Advice Matters

July 2018

Volume 5, Issue 7

- One hour of structured CPD
- Industry update
- Key factors for your business
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- Technical know how

The CPD Solution For Financial Professionals

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Welcome to the July Edition of Advice Matters

ApEx standards

The learning outcomes and the ApEx Standards can be found at the end of this edition of Advice Matters

Welcome to the July edition of Advice Matters.

Well the first 6 months of the year have gone …..watch out Christmas …..hard to contemplate when we are having such a wonderful spell of warm, sunny weather.

We begin this month's edition with a look at the regulator's favourite area of focus as it effects a myriad of aspects in a firm - Culture and Conduct and how they are inextricably linked.

The second article has a very interesting slant on Hedge Funds, who invented them and how they work – put in a way that simplifies the complexity of an area of financial services a lot of us don't even attempt to get our heads around.

We finish July's edition with little pigs – not the ones that went to market to invest in hedge funds but those that lived in fear of the big bad wolf…I will leave you to read the article.

If you are off on your summer holidays you can always take your copy of Advice Matters with you. What better way to complete an hours' worth of structured CPD (we are only joking)!

Happy July

The Advice Matters Team at FSTP

Coming up next month, we will be looking at:

- Pension beliefs
- Suitably appropriate
- FCA annual report

Recognised CPD programme

The London Institute of Banking & Finance

Staying On Track

This section will keep you up to date with the changes in Market, Product, Legislation and Regulation

Conduct of Culture

"Culture in financial services is widely accepted as a key root cause of the major conduct failings that have occurred within the industry in recent history, causing harm to both consumers and markets."

Transforming Culture in Financial Services
FCA Discussion Paper DP18/2
March 2018

As we saw in last month's edition of 'Advice Matters', the culture and governance of regulated firms remains one of the FCA's key cross-sector priorities for 2018/19. Since its inception in April 2013, the FCA has been banging the 'culture and governance drum' very hard indeed – quite rightly so in view of the various scandals that blighted the Financial Services sector in the opening decade of the 21st century and whose ramifications are still being felt today.

FCA FINANCIAL CONDUCT AUTHORITY

"Firms' culture and governance should drive behaviours and produce outcomes that are likely to benefit consumers and markets."

FCA Business Plan 2018/19

'Culture' is by no means a new concept for us to grapple with – it was born neither from the banking crisis, nor the 'credit crunch', predating both of these by several millennia – but it can be a difficult thing to define and even harder to get right in practice; hence the FCA's ongoing commitment to giving it a top spot on the regulatory agenda.

We only have to take one look at the FCA's output over the last 5 years to see how fundamentally important it is for organisations to get culture and conduct right. As recently as March 2018 the FCA published a 120 page discussion paper – 'DP18/2 Transforming Culture in Financial Services', a series of essays written by 'thought-leaders' from a wide variety of backgrounds.

Getting organisational culture right can be nigh on impossible unless several fundamental elements are in place and properly aligned. It is also an issue that individuals and organisations can sometimes be guilty of over-thinking and, therefore, over-complicating.

What is 'Culture'?

There are many ways of defining 'Culture' depending on environment, circumstance and context, but for the purposes of this article it is best to turn to the conduct regulator for a definitive answer.

In a speech delivered to the 2nd Annual Culture and Conduct Forum for the Financial Services Industry, on 12 July 2016, Jonathan Davidson (FCA's Director of Supervision) stated:

"We define culture as the typical, habitual behaviours and mindsets that characterise a particular organisation. The behaviours are the 'way things get done around here', they are the way that we act, speak and make decisions without consciously thinking about it."

In very simple terms, the basis of a 'good' – or 'positive' – organisational culture is all about doing the right things right, putting the customer at the very heart of everything we do. For some, achieving this may be easier said than done and will be a particularly challenging task for those organisations in which deep-seated 'negative' culture prevails, some danger signs being:

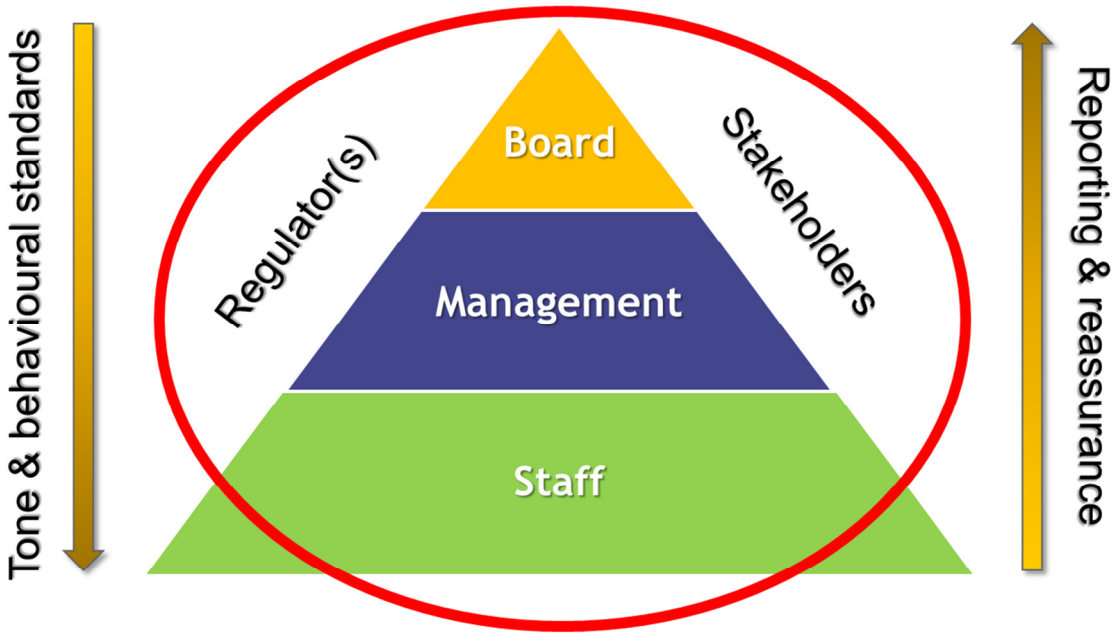
- Insufficient and / or inefficient management of conflicts of interest
- Systemic weaknesses in systems and controls
- Poorly defined accountabilities and responsibilities
- Lack of staff engagement
- Inadequate risk management arrangements
- Poor governance on new product design & development
- Lack of transparency around decision making
- Pressure selling
- Sales incentives narrowing customer choice
- Inadequate business continuity planning
- Changes in existing policy or strategy which may be unfair, or cause harm to customers

Setting the tone and culture

Culture will always be firmly rooted in the values that an organisation espouses and ideally, those values will be aligned to a clearly defined corporate vision which is the primary motivator of the business's strategy.

Vision, strategy and values should all emanate from an organisation's governing body – for example, a Board of Directors.

Those at the highest level of the management hierarchy are responsible for setting and maintaining the organisation's culture and its associated tone. There has to be absolute authenticity in this. Any paying of lip service to the notion of 'doing the right things right' and of putting the customer at the heart of decision making will quickly be identified and emulated by those in subordinate roles – in short, the likelihood is that the behaviours and attitudes modelled by those at the top will be imitated by those lower down, to a greater or lesser extent.



In this diagram we see that tone and behavioural standards (Culture and Conduct) are cascaded through all levels of the organisational structure – from 'Board Room to Post Room'. A positive indicator of 'good' culture is the existence of reporting and feedback mechanisms which provide reassurance to those at the top that the prevailing culture throughout the organisation remains healthy and that individual and collective conduct reflects this. These mechanisms may include:

- Analysis and reporting of customer / client complaints including evidence of any remedial actions taken to address systemic issues
- Regular quality assurance testing and reporting, particularly around sales and service
- Regular review of employee remuneration and incentives with reporting to provide reassurance that poor performance and / or bad conduct is not rewarded

- Independent scrutiny and reporting of the organisation's systems and controls, via compliance and audit (internal and external) functions
- Confirmation of the application of clearly defined training and competence arrangements at all levels of the organisation's hierarchy
- Confirmation of the application of robust HR policies and procedures – such as recruitment being based on individual fitness and propriety and zero tolerance of poor conduct / behaviour
- Feedback from regular staff surveys with results collated to highlight perceived cultural strengths and weaknesses for Management's further consideration
- Evidence that 'speak-up' arrangements are properly communicated and working effectively

"Only 4% of an organisation's frontline problems are known by top management, 9% are known by middle management, 74% by supervisors and 100% by employees…"

Sidney Yoshida
The Iceberg of Ignorance
1989

Sitting outside the organisation, looking in, are a number of parties who are affected by and / or have an interest in the prevailing culture. In general terms these parties fall into two categories – regulators and stakeholders.

Regulators	Clearly the regulators take a keen interest in organisational culture within regulated firms – the FCA will expect to see evidence of the practical application of its eleven 'Principles for Businesses' and, for dual regulated firms, the same will be true for the PRA and its eight 'Fundamental Rules'. The FCA's Principles and PRA's Rules (for dual-regulated firms) should be the bed-rock on which Financial Services organisations build 'good' culture.
Stakeholders	Stakeholders will include: • Customers • Shareholders • Potential investors Firms that demonstrate a sound business culture and high standards of conduct will be more attractive to these stakeholders.

Just as corporate strategy should be driven by an overarching vision, so the strategy itself should be the primary influencer of the attitudes and behaviours that prevail within the organisation. Senior managers must be the role models for the behaviours and attitudes that embody the culture of the organisations that they govern. When it comes to setting moral and ethical standards, they are expected to take the lead – in other words they should, 'talk the talk and walk the walk'. This practical application of attitudes and behaviours can be summed up in one word – 'Conduct' – another area that is high on the regulator's agenda.

"Culture is primarily a function of individual behaviour. Behaviours can be assessed through three elements: the character of the individual, the judgements of the individual and the outcomes of their decisions."

Sir Hector Sants
former CEO, Financial Services Authority (FSA)

It is important to stress that this role-modelling of behaviours and attitudes is not confined solely to working hours because the requirement to demonstrate sound moral and ethical principles carries over into 'off-duty' life.

"Leaders have to be beyond reproach in the example we set, and unfortunately I fell short of that standard …"

Jonathan Friedland – ex-Head of Communications, Netflix
fired for using racially offensive language, June 2018

Culture and conduct are, therefore, inextricably linked; you cannot have one without the other. A poor culture will result in conduct that is questionable from a moral and ethical standpoint. A good culture will result in conduct that is ethically and morally sound.

The following examples provide a view from opposing ends of the cultural spectrum.

FCA FINANCIAL CONDUCT AUTHORITY

FCA fines Bluefin £4m for misleading customers

6 December 2017

Between 9 March 2011 and 31 December 2014, Bluefin, a large insurance broker which was wholly owned by the insurer AXA UK Plc during this time, held itself out to be 'truly independent' in the advice it provided and the insurers it recommended to customers.

However, Bluefin failed to implement adequate systems and controls to manage the conflict that arose from Bluefin's ownership. Bluefin's independence was compromised by its culture which promoted business strategies, including a policy which focused on increasing the business placed with its parent company, over treating customers fairly.

Mark Steward, Executive Director of Enforcement and Market Oversight, said:

"'Insurance brokers must promote a culture in which they act in their customers' best interests and provide them with the information they need to make an informed decision. This is central to the relationship between the industry and its customers ..."

Source: https://www.fca.org.uk/news/press-releases/fca-fines-bluefin-4m-misleading-customers

"We've heard culture described as "the way things are done around here." We set culture through what we do as leaders, the way we talk about our customers, the behaviours we reward or punish. Monzo doesn't have an explicit set of values published in an annual statement or painted on the walls of our offices. But last year we asked our staff "What three words would you use to describe Monzo's values?" and their responses were welcomingly consistent (Huckenstein, 2016)."

Source: Transforming Culture in Financial Services
FCA Discussion Paper DP18/2
Essay 1.4 "Can you have your cake and eat it? Building a high performance business model that co-exists with a culture of integrity"
March 2018

Accountability

At the heart of good culture is accountability – an individual's and / or collective's willingness to be answerable for their actions and behaviour. Accountability can either be innate, or demanded by legal and regulatory obligation. Responsibility flows from accountability.

"Lack of accountability of senior management can drive poor conduct, from selling unsuitable products to excessive risk taking or mis-selling, that harms those who use financial services."
FCA Business Plan 2018/19

The FCA recognises that culture will vary from firm to firm and that one size does not fit all. That being said, the onus on individual accountability is clearly reflected in the minimum standards of behaviour which underpin the Senior Managers and Certification Regime (SM&CR) – the 'Accountability Regime'. Through this, the FCA aims to promote cultures where senior managers take responsibility for identifying

where harm might occur and take action to prevent it. SM&CR creates a formal link between the behaviour of individuals and the conduct of the firm.

At the moment, SM&CR applies only to the banking sector, but the FCA is preparing the final rules for extending the regime to all FSMA firms, including dual-regulated (FCA and PRA) insurers and solo-regulated (FCA only) firms – a total of around 47,000 regulated organisations.

H.M. Treasury has confirmed the Regime will start for insurers on 10 December 2018 and the implementation timetable for solo-regulated firms is expected to be mid – late 2019.

The Regime's Conduct Rules apply to all relevant employees within FCA-regulated firms:

Rule 1:	You must act with integrity.
Rule 2:	You must act with due skill, care and diligence.
Rule 3:	You must be open and cooperative with the FCA, the PRA and other regulators.
Rule 4:	You must pay due regard to the interests of customers and treat them fairly.
Rule 5:	You must observe proper standards of market conduct.

Four senior manager-specific conduct rules (SC) supplement the five general conduct rules

SC1:	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
SC2:	You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system.
SC3:	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.
SC4:	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

Benefits of good culture

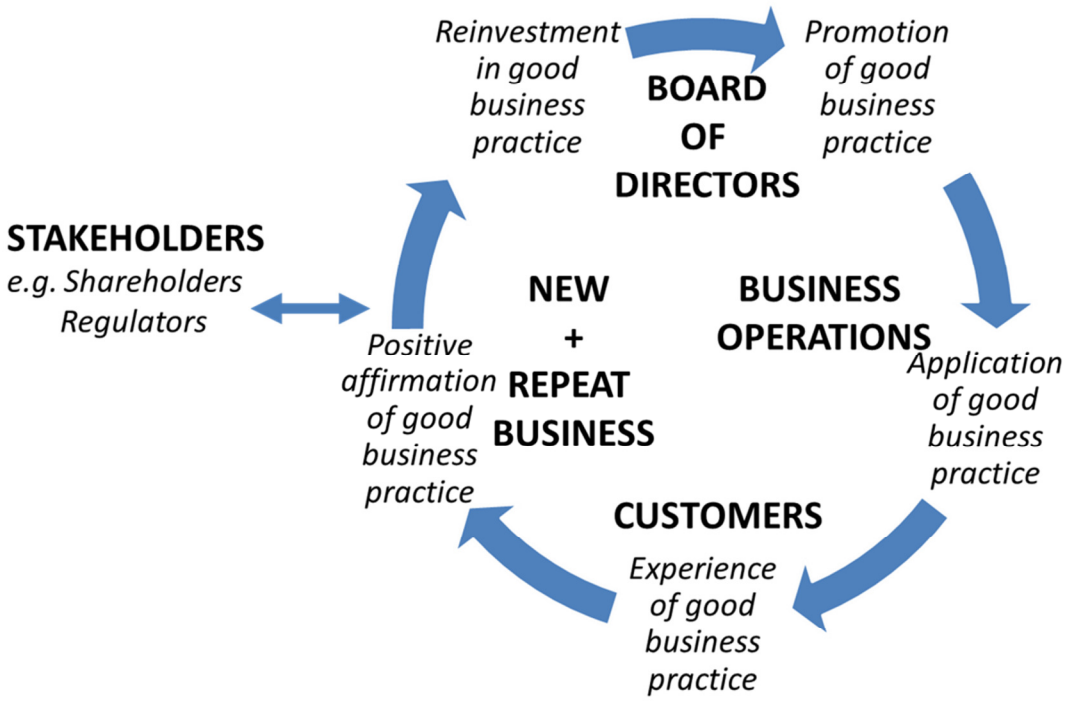
Establishing and maintaining a good and healthy organisational culture should be done because it is the right thing to do, not because a regulator demands it. One might argue that if an organisation is being run in an ethical, responsible, accountable and morally sound way, regulation becomes, if not irrelevant, then certainly less of an issue.

This is not to say that good culture will render an organisation immune from problems – accidents do happen and apples do go rotten. However, it will enable the organisation to identify and respond to issues quickly and effectively, thus minimising the potential harm to customers, employees, the market and the organisation's own reputation.

The concept of the Service Profit Chain (SPC) was first proposed in 1994 and in the diagram, below, we have replaced the word 'service' with 'good business practice' – a phrase that is synonymous with good culture.

The basic premise of the model is that an organisation's governing body (e.g. a Board of Directors) promotes good business practice which is applied at an operational level – internally (e.g. employee engagement through training and development, appropriate award and recognition mechanisms etc.). The application of good business practice is experienced by the organisation's customers and this is affirmed through repeat and also referred business which, in turn, drives profit which can be reinvested in the further promotion of good business practice.

Simple, but effective, as a number of Financial Services institutions – such as Monzo, Nationwide and Metro Bank – will attest.



Conclusion: Culture – a holy grail?

So, does all this mean that the FCA expects us to be paragons of virtue? No, not at all. The regulator appears to accept that creating a perfect culture is a Utopian ideal – what exactly would make a culture perfect anyway … and in whose opinion? However, this should not block us in striving to achieve the highest standards possible in the context of the real world situation that we find ourselves in.

If in doubt just remember – do the right things right!

To misquote Mahatma Ghandi (slightly),

'An organisation's culture resides in the soul of its people'