre-employment screening requirements extend to individuals appointed to carry out regulated activities on behalf of institutions, such as appointed representatives.

A case study of Singapore

The Monetary Authority of Singapore's (MAS) Circular on Due Diligence Checks and Documentation in Respect of the Appointment of Appointed, Provisional and Temporary Representatives (Circular)[87] sets out detailed expectations for firms to carry out due diligence on the fitness and propriety (including previous conduct and financial records) of individuals they appoint to conduct regulated activities on their behalf (representatives). Industry associations such as the Association of Banks in Singapore (ABS), Investment Management Association of Singapore (IMAS) and Life Insurance Association (LIA), have also issued guidance on conducting reference checks that firms are encouraged to adopt, including templates for reference check forms.[88]

The scope of reference checks includes individuals conducting capital markets and financial advisory activities under the Securities and Futures Act and Financial Advisers Act respectively.

In the reference check forms provided by the industry associations, written confirmation should be sought from the prospective employee to authorise the firm to conduct reference checks with a past employer; and release the past employer from liability for information provided in response. The past employer should generally provide the following information:

- Period of employment at the previous firm and last position held;
- Reasons for leaving the previous firm;
- Information on disciplinary actions/sanctions taken against the prospective representative by his or her previous firm, and the nature of the relevant incidents;
- Any adverse information (including whether subject of complaint, proceedings/disciplinary actions/investigation, breach of laws/regulations, misconduct reported to MAS); and
- Any other relevant information.

Firms are required to notify MAS of the intended appointment of representatives. Once the notification has been processed, the name, unique representative number, and other relevant details will be published on the online "Register of Representatives." Publication on the Register implies that the representative has been certified by his/her firm as having met MAS' fit and proper criteria as set out in the Guidelines on Fit and Proper Criteria.

4. Public registries

Registers managed by supervisory authorities perform two non-mutually exclusive, purposes. On the one hand, they provide information to employers. On the other, they help inform consumers, counterparties, and customers – but only if those parties check the databases.

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87 Monetary Authority of Singapore, *Due diligence checks and documentation in respect of the appointment of appointed, provisional and temporary representatives*, February 2011.

88 Association of Banks in Singapore, *Reference check form on dealers: sample letter from prospective employer to previous employer*, June 2013; Investment Management Association of Singapore, *Letter from new / prospective employer / principal / company to previous employer / principal / company*, August 2011; and Life Insurance Association, *Reference checking on representatives*, May 2017.

At a minimum, information in supervisory authorities' registers tends to include an individual's:

- Name and personal details;
- Current or most recent role;
- Previous roles at institutions supervised by the relevant supervisory authority and/or other supervisory authorities in the same jurisdiction;
- Licenses/qualifications held by the individual which are required/accredited for carrying out regulated activities; and
- Enforcement decisions or other regulatory actions imposed by the relevant supervisory authority involving the individual.

The amount of information on individuals' conduct, disciplinary history and fitness and propriety varies significantly among supervisory authorities.

HKMA Register of Securities Staff of Authorized Institutions

The HKMA maintains a public register pursuant to the Banking Ordinance that contains information on employees of authorized institutions engaging in regulated activities under the Securities and Futures Ordinance (relevant individuals). Authorized institutions need to register with the SFC[89] if they intend to engage in securities business or other regulated activities (registered institutions).

The name and other specified particulars of relevant individuals must be submitted by registered institutions to the HKMA for entry into the register. The HKMA assigns a unique registration number to each relevant individual, which will be attached permanently to him or her. Only individuals whose names are entered in the register can engage in the relevant regulated activities for a registered institution.

The register includes records of public disciplinary actions against relevant individuals by the HKMA and/or SFC for a period of five years from the date when the disciplinary action takes effect, and is available for public inspection. Registered institutions have a legal duty to ensure that all relevant individuals are fit and proper according to SFC standards.

BrokerCheck

BrokerCheck, which is also described above, provides information on registered broker-dealers and their broker-dealer registered representatives with FINRA. As of April 2016, BrokerCheck contained data on 644,277 current and 638,528 former broker-dealer registered representatives. [90]

BrokerCheck searches are free and unrestricted. The database lists each registered representative's registrations, licenses, and industry exams; employment history in the financial services industry; and customer complaints and arbitrations, regulatory actions, employment terminations, bankruptcy filings, and civil/criminal judicial proceedings (both current and pending).

Compared to most databases/registers, BrokerCheck offers extensive information on certain actions, including:

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[89] The SFC also maintains a public register for all licensed corporations, registered institutions and licensed individuals who are licensed or registered for carrying on regulated activities.

[90] See section 3.1.

- Pending judicial or regulatory cases;
- Arbitral awards;
- Cases or decisions by other agencies; and
- Dismissals/resignations ("employment separation") following allegations of misconduct.

Canadian Securities Administrators

The Canadian Securities Administrators maintains a publicly available database that provides the registration information and disciplinary information for firms and individuals who are in the business of trading or advising in securities. The National Registration Search database and Disciplined List provides the investing public with access to information on a firm's or individual's registration category, the provinces where they are registered and if a regulator has imposed restrictions on their registration. These restrictions are known as "terms and conditions". Additionally, the Investment Industry Regulatory Organization of Canada (IIROC) provides information on an IIROC–regulated adviser's background, qualifications and discipline history, through IIROC's "AdvisorReport".

5. Non-public databases/registries databases/registries

As highlighted in the IOSCO Report, some jurisdictions also have non-public databases which they may use for the purposes of tracking rolling bad apples.

Germany

As a supplement to fitness and propriety assessments for board members in Germany, BaFin operates a proprietary database that tracks the movement of employees and complaints regarding individual misconduct. When relevant individuals seek to change employment to another investment firm, BaFin may use the information in the register to consider whether it may be appropriate to prohibit the firm's employment of such individuals.

Switzerland

The Swiss Financial Market Supervisor Authority (FINMA) maintains a data collection to monitor proper business conduct. FINMA may enter data required to assess compliance with proper business conduct requirements in a non-public database, also referred to as FINMA's watch list. The aim of the database is to make sure that only individuals who meet the proper business conduct requirements under financial market laws are involved in the strategic or executive management of authorised institutions, or hold qualified participations in them. The data collection contains only information necessary to assess compliance with the proper business conduct requirements.

FINMA informs the person concerned in writing about any data collection entry. It can defer informing the person concerned if there are predominant interests for doing so. FINMA reviews a person's business conduct (fitness and propriety) if they are about to assume a specific role subject to the proper business conduct requirements. FINMA therefore recommends that a person informed about a data collection entry should contact FINMA in advance if they intend to assume a position subject to these requirements, or if they are applying for such a position and are not sure whether it is subject to these requirements. If a person's fitness and propriety are assessed, it may be done by means of enforcement proceedings. FINMA may instruct the supervised institution to remove the person from the position in question.

Annex F: Information sharing concerns in other sectors

To better understand the concerns, legal risks and market forces that may contribute to a lack of information sharing about employees in financial services, examples of other industries facing similar issues were examined.

The best documented example concerned airline pilots. In the late 1980s and early 1990s, while the banking sector in the US was undergoing the savings and loan crisis, the airline industry confronted another: fatal accidents. Post-accident reviews by the National Transportation Safety Board (NTSB) concluded that pilot error contributed to or caused at least seven commercial airline crashes in a period of as many years. In each of those crashes, the pilots had been hired without effective background checks. It was only belatedly that the NTSB uncovered safety violations and training deficiencies involving the seven pilots in their previous airline employment.

Congress responded by passing the Pilot Records Improvement Act of 1996 (PRIA). According to the legislative history of that statute, although the overall quality of airline pilots was high, there were gaps in information sharing – especially on pilots hired for commuter routes. "[T]wenty per cent of these carriers may not conduct background checks on professional references."[91] Legal risks were to blame for the gaps in employee information:

> The Committee [on Transportation] is aware that airlines, while sympathetic to the view that pilot performance records should be shared between carriers, are very concerned about the costs of potential law suits that could arise from pilots upset about evaluations in their records. At the same time, the matter of employee privacy rights, that arises when pilot performance records are shared, is an important concern.[92]

Congress acted to "weed out those few pilots who undermine the excellent performance and reputation of the pilot community as a whole."[93] The PRIA mandated three types of hiring due diligence: (i) references from prior firms that are also airline passenger or cargo carriers; (ii) pilot safety records maintained by the Federal Aviation Administration (FAA); and (iii) a query of the National Driver Registry, a database of motor vehicle records. PRIA conditioned the background check on pilot consent and limited lawsuits that may be brought by pilots seeking employment, with an exception for knowingly false reports by a former employer.

Was this system effective? A 2002 audit by the US General Accounting Office (GAO) concluded that compliance with PRIA was "not always complete or timely".[94] Among other observations, airlines tended to request information from fewer than all three sources. The convenience of a central repository of information administered by the FAA appears to have gained precedence over multiple employer-to-employer references. Some airlines reported fulfilling the mandatory three methods of due diligence for half or fewer of the pilots they hired. Some of those airlines explained that their incomplete diligence resulted from delays in receiving responses from prior firms.

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[91] US Congress, *Airline Pilot Hiring and Safety Act of 1996*, July 1996, H.R. Rep. no 104-684, p 6.

[92] Ibid.

[93] Ibid.

[94] US General Accounting Office, *Aviation safety: better guidance and training needed on providing files on pilots' background information*, August 2002, p 3.

Moreover, even where firms supplied references, information was often vague or incomplete. And some of the information supplied was out of scope: either because it was more than five years old, was unrelated to safety performance or had been modified or vacated as a result of subsequent proceedings. The GAO concluded that a lack of pilot awareness about their rights to receive and challenge information in shared employment records contributed to the problem of inaccurate information.[95]

Congress addressed these and other concerns in the Airline Safety and Federal Aviation Administration Extension Act of 2010,[96] which required the FAA to create an electronic database containing all of the information previously required from the three sources listed above. So, in addition to records already maintained by the FAA, the database would include motor vehicle records and relevant records from airline companies. This latter category would include all records required to be maintained by regulation and records of professional competence and disciplinary action.[97]

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95 Ibid. p 4.

96 *Airline Safety and Federal Aviation Administration Extension Act of 2010* (August 2010), Pub. L. No. 111-2016, 124 Stat. 2348, Section 203.

97 *Pilot Record Improvement Act of 1996*, 49 USC. § 44703(i)(2)(B), October 1996.

Annex G: Industry information-sharing regimes

In certain jurisdictions, financial services industry bodies provide a number of services designed to address the issue of rolling bad apples, including but not limited to:

- Providing a centralised process for screening prospective employees of financial services institutions;
- Delivering training and offering qualifications on competency, conduct and professionalism;
- Developing and managing industry codes of conduct;
- Managing databases/registers of financial services professionals; and
- In a few instances, enforcing breaches of industry codes and relevant professional standards.

Whilst these industry bodies are formally and functionally independent from the official sector, the exercise of some of their functions referred to above is sometimes codified in legislation, regulation and/or memoranda of understanding with supervisory approaches. The Netherlands is the main example of a jurisdiction where institutions and the official sector co-source employee screening, monitoring, training and even the enforcement of professional conduct standards to membership organisations.

1. Dutch Securities Institute

The Dutch Securities Institute (DSI) was founded in 1999 by the financial industry in the Netherlands and has memoranda of understanding and agreements with the two supervisory bodies in the Netherlands: the Financial Markets Authority (AFM) and the De Nederlandsche Bank (DNB). The DSI promotes and monitors the integrity and reliability of financial services by:

- Carrying out pre-employment screenings of employees;
- Offering voluntary certification to employees; and
- Enforcing its industry Code of Conduct.

Screening. Once a person applies for screening, the DSI checks and verifies information including his/her identity, diplomas, work experience, Certificate of Good Conduct (VOG) and personal bankruptcies. The DSI produces a report of its observations, noting any relevant particulars, and sends it to the candidate. It is up to the candidate to decide whether to disclose the report to their prospective employer. The institution remains responsible for determining whether the candidate is fit and proper.

Voluntary certification. Financial professionals can register with the DSI for certification. These certifications are later available in DSI-administered databases, which are accessible by participating financial institutions. In addition to screening, DSI-certified individuals are subject to periodic training and assessments. They are also subject to the DSI code of Conduct and enforcement actions.

Ethics enforcement. The DSI facilitates an ethics committee and an appeals committee. Both are independent and comprise academics, lawyers, and practitioners. These committees can take disciplinary action if a relevant individual violates the Code of Conduct. Measures can vary from reprimands or fines to suspension or expulsion from the DSI register(s). All ethics enforcement measures are listed in the DSI register for three years. Enforcement action by the DSI can trigger subsequent action by employers, civil/criminal investigations or regulatory action.

Banker's oath. Since 1 April 2015, employees of financial undertakings such as banks, insurance companies, investment firms and intermediaries (almost 90,000 individuals) are legally required to take an ethical oath. Banks with a registered office in the Netherlands must ensure that their employees take the oath. These banks must also implement a code of conduct, corresponding to the general code of conduct for bankers, which must be observed by all individuals who:

- Determine the day-to-day policy of the bank (e.g. executive directors);
- Substantially influence the risk profile of the bank;
- Are directly involved in providing financial services; or
- Are supervisory board members (non-executive directors).

If an individual who has taken the oath violates the code of conduct, the individual can be disciplined through disciplinary regulations, which have a statutory basis but are enforced by the DSI (see above).

2. South Africa Register of Employees Dishonesty System (REDS)

REDS is a centrally maintained database containing the names of all employees in the banking industry who have been dismissed for dishonesty-related offences. It was established in the mid-1990s by the Banking Association of South Africa (BASA), an industry group that represents all registered banks in South Africa. All of BASA's members subscribe to a common Code of Banking Practice.

REDS is accessible only to banks as a screening tool on prospective employees. As at 2010, there were 9164 names on the register, representing employment across 26 financial institutions.

In order to participate in REDS, banks enter into a written agreement which states that:

- An employee's name will be placed on REDS only if s/he is dismissed for a dishonesty-related offence.
- A disciplinary hearing must take place in the institution. If the employee resigns or leaves before the hearing, it can be conducted in absentia.
- Employment contracts should include consent to the REDS process and employees made aware.

One issue that has emerged in REDS – and is a recurring theme in other scenarios – is whether a firm could make an entry in REDS relating to an employee who had resigned with immediate effect before the relevant disciplinary hearing. In one court case, a former employee argued that he had ceased to be an 'employee' the moment he tendered his resignation, which made him incapable of dismissal and prevented his former employer from updating REDS.[98] The court determined that it had no jurisdiction, but observed that "it might be thought a little startling if the underlying purpose of such database – bearing as it does an important public interest ingredient – could be stultified in a particular instance through no more than a resignation".

3. UK Banking Standards Board (BSB)

The BSB is a private sector body funded by membership subscriptions and open to all banks and building societies operating in the UK. It was established to promote high standards of behaviour and competence in the UK banking industry. Its creation coincided with the development of new legal

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[98] See *Muthusamy v Nedbank Ltd*. (J2211/09) [2010] ZALC 216; (2010) 31 ILJ 1453 (LC), 16 April 2010.

regimes that promote individual accountability and good corporate governance in the UK financial services industry. The BSB began its work in April 2015.

The BSB is neither a regulator nor a trade association. It has no statutory powers, and does not speak or lobby on behalf of the industry. Instead, the BSB provides challenge, support and scrutiny for firms committed to rebuilding the sector's reputation, and impartial and objective annual assessments of individual firms and the industry's progress.

The BSB has published a number of pieces of good practice aimed at achieving high quality 'fit and proper' assessments for the Certification Regime. Related to this, the BSB has explored informally whether banks and building societies could collectively own a register of material risk takers and other certified staff. Rather than requiring a central authority to host and maintain this register, it could potentially be decentralised, using distributed ledger technology (an example of which is "blockchain" technology). Whilst blockchain technology is most commonly associated with cryptocurrencies, it can also be used in databases. An advantage of such a register would be that the number of individuals or institutions capable of amending an entry could be strictly limited (e.g. the institution, authority and individual). Moreover, like the "Broker Comment" functionality in BrokerCheck, this register would enable the individual to comment on misconduct information entered by the other two parties.

4. Japan Securities Dealers Association

The Japan Securities Dealers Association has rules under which its members must inform the association about inappropriate acts that employees have committed. When a member firm intends to hire a person, it must enquire with the association whether that person has committed an inappropriate act. In response to the enquiry, the association replies to the firm based on the record of inappropriate acts it keeps. The association may prohibit member firms from hiring persons for a certain period of time, if the act committed by them is considered to impair public confidence in the financial instruments business.