

Using automation to demonstrate compliance against the backdrop of principled based regulation

Best Practice for the Financial Services Industry

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Executive Briefing

The compliance and risk landscape is drastically changing in light of the impact of the credit crisis and data protection failures of 2007 and 2008. The complexity of global economics and strategies within the Financial Services industry in EMEA and North America to become compliant, and adhere to regulations and reporting requirements, have created a novel urgency to consolidate functions and implement automation to develop a more comprehensive, focused approach to Risk Management.

This paper discusses a number of issues faced by the Compliance and Risk Department in meeting regulatory requirements and shows how automation can be used effectively in a principle based regulatory environment.

We have concluded that automation has numerous benefits and believe that the traditional paper based approach, currently used by many firms creates an unnecessary amount of work for Compliance Officers, exposes firms to avoidable risks and is, quite simply, inefficient. Furthermore, automation can protect firms against potential enforcement actions.

We recommend that firms assess the scale and complexity of their operations and utilise automation where possible when developing their systems and controls.

Background

As the FSA moves to a more principle based regulatory model senior management at regulated firms are seeking innovative ways to develop systems and controls that are proportionate to the scale and complexity of their operations and that focus clearly on outcomes. Regulatory change is here to stay, and as firms grapple with the recent changes under the Markets in Financial Instruments Directive (1 November 2007) and the Third Money Laundering Directive (15 December 2007), any tool that can assist the compliance manager to more easily demonstrate compliance will be welcomed.

The aim of this paper is to look at ways in which a firm's compliance function can use automation to:

- Improve the effectiveness of Compliance Officers in demonstrating compliance;
- streamline processes and make them more efficient;
- protect firms by removing user "ignorance" as a defence;
- provide firm's management with accurate and timely management information.

About the author

The author, Gerry Morgan, is a director at City Capital Consulting Limited. City Capital is a London based independent compliance consultancy firm that specialise in assisting FSA regulated entities with compliance matters. Prior to embarking on a career in consulting, Gerry worked at the FSA for seven years in a variety of roles covering supervision and enforcement.

The challenge at hand for the Financial Services Industry

During 2007, as the FSA and financial services firms prepared for the implementation of MiFID, views on principle based regulation became increasingly polarised. On the one hand, many supported the rule based regime and believed that while principle based regulation would reduce rules it would be replaced with pages and pages of industry guidance. On the other hand, some firms viewed principle based regulation as an opportunity whereby they could develop systems and controls that reflected their business model and, in turn, would result in greater efficiencies. Others, especially small firms (which make up approximately 95% of the 30,000 firms regulated by the FSA) were of the opinion that principle based regulation would create more work for them. While the debate continues as to the pros and cons of principles based regulations, Mr. Hector Sants (the FSA CEO) confirmed at the FSA Retail Firms Conference on 27 February 2008 that:

“The FSA will continue to move towards reliance on principles rather than detailed rules, and will move to a regime focused on achieving the outcomes to support our aims”

How can automation assist in the challenge of demonstrating compliance?

Organisations who have embraced this new regulatory philosophy are already looking at ways to mitigate risk, for instance by streamlining cumbersome processes like disseminating compliance policies and procedures to staff while maintaining an audit trail. This process is complicated by the fact that a firm’s policies and procedures need to be regularly updated to reflect internal and external factors. We believe that one solution to this traditionally paper based process is to adopt a system whereby staff members electronically self certify that they have read and accept the contents of, for example, an Anti Money Laundering Policy.

Efficient Compliance processes mitigate the threat of an audit failure

Sustaining regulatory audit and maintaining agility in a rapidly changing global economy are making improvements in risk management a key initiative for senior executives. This stems largely from the brand damage and bottom line impact that occurs in recent times as a result of a compliance failure.

In many financial organisations a risk committee, led by the Head of Compliance, is responsible to the Board for the implementation of compliance best practice and the avoidance of regulatory sanction. In this document, an attempt is made to map automation to some of the key compliance issues facing the Financial Services industry.

Compliance Procedures

Regulated firms are required to have in place a number of documents to satisfy FSA requirements. In addition, many firms have other documents that they circulate to staff on joining a firm and periodically throughout the course of their employment as noted below (list is not exhaustive):

- Compliance Manual
- Policies & Procedures Manual
- Anti Money Laundering Procedures
- Disaster Recovery Plan
- Data Protection Policy
- Code of Conduct
- Fitness & Properness Questionnaire (for FSA approved persons)

Compliance procedures are usually distributed to a new employee during their induction, the individual is advised to read said procedures before signing an undertaking at the end of the document confirming that they accept. The problem with this approach is that because procedures are required to be regularly updated the undertaking signed by the new employee quickly

becomes obsolete. One option is for the employer to send each employee a paper update each time procedures change, however this process can involve a considerable amount of administration for a firm's compliance function, and is really only manageable in an operation with a small number of staff. A more practical solution would be to automate this process and send an electronic update to the relevant employee asking them to self certify that they have read, and accept, the new procedures.

Advantages of automating compliance procedures

Using automation to circulate compliance procedures provides a practical, cost effective solution. For example, the Compliance Officer could send electronic updates to relevant employees and have them self certify that they agree to comply with the contents of the procedure. This process has several advantages as noted below:

- Efficiency - saves time, no need to collect and store paper documents and data is readily available to retrieve at any point in time.
- Best Practise - makes compliance officer's job much easier
- Reporting - electronic audit trail is maintained
- Targetting - procedures can be targeted at relevant employees (for example, FSA approved persons)

Disseminating key FSA messages using automation

Under principle based regulation, the FSA accepts that it needs to adopt a more proactive stance in providing firms with guidance to ensure that this new regulatory philosophy is successful. Therefore, firms will require a mechanism that ensures that the increased levels of information received from the FSA is distributed to relevant staff in a timely manner. Furthermore, FSA senior

management use a number of other documents to disseminate important regulatory information, in particular, 'Dear CEO' letters and speeches. Compliance functions are expected to review the messages that are communicated in these documents and filter them to relevant staff. So, having a platform that enables a compliance function to automate the distribution of information in a timely manner is both necessary and desirable.

Treating Customers Fairly ("TCF")

Of particular relevance to firms in the retail sector (although it does impact on wholesale firms who manufacture products) is the FSA's TCF initiative. This initiative was one of the main drivers behind the authorities move to a more principle based regime, and the FSA expects firms to have appropriate management information in place, by the end of March 2008, to test whether firms are treating their customers fairly. Furthermore, by the end of December 2008, firms need to be able to demonstrate to both themselves and the FSA that by using this management information they are consistently treating their customers fairly.

Automation can assist in meeting TCF requirements

While a review of TCF is outside the scope of this paper, we have identified a number of areas of the initiative that can benefit from automation. An important element of the TCF initiative relates to changing the culture within firms. It is widely accepted that changing culture requires strong leadership from senior management and a clear communication strategy. Communicating compliance information via traditional channels can be cumbersome, and can create a significant amount of work for compliance functions. In addition, producing a clear audit trail that can be incorporated into a firm's management information system is less achievable using the traditional paper based approach.

The training and competence of staff is a further important strand of the TCF initiative. Again, automation can be used effectively to confirm who has completed specific training and when.

Enforcement Action

In deciding whether to take action against a firm for a breach of rules or principles, the FSA's enforcement division will review a firm's systems and controls. In doing so they will request sight of the policy and procedures that were in place at the time of the breach, therefore, it is essential that firms can produce such documents. In addition, if the breach relates to the actions of an approved person the firm will want to ensure that the approved person was made aware of the policy and procedures, and that he/she had agreed to comply with them. Failure to do so will leave the firm liable to possible disciplinary action.

Speaking at the FSA's annual conference on financial crime, Mr. Philip Robinson, Director of the Financial Crime and Intelligence Division, said:

"Some firms have made progress by adopting good practice while others need to do more in this area to ensure that they are treating their customers fairly. Firms getting data security right is a key priority for the FSA and we expect the industry to raise its standards".

Automation protects firms

The FSA places much emphasis on firms having systems and controls in place that are proportionate to the scale and complexity of its operations; consequently, senior management have devised appropriate systems and controls. An important element of these controls focuses on ensuring that senior management are protected in the event an employee does not adhere to FSA requirements. For example, the FSA's transaction monitoring unit identified that certain individuals had been conducting a large amount of

trading in a security prior to the announcement of a takeover. On further investigation it appeared that a number of employees at the firm were purchasing stock, prior to the announcement, for their own gain. The FSA suspected that staff may have been trading while in possession of price sensitive information.

Following the investigation it came to light that the employees had not followed the firm's procedures in relation to personal account dealings. In these circumstances the FSA will review the firm's controls in relation to personal account dealings; if the firm can produce sufficient evidence that robust controls were in place (for example, Chinese walls and risk based trade monitoring), and were supported with detailed policy and procedures in relation to personal account dealings (that had been communicated to and accepted by staff), the FSA will focus their attention on the individuals and not the firm. With such evidence it can only be construed that the company had taken reasonable steps to ensure that staff complied with the FSA COB rules on personal account dealings, and senior management will be protected.

On the other hand, if the firm cannot produce such evidence, the FSA will consider taking action against the company for failing to have adequate controls in place. So, it is essential that a firm can produce an audit trail of:

- the policy and procedures that were in place at a specific point in time;
- an undertaking confirming that the employee has read and agreed to comply with the contents of the policy and procedures.

This requirement is best managed using policy management automation.

Senior Management Arrangements, Systems and Controls (“SYSC”)

To comply with the requirements under the SYSC Handbook the FSA has provided guidance (SYSC 2.2.2 G) with respect to the apportionment of significant responsibilities (SYSC 2.2.1 R) among senior management and the allocation of functions (SYSC 2.1.3 R). The guidance states that a firm can comply with these rules by maintaining appropriate records, providing they are kept up to date. The records include, for example, organisational charts, job descriptions, project management documents and committee constitutions. Furthermore, SYSC 2.2.1 R (2) states that records with respect to the apportionment of significant responsibilities must be retained for a period of six years from the date on which it was superseded by a more up-to-date record.

Automation can assist firms in complying with FSA Rules

Complying with these requirements can be labour intensive for the compliance function. For example, as people leave or move around a firm, job descriptions, organisational charts, reporting lines etc. will change. More importantly, firms must ensure that changes are effectively communicated to staff in a timely manner. For example, if a firm changed its Money Laundering Reporting Officer staff would need to be informed immediately and the firm’s organisational structure chart and job descriptions would need to be updated. Failure to do so would result in the firm failing to comply with the requirements under SYSC.

Using a paper based approach to satisfy the requirements under SYSC can be difficult, especially when taking into account the fact that records must be maintained for a period of six years from the last update. A more efficient alternative is to record changes and disseminate the information to staff electronically, and have them self certify that they understand the new reporting lines etc.

Automation mitigates risk

Many firms continue to adopt an approach whereby a compliance manual sits on the compliance manager's desk, to be opened when a member of staff approaches with a question. This method is used for a number of reasons,; one being that compliance manuals are not the most user friendly of documents and can run to well over one hundred pages; it could take a member of staff a significant amount of time to find an answer in a compliance manual. A more productive option is for the manual to be stored electronically, with a search facility that links to relevant documents. For example, if a member of staff wants to know the procedure for giving or receiving gifts to a client they would type 'gift' into the search facility. This would take the employee straight to the relevant section of the manual which would first explain the firm's policy, and then provide a link to the form that has to be authorised when giving or receiving gifts. Staff are much more likely to check a firm's policy via this means, and therefore this is a useful tool for mitigating risk. More specifically, a percentage of employees will refrain from going through the process of speaking to compliance but are more likely to check something via their computer if it can be accessed immediately with limited fuss.

Conclusion

The importance of compliance and risk management has increased in recent years as the FSA has shifted responsibility onto the shoulders of senior management at financial services organisations. Consequently, compliance is now seen as an integral part of a firm's operational processes. Efficiencies and cost savings are desirable to ensure that compliance functions are adding as much value to the business as possible, and, like any other process, the function is subject to continuous improvement. However, to date, compliance functions have lagged behind other areas of a firm's operation with respect to embracing technological solutions.

Surprisingly, paper is still used extensively in communicating compliance matters in companies ranging from major European banks to small corporate finance boutiques. In addition to creating avoidable risks, firms are not making the best use of their limited resources by continuing to adopt a paper based solution to address an issue that is more effectively managed electronically. However, now that the principle based regulatory model has arrived, senior management and compliance professional alike are searching for innovative, cost effective solutions to replace inefficient processes. We conclude that Self Certification Automation must be top of the list. The benefits outlined in this document are significant and will lead to the best practise systems and controls demanded by principled based regulation.

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