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The changing role of compliance



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1. Introduction

The combination of the global financial crisis that started to emerge in 2008, continuing challenges in respect of the mis-selling of PPI and, more recently, misconduct in relation to LIBOR and foreign exchange benchmarks has put the spotlight on governance, culture and standards across the whole of the financial services industry, and particularly on banks. The political, regulatory and supervisory responses to this have been far-reaching and intense, leaving few aspects of the regulatory landscape and the governance of regulated firms untouched. As part of this, the role of the Chief Compliance Officer (CCO) and the Compliance Function more generally is subject to ongoing and significant change, particularly in the UK.

Both the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) emphasise the importance of “judgement-based supervision”. In short, this means looking beyond compliance with the letter of regulation (which of course remains important) and asking normative questions about whether or not a course of conduct is the right thing to do, even if it is currently not prohibited by the regulations. Although judgement-based supervision is not new, it is clear that its application still has a long way to run and the increased prominence being attached to it raises risks relating to supervisory predictability, consistency and the use of hindsight. All of these pose particular challenges for the CCO.

Simultaneously, the focus on the importance of firms having the right culture to deliver compliance with regulatory obligations in the broadest sense reinforces the principle that compliance is an issue for everyone in the firm, not only the CCO. Moreover, culture is not something that can be “managed” or “mitigated” through controls. Too much emphasis on controls can lead to a culture where something not expressly prohibited is viewed as acceptable. The focus needs to shift to promoting behaviours which encourage all staff to take responsibility for doing the right thing all of the time. This is a positive development in that it reinforces accountability within the business (the first line).



If compliance is for all in the firm, *what* is the Compliance Function for?



But it also raises some questions about where the CCO's role starts and finishes. If compliance is for all in the firm, what is the Compliance Function for?

The introduction of the Senior Managers Regime (SMR) and the Senior Insurance Managers Regime (SIMR) will be important in this regard. Not only will they reinforce the role of the senior management team as a whole in delivering compliance with regulatory requirements but they will also mandate clarity around each senior manager's role and responsibilities.

The significant preparatory work which implementation of these regimes requires of some firms will provide clarity in many areas which have remained "grey" for years. If implemented rigorously, this should minimise any scope for uncertainty or misunderstanding around the boundaries of the CCO's responsibilities. These new frameworks will also reinforce the need for Non-Executive Directors (NEDs) on the Board Risk and Audit Committees to take a strong and direct interest in the CCO and the Compliance Function.

All that said, clarity in and of itself will not deal with the many challenges faced by the CCO in terms of the breadth of the role.

The range of skills needed by the CCO and the Compliance Function is both broadening and deepening at a time when competition to recruit compliance professionals is high.

Although conventional solutions such as recruitment and training will continue to play a key role, we are seeing CCOs looking to adopt more innovative approaches and solutions. Key among these is greater (and better) deployment of technology to support the CCO and the Compliance Function, taking advantage of the pace with which new applications and solutions are being developed and also reflecting the cost pressures which firms face (e.g. to use shared services, low cost environments, etc.). However, technology is no panacea – in order to achieve a return on the potentially significant investment needed firms must first have a foundation of effective compliance policies and processes.

Against this background this paper explores some key areas of change that we are seeing take effect across our network of clients, looking specifically at:

- changing supervisory expectations, including the move to more judgement-based supervision in the UK and the consequences for the CCO and the Compliance Function;
- the role of the CCO as part of the overall senior management team of the firm and the need to satisfy multiple demands from different stakeholders; and
- how CCOs can respond to the changing environment and the tools and techniques available to support them.

In summary: while the challenges facing CCOs have undoubtedly risen, given increasing demands from both regulators and from internal stakeholders, we see a range of innovative approaches in relation to people, processes and technology which can support CCOs and Compliance Functions in navigating through them successfully.

2. Supervisory expectations and the spotlight on culture

In the UK, the PRA and the FCA both emphasise 'judgement-based supervision'. Although judgement-based supervision is not new, it has been given greater emphasis and much more supervisory attention is being devoted to firms' culture, not only in the UK but across the world. The following section explores the implications of these changes in more depth.

Judgement-based supervision and culture

The PRA and the FCA, both when they were first established in April 2013 and frequently thereafter, have emphasised the importance of judgement-based supervision in their overall supervisory approach¹. Their statements establish that while compliance with the letter of regulation is necessary it is unlikely to be sufficient to prevent supervisory intervention or *in extremis* enforcement. Further support for this view can be found in pronouncements to the effect that firms should refocus from asking themselves whether they can do something (i.e. whether it is permitted by the rules) to whether they should do something. Martin Wheatley, the Chief Executive of the FCA, has contrasted the "ethics of obedience" with the ethics of care and of reason². And this shift is not confined to the UK. In the US, William Dudley, President of the Federal Reserve Bank of New York, has spoken of his supervisors looking for evidence of "consistent application of "should we" versus "could we" in business decisions"³. Regardless of the precise words or formulation chosen, there is clearly now an increasingly ethical dimension to the issue of regulatory compliance.

Despite the increased focus, judgement-based supervision should not be a new concept for the CCO and for UK firms generally.



A number of the considerations set out above were present in the Financial Services Authority's use of its Principles for Businesses as a focus of supervision and, in some cases, as a basis for enforcement action.

What has changed is the degree of emphasis now being placed on integrity and ethics over and above compliance with the letter of the rules. Moreover, there are differences in the extent to which CCOs, their Compliance Functions and their wider organisations are attuned to this new reality.

A number of consequences follow from this:

- While pursuing a judgement-based approach to supervision offers advantages to both supervisors and firms (because in theory it offers some flexibility for firms as to precisely how they deliver compliance with regulatory requirements) it can also give rise to unpredictability and inconsistency. This risk is mitigated to the extent that both the PRA and FCA escalate the more significant supervisory judgements to increasingly senior individuals and/or committees who will be involved in a broader range of decision-taking than an individual supervisor. Nonetheless, this risk remains.
- Firms' and individuals' concerns about the use of hindsight increase, particularly in relation to how a supervisor might judge a particular course of conduct or decision after the event. These concerns are further heightened if there is little or no guidance (whether formal or informal) from the regulators that indicate how they are likely to view such conduct. As a consequence firms continue to spend significant time and effort creating an audit trail to demonstrate their rationale for reaching a particular decision and the introduction of the SMR may exacerbate this. So in some respects even if "box ticking" is eschewed by the supervisors in favour of a judgement-based approach, it is still very much needed by firms, particularly to justify their actions if they are called to account by their supervisors. Even though supervisors recognise that their own judgments may, in hindsight, be wrong⁴, firms are sceptical about how much understanding they will receive from their supervisors in such circumstances.

- The Remuneration Code⁵ and the requirement for firms to adjust compensation where specific risk events crystallise, such as compliance breaches, mis-selling, other risk management failures or a material downturn in financial performance have added another dimension to the CCO's role. This is now a significant responsibility for firms, cutting across the Compliance Function, Risk, HR, Internal Audit and ultimately the Remuneration Committee. Decisions in this area require judgement to be applied to complex situations based on the evidence available.
- The supervisors' focus on the role of strategy, business model and a firm's culture in delivering compliance with regulatory expectations in the broadest sense means that "compliance" is, more than ever before, a matter for the entirety of the organisation, albeit one in which the CCO and the Compliance Function have an essential role to play.

This in turn raises some important questions about what the role and responsibilities of the CCO and the Compliance Function are relative to the organisation as a whole and what skills and capabilities they need to operate in this changing environment. In short, if compliance is for all, what is the Compliance Function for?

What is Compliance?

The CCO has a number of different and, on occasion, competing stakeholders: regulators and supervisors, the Board, the Risk or Risk and Compliance Committee, the Audit Committee, the CEO, the front line of the business, Internal Audit, law enforcement agencies and so on. All will have a common view of the core of the role of the CCO and the Compliance Function, but it is likely that at the margins their expectations will diverge.

The CCO is now much more frequently involved in corporate strategy, advising on whether and how strategic and business model considerations are likely to satisfy the supervisors' judgements about the fair treatment of customers, market integrity and, in some cases, financial soundness. Yet he or she will also be expected to be independent in terms of monitoring and assuring the outcomes of any advice given.

Although the FCA provides some guidance⁶ in relation to the nature and composition of the Compliance Function, this too is very broad and does not pin down specific responsibilities. Against this background, there is a risk that the CCO and Compliance Function become "all things to all people", lacking the distinct identity of, say, the Legal Function or Internal Audit and further complicating the relationship it has with the business. This can, at best, lead to confusion and, at worst, to the Compliance Function being held accountable for something that has gone wrong without having ever been told that it was allocated that responsibility in the first place.

These risks are manageable, primarily through a clear delineation of responsibilities for the CCO and the Compliance Function. One framework for doing this is through the apportionment of responsibilities to the "three lines of defence", where the first line typically comprises the business (which may have its own local control/compliance resource), the second line the control functions (the Risk and Compliance Functions) and the third line assurance in the form of Internal Audit. Although these distinctions seem reassuringly clear cut, closer examination suggests that there are grey areas.

In many organisations, the Compliance Function encompasses elements of advisory (including, in some cases, legal advice), monitoring, assurance, control and the management of regulatory relationships. This can blur perceptions: is the Compliance Function working in partnership with the business; a "Big Brother" peering over the shoulders of the business and challenging every action; or a combination of both?

If the answer to this question is "both", there is a material issue about how the Compliance Function can be a truly independent second line of defence if it is challenging a course of conduct or a transaction on which it has already given advice.

As a consequence, there may well be some evolution in terms of the “advisory” aspect of the Compliance Function. It may be that UK firms move further towards the approach that we have seen some US firms adopt, whereby the Compliance Function is strictly “second line”, confined to carrying out monitoring and assurance. In such a structure, activities such as advising on transactions, managing relationships with the regulators, and compliance policies typically sit with a Legal Function. Clarity in this respect is not costless – the Compliance Function, being less involved in day to day advisory matters, can become more remote from the business and lose some of its currency in terms of market practice and standing with the “first line”. Moreover, the fact that the Compliance Function is involved solely with monitoring and assurance means the demarcation between it and Internal Audit is less evident.

All this points to the need for *ex ante* clarity in terms of the allocation of roles and responsibilities to the CCO and the Compliance Function more generally and, as part of this, dealing with any scope for conflicts of interest within the function itself.

We expect that the introduction of the SMR and SIMR for banks, the largest investment firms, building societies, credit unions and Solvency II insurers will give further impetus to the drive for clarity as to precisely who is responsible for what.

Whilst the SMR and SIMR apply to dual regulated firms only, we nevertheless anticipate that the FCA will read across the guiding principles of greater clarity around individuals’ responsibilities and accountabilities to its supervision of firms more generally.

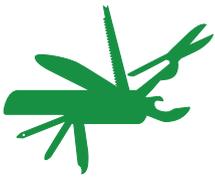
The impact of the forthcoming SMR and SIMR

The proposed new SMR⁷ which will come into force on 7 March 2016 and SIMR⁸ which will come into force on 1 January 2016, clarify the lines of responsibility at the top of those firms directly affected, thereby enhancing the supervisors’ ability to hold senior individuals within them to account. It will also place increased emphasis on the need for firms to satisfy themselves on a continuous basis that their senior managers remain fit and proper in relation to the responsibilities they hold.

Central to the proposals set out by the PRA and FCA is the need for increased clarity – relative to the *status quo* – as to precisely which senior management function (SMF) is responsible for what. This will be achieved through the allocation of specific responsibilities to individuals in Statements of Responsibilities and the creation of firm-wide Responsibilities Maps or, in the case of insurers, Governance Maps. A number of changes follow from this which will, directly or indirectly, affect the CCO:

- Culture takes on a central role for all firms covered by the regimes. For firms covered by the SMR and SIMR the PRA has identified two prescribed responsibilities: leading the development of the firm’s culture; and embedding it in relation to its business and the behaviours of its staff. The PRA has stated that it expects the Chair to be responsible for “*leading the development of the firm’s culture*”⁹. Although CCOs have a key role to play in relation to culture, particularly in relation to embedding, this is plainly not for them alone.
- All SMFs will be subject to Conduct Rules which stipulate that they must take reasonable steps to ensure that the business of the firm for which they are individually responsible complies with the relevant requirements and standards of the regulatory system. This removes any ambiguity as to where compliance responsibilities (broadly defined) lie and we expect this to incentivise all SMFs to be very closely involved in the compliance arrangements for those activities for which they are individually responsible. The fact that SMFs also have to satisfy themselves that any delegation they make is appropriate is also concentrating minds. This will include systems and controls, testing, assurance and training.
- Although the guidance¹⁰ for this particular Conduct Rule in both the SMR and SIMR does contemplate the SMF looking to the Compliance Function to implement and/or monitor compliance with the relevant requirements, the onus remains with the SMF to determine that this is a reasonable course of action to take.
- Reflecting the importance of the Compliance Function and the necessity for it to maintain a level of independence from management control, the PRA has mandated that a SMF from the NED pool must take on specific responsibility for ensuring that the Compliance Function has the necessary authority, resources, expertise and access to all relevant information¹¹.

... there is a question as to whether a regulatory contravention in an area of an SMF responsibility also automatically triggers a related CCO accountability because of a perceived failing in the prevailing compliance controls.



... the skills needed to succeed as a CCO or in the Compliance Function are both broadening and deepening.

Taken together these considerations are, on balance, constructive in terms of underlining the role of the Board and senior management teams as a whole in relation to culture and compliance. They provide clarification that individual SMFs are personally accountable for compliance with relevant requirements in the area of business for which they are responsible and reinforce the need for the CCO to be satisfied that the authority and the resourcing of the Compliance Function are sufficient. That said there is a question as to whether a regulatory contravention in an area of an SMF responsibility also automatically triggers a related CCO accountability because of a perceived failing in the prevailing compliance controls. On the face of it, such linking would seem to run contrary to the individual accountability that the SMR is seeking to instil. But this will be scrutinised carefully as the SMR is rolled out.

Under the current Approved Persons Regime (APER) the individual within a firm responsible for compliance oversight must be approved to take on the (APER) CF10 Controlled Function. Ownership of the CF10 role currently varies across firms. It is often held by the Chief Risk Officer (CRO) (who is usually a Board member), with the CCO reporting up to the Board through the CRO. Although we have seen many instances of the CCO reporting into the CRO, as yet there is no orthodoxy of the CRO representing the Compliance Function at the level of the Board. We have also seen the Legal Function as a common reporting line for the CCO. That being said, however, we are seeing an increasing trend towards more direct reporting to the CEO by the CCO. Amongst the new SMF roles announced under the SMR there continues to be a Compliance oversight role (SMF16) but there is now a specific role for the Chief Risk Officer (SMF4).

It is therefore possible that as CROs take on the new SMF4 role, CCOs not currently operating in the CF10 role may be elevated to the status of a senior manager carrying out the SMF16 role in the new regime.

Overall, it is still too early to say whether the introduction of the SMR will cause reporting lines for the CCO to converge on a single model or whether this will increase the prominence of CCOs at the highest levels within firms.

Skills and experience – a “war” for compliance talent“?

Given increasing expectations of the CCO and the Compliance Function more generally, we observe two significant trends.

First, the skills needed to succeed as a CCO or in the Compliance Function are both broadening and deepening. In addition to the “traditional” skill sets of understanding the rules and other regulatory requirements and their application to the firm’s business, regulatory and supervisory horizon scanning, advocacy, negotiation, project management etc, CCOs and their Compliance Functions must also now:

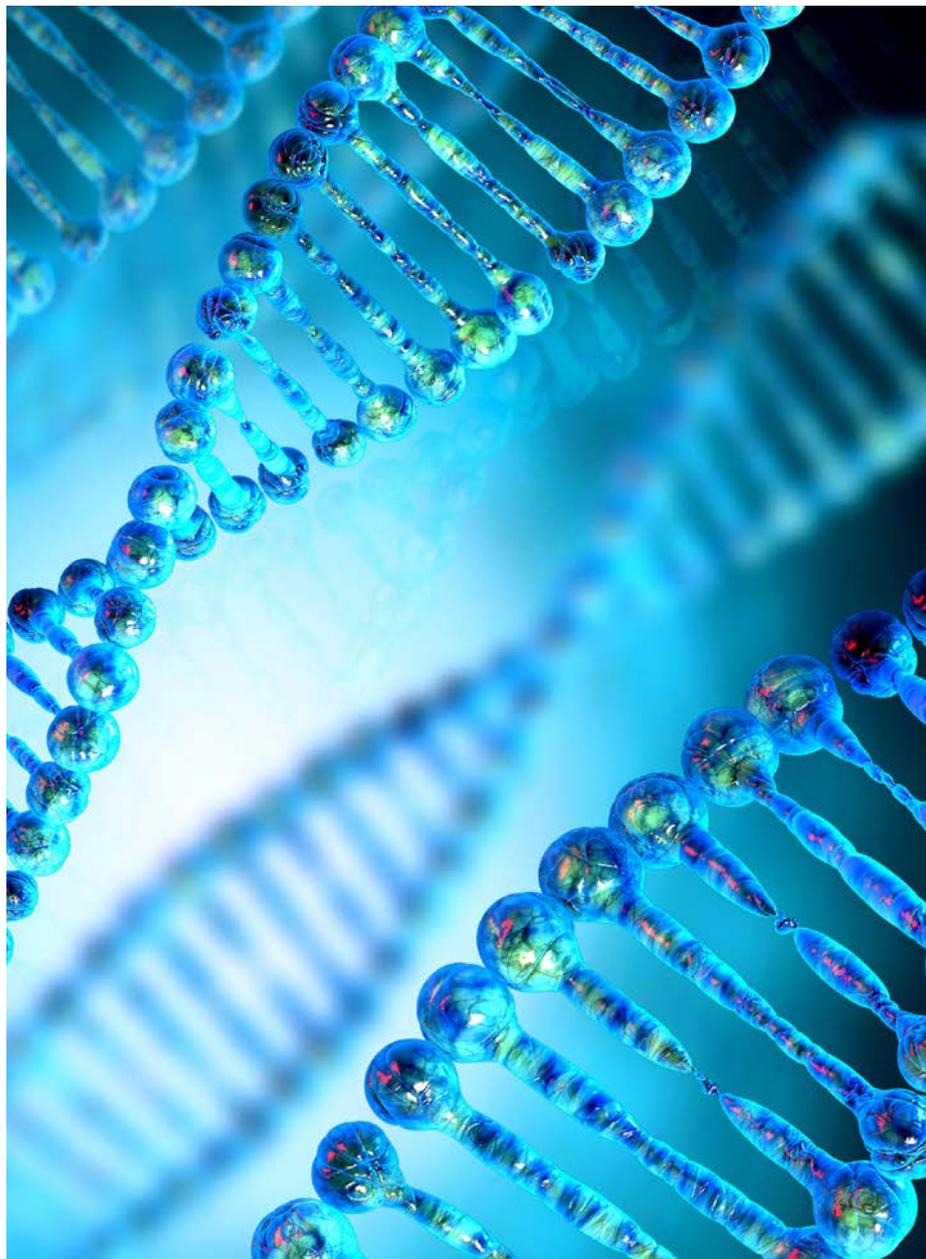
- Use insights from behavioural economics to help firms identify risks of possible customer detriment, internalising the FCA’s concerns about firms consciously or unwittingly taking advantage of (retail) consumers’ behavioural biases.
- Understand competition theory and economics, in particular, which aspects of the firm’s products and activities expose it to the threat of competition intervention, whether by the new Competition and Markets Authority (CMA) or the FCA. Although retail banks have historically been used to dealing with competition authorities and their distinct perspectives, other types of financial services firm have had less such exposure. Also financial services firms generally are not accustomed to their financial services regulators viewing their actions initially through a competition lens.
- Draw on their knowledge of and insights into the firm’s strategy in order to anticipate the challenges of moving into new activities and/or geographies and to recruit and/or develop the compliance skills needed to operate successfully in these new activities/markets.
- Continually reassess the compliance and conduct risks inherent in new technology, including linking old legacy systems with new, differing global infrastructure and data protection laws as well as threats to cyber security.
- In many cases, act as the adjudicator or decision-maker in *malus* or claw back cases, often chairing the internal committee.

- Understand the interplay between prudential and conduct issues – for example Solvency 2 Article 45¹² imposes on firms the expectation that all risks, both quantifiable and non-quantifiable are included in the Own Risk and Solvency Assessment (ORSA). Likewise, Article 46 ‘Internal Control’ imposes on the Compliance Function the requirement that compliance risks (which we interpret to include both prudential and conduct risks) are identified and assessed. In this connection, the PRA’s recent consultation on assessing banks’ capital adequacy under Pillar 2¹³ is also important. This proposes separating conduct from non-conduct risks in terms of setting Pillar 2 capital requirements for operational risk. And although it concludes that the determination of capital for conduct risk is “driven primarily by supervisory judgement”, it will be essential for banks to form their own robust estimate of the Pillar 2 capital charge as a basis for discussions with the PRA.

Second, and related to the first, is increasing competition for the compliance professionals who either already possess or show themselves capable of developing both the traditional and newer skills and capabilities. This has been described by some as a “war” for compliance talent. In our discussions with CCOs we have heard how almost all have actively broadened the range of skills within their teams by employing auditors, former supervisors and consultants. Nevertheless, staff retention and recruitment are still seen as a key obstacle to achieving the right mix and seniority of staff within the Compliance Function.

This is hardly surprising given some firms’ well publicised plans to increase headcount in their Compliance Functions¹⁴. However, this comes at a time when many firms are facing pressures to cut costs to offset (especially in the case of banks) the impact of much higher capital and liquidity requirements and thereby improve returns to shareholders. The CCO and the Compliance Function are certainly not immune to such pressures and, in the face of escalating staff costs, are looking to innovate in terms of their development of compliance professionals, introduce more effective processes and make better use of technology. These developments are discussed in the following section.

... increasing competition for the compliance professionals who either already possess or show themselves capable of developing both the traditional and newer skills and capabilities.



3. How can Chief Compliance Officers respond to the increasing breadth and complexity of their role?



Section 2 set out the increasing supervisory and other stakeholder expectations of the CCO and the Compliance Function. This has in turn driven the demand for more, and more highly skilled, compliance professionals at a time when pressures to contain costs are also rising.

In order to deal with these multiple constraints we are increasingly seeing CCOs move to adopt, either in whole or in part, a three-pronged approach to resourcing their Compliance Functions, involving people, processes and technology.

People

The compliance failings highlighted by the financial crisis and the regulatory and supervisory responses since then leave no doubt about the breadth and depth of skill sets required to build and maintain a successful Compliance Function. As noted above, this has led to a very buoyant and competitive recruitment market to which many CCOs have responded by taking an innovative approach to sourcing, developing and retaining talent within the Compliance Function.

i. Compliance Function capability

While starting with a capabilities matrix is not in itself innovative, it is a necessary first step. To produce it requires a structured approach: the first building block is clarity about the roles and responsibilities of the Compliance Function in the face of the changing demands from supervisors and other (internal) stakeholders set out in Section 2, recognising that the “traditional” skills need to be augmented by new capabilities and perspectives. Moreover, capabilities need to be aligned to the firm’s strategy, including whether it intends to use offshoring or outsourcing as part of its Compliance Function. In other words, this is not a case of dusting off the capabilities matrix that has served the CCO well for a number of years, but rather about taking a fresh look at what is really needed from first principles, recognising the changing demands and realities.

Given the increasing difficulty and rising costs of recruiting compliance professionals externally, we are seeing some firms looking to attract talent into the Compliance Function through internal job moves and to enhance the training and development they provide to compliance professionals.

As part of this “grow your own” strategy we know of some Compliance Functions which have recently started to hire graduates directly, partly because of cost considerations, but equally because graduates may often be more receptive to new ways of working.

Defining those capabilities should provide the basis for a first view of headcount and skills gaps as well as “key person” risks across the business. This in turn enables the recruitment and development of talent in the Compliance Function to align to overall business strategy. In addition, those firms which have moved to centralise more compliance professionals in a group Compliance Function are perceived to have more flexibility in terms of deploying people across business lines and geographies, thereby increasing career development and promotion prospects. The risk of remoteness from the business and a resulting lack of informed oversight that can be present in “group” approaches must be carefully managed in order to preserve these benefits.

ii. Compliance training

Investing in staff and building capabilities require a structured training approach which will include developing behavioural skills and technical knowledge for all levels within the Compliance Function.

While the costs of such programmes can be significant, they have to be set against the likely counterfactuals – the escalating costs associated with recruiting externally or, in the absence of investment in the required skills and capabilities, the prospect of ever higher financial penalties for both individual and corporate misconduct. One way of achieving such a structured approach is for firms to establish some form of training academy for the Compliance Function, including a compliance curriculum and accredited training.

A structured and successful compliance curriculum of this nature both develops the required skills within the Compliance Function, while providing staff with the opportunity for personal and professional growth.

This approach could be invaluable in distinguishing the Compliance Function and for attracting and retaining talented individuals from other areas of the firm or externally.

Processes

Whilst progress to increase the resources and skill sets available to Compliance Functions is essential, it is only one part of the wider solution. Increasing compliance headcount, investing in training and expanding hiring budgets alone are not sustainable solutions for most firms to their medium-term compliance challenges. These new investments will only deliver returns if firms can increase the productivity of their existing resources. This means improving operations, containing compliance expenditure and meeting compliance mandates by enforcing effective compliance processes and having supporting technology in place.

It is vital that firms define and implement a globally consistent set of compliance processes: a “compliance taxonomy”.

An effective compliance programme is grounded in process, notwithstanding the supervisors’ move to a much more judgement-based approach. Compliance must be a proactive endeavour, where policy and practices are embedded in the firm as robust, repeatable processes.

This remains essential for firms looking to demonstrate that effective compliance is part of their overall culture. Moreover, the existence and effectiveness of such processes will be a key element for individual senior managers should they have to avail themselves of the “reasonable steps” defence under the reversed burden of proof introduced in the SMR.

While the quantity of information generated by a firm can seem dauntingly large to manage, a robust and accurate set of processes sets the foundation for compliance technology. Technology can then provide records management capabilities, mitigating the complexity of handling so much data. Records management processes which solely rely on human beings to identify the correct data for compliance and regulatory reporting will ultimately fail, as data volumes can often overwhelm manual approaches. A combination of human judgement and automatic categorisation is therefore essential.

Achieving efficient processes will ultimately result in reduced operational risk through having to rework less, fewer instances of risk appetite breaches and greater standardization. It will also enable integration of compliance assurance, planning and reporting alongside the business, Risk and Internal Audit. This will in turn relieve some of the administrative burden on the CCO and enable more effective governance of compliance issues. Equally, process excellence is a necessary prerequisite to considering potential technology solutions to compliance issues and challenges, since without this there is likely to be inefficient automation, at a significant cost.

Technology

i. Systems

Technology can be a great enabler of an effective compliance programme, but it is not a panacea and it must be used appropriately. As discussed above, the foundation of effective automation lies in sophisticated process. Once CCOs have achieved this, they are much better placed to exploit technology tools in order to improve the efficiency of compliance operations and expand the firm’s ability to manage and monitor its compliance risks.

We have observed that firms are often reluctant to take a forward-looking approach to investment in technology in compliance (for example for monitoring). Instead, there is a tendency to bolt piecemeal solutions onto legacy systems. Firms often benefit from taking a strategic approach.

Removing an inefficient system may be expensive in the short term, but it could cost less than a financial penalty imposed by a regulator for a breach which resulted from that inefficiency.

Similarly, we have observed differing approaches between those systems which are used to manage compliance within business units in the same group. This is usually caused by firms trying to find solutions to address a particular problem existing within one business unit. This often manifests itself in a home-grown system that is inefficient or does not adequately manage the risk. There is often also some duplication across these systems.



These new investments will only deliver returns if firms can increase the productivity of their existing resources.

Linking data allows the CCO to “join the dots” and enables more exceptions posing real risks to be investigated and fewer ‘false positives’.

There is a multitude of technology solutions which can help the CCO utilise existing compliance resources more productively and extend the scope and depth of Compliance Function coverage, in particular to test the adequacy of compliance policies and procedures.

Robust technological tools, which supplement and in some cases replace manual compliance processes, increase the ability to report, govern and aggregate risks. This allows the Compliance Function to focus more of its time on the analysis of results, root causes and forward looking horizon scanning.

In a resource constrained environment, where it is difficult to deprioritise any compliance related task, freeing up time in this way can be invaluable.

Through our experience of implementing technologies in order to deliver efficient and effective compliance processes we have identified the following key areas where technology can help the Compliance Function:

- integration of operational and compliance risk technology platforms enabling operational risk-based exception reporting on conduct and broader compliance risk issues in a joined up-way;
- better results from exception reports, so that firms can more easily track and review the items arising with the highest real risk, rather than the many “false positives” that exception reporting can generate;
- improved capability to retrieve information and monitor across a range of media platforms such as voice, instant messaging, etc;
- better capability for the Compliance Function to access front office systems (and resources) to undertake best execution monitoring for algorithmic or high frequency trading; and
- increased scalability for the Compliance Function to monitor across a broader number of transactions using computer-based testing.

ii. Analytics

In order for Compliance Functions to meet the array of compliance obligations which they face, end to end dataflow and compliance information is critical. “Analytics” describe a range of data-driven approaches that, when combined with deep business and sector knowledge, can highlight risks normally obscured by large data volumes.

Analytics draw on data sources from all compliance activity in the firm and potentially from external sources to establish insights that provide a more comprehensive assessment of risk.

This is particularly powerful when a risk, such as conduct risk for example, is dispersed across multiple data sets.

Because they are based on facts rather than hypotheses, analytics rely on both data volume and data quality to be accurate. This requires those working with the data to understand it and what to analyse. This links back to the human resources element of the CCO’s solution. Since data, which is often stored and processed separately, needs to be pooled from across the firm, a fully resourced data function needs to be in place to bring together an accurate and comprehensive data set and to analyse it. Inaccurate or incomplete data will hinder efficiency and may create significant false positives (which take time and resources to resolve) and false negatives (which store up problems for the future).

In the judgement-based world, in which the many challenges that we have discussed exist for the CCO, analytics can help the CCO tackle compliance in a holistic and integrated manner. Linking data allows the CCO to “join the dots” and enables more exceptions posing real risks to be investigated and fewer “false positives”. Analytics can link customer data, insights, knowledge and relationships, which in turn enable more informed judgment. Ultimately the data can be used to estimate the probability of future risks arising, which means that CCOs can become more risk sensitive and proactive in their approaches. Analytics enable the CCO to add significant detail and context around compliance issues and, ultimately, put more relevant information to the Board, driving better decision-making at the top of the firm.

4. Conclusions

We have established that while judgement-based supervision is by no means a new concept, it is also clear that the degree of emphasis now being placed by UK supervisors on integrity and ethics over and above compliance with the rules is substantial. This is changing the breadth and complexity of role of the CCO and the Compliance Function in financial services firms and in turn fuelling the “war” for compliance talent across the industry.

These changes can increase the risk that the CCO and the Compliance Function become “all things to all people”, which can blur perceptions of their actual role and objectives, as well as interpretations as to what these should be. As we have discussed, this is compounded by the “grey areas” in which compliance can operate: advisory, monitoring, control and regulatory relations.

Alongside this, the upcoming transition to the SMR and SIMR from the current APER is likely to affect the role of the CCO. As we have highlighted, at present there is a variety of reporting lines for the CCO to the Board and no single approach dominates. Although we are seeing an increasing trend towards more direct reporting to the CEO by the CCO, it is still too early to say whether the introduction of the SMR will cause reporting lines for the CCO to converge on a single model.

Equally, we expect the role of the CCO and the Compliance Function to focus somewhat less on process design and review and more on providing challenge to the firm’s Board, asking new questions of the firm and its staff and demonstrating the firm’s prevailing culture. In this respect, controls can be a double-edged sword – while essential, they can, in some cases, detract from individuals taking ownership and from promoting a culture of responsibility. Ultimately, promoting and embedding the right culture within firms will be key to avoiding some of the well-publicised and very costly problems of the past.

Against this backdrop we also suggest that in a judgement-based world, the CCO will be better placed to secure the investment that will be needed in the Compliance Function by demonstrating innovative approaches and increased productivity through a combination of people, processes and compliance technologies and systems.

CCOs should be proactive in addressing the immediate needs of their Compliance Function in terms of putting in place structured training and development in order to attract and retain talent with the right mix of capabilities. Ensuring that processes within the Compliance Function are streamlined is a precursor to long-term investment in technology to enable more effective compliance. Technology and analytics solutions can be enablers of an effective compliance programme and reduce much of the administrative burden on compliance professionals, allowing more time to be spent on analysis. However, without process excellence, technology investment is likely to be an unsuccessful, costly endeavour.

Any changes should not be implemented in isolation. Instead CCOs should take a strategic view of how the various areas within the Compliance Function can link and where synergies can be drawn. This will be crucial to enabling the CCOs to adapt to the challenges of current and future expectations from supervisors and from stakeholders within the business.

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Endnotes

1. <https://www.fca.org.uk/static/documents/fsa-journey-to-the-fca.pdf>
<http://www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf>
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2. <http://www.fca.org.uk/news/speeches/ethics-and-economics>
3. <http://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html>
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Ref. p13 para 42: "Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong."
5. <http://www.fca.org.uk/static/documents/consultation-papers/cp14-14.pdf>
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9. Annex 7.3, 4.11 "responsibility for embedding the firm's culture and standards in relation to the carrying on of its business..."
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11. Annex 7.3, part 3.2 "Allocation of Responsibilities" and Annex 7.2 part 4 "Oversight".
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