# Armstrong Wolfe Institute

*Train, develop, retain - knowledge and capability enhancement within business management*

## Example

# Conduct Training Module

Designed in consultation with a client to meet their specific training requirements

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# Module: How are the Regulators feeling about Conduct Risk?

- CFTC leaders have made a priority of improving the agency's analytics capability

  *"Our ability to go through the electronic order book and look across markets has enabled the CFTC to not only spot misconduct, but also to uncover false and misleading statements,"* Tarbert said. *"Wrongdoers now have increasingly fewer ways to conceal their misconduct."*

- The Securities and Exchange Commission, has also built internal tools to root out fraud in stock and bond markets since the financial crisis. The SEC devised its own software to spot insider trading

  - The Regulators have re-staffed and re-tooled - they have access to large data sets with the expertise to surveill the markets

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# Module: Selected Observations from the FCA '5 Conduct Questions' survey. Conducted with VPs across Markets - 'Tone from Within'

- The identification of conduct risk remains weak; Inconsistent use of data/trends
- Good conduct is recognized, but not fully tied to monetary reward or promotion (the "production" argument)
- Observed a persistent and significant lack of psychological safety in day-to-day speak up and challenge
- Staff were often unclear about their firm's corporate purpose statements and how their own roles and responsibilities contribute to that purpose
  - Business Supervisors take note - reflect on your environment and how you can continue developing a strong conduct culture
  - How would your team respond to conduct-related questions if they were visited by the Fed or the FCA?

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# Reminder: 25 Behavioral Risks embedded in the Markets Business
# Are Controls and Supervisory Information responsive to managing these risks?

Financial Markets Standards Board

### Price Manipulation
- Spoofing/Layering
- New Issue/M&A Support
- Ramping
- Squeeze/Corner
- False Rumours

### Inside Information
- Spoofing/Insider Dealing
- Soundings
- Research

### Circular Trading
- Wash Trades
- Matched Trades
- Ramping
- Money Pass & Compensation Trades
- Parking/Warehousing

### Collusion & Information Sharing
- Pools
- Information Disclosure

### Reference Price Influence
- Benchmarks
- Closing Prices
- Reference Prices
- Portfolio Trades
- Barriers

### Improper Order Handling
- Front Running
- Cherry Picking and Partial Fills
- Stop Losses & Limits

### Misleading Customers
- Misrepresentation
- Window Dressing
- Guarantees

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# Conduct in Markets: We have come a long way, but it still is happening

**Examples: CFTC 2020 Fines:**

- Swap Dealers for inappropriate/lack of disclosures in pre-trade
- Brokers and FCMs for spoofing and other market abuse violations (other forms of fictitious trades or quotes)
- Front running and MNPI leakage
- Market abuse actions can occur across desks internally to coordinate asset classes (cash/derivatives)
- Showing corrective actions, proactivity, and commitment all contribute to minimizing fines and resolving orders timely. Integrity of communications with Regulators is paramount

# Conduct in Markets: We have come a long way, but it still is happening

**FCA 2020 Fines:**

- Failure to disclose the risk and suitability of higher risk financial products (i.e. consumers seek better returns in a low interest-rate environment)
- Mis-selling pension annuities and insurance products. (i.e. one individual was heavily fined for his role as chief executive)
- +700 ongoing investigations
    - The FCA has often preferred to use its enforcement tools to identify harm or potential harm and work with firms to remove or correct the cause or outcomes without formal enforcement.

# Conduct in Markets: We have come a long way, but it still is happening

**Example FINRA 2020 Fines:**

- Maintaining proper records on ‘short interest’, and ensuring compliance with all short sale locate requirements
- Recordkeeping: ensuring clear and logical time stamps during trade life-cycle
- Supervision of money and securities transfers especially in high risk jurisdictions
- Inappropriate and uncontrolled market access - fat finger / manual input, registrations
- Failures in routing and achieving best execution

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# Module: As a Business Supervisor, what are the types of factors I should look out for that can trigger conduct issues?

### Follow the Money

- PL under budget
- PL grossly exceeds expectations
- Lack of PL explain
- Inconsistent risk breach explanations

### Organization

- High staff turnover
- Significant compensation changes
- Restructurings and discontinuations
- ”High pressure” initiatives
- Client coverage assignment changes

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# Module: Emerging Conduct Risk Factors to Consider

- Does the product marketing align with client sophistication
- Evaluate conflicts of interest in roles and client interactions i.e. origination / sales
- Are there concentrated areas of risk i.e. key-person risk, lack of information access, broker concentrations
- Complex, manual systems and processes
- Discretionary allocations
- Undue dependency on third parties
- Conflicting cross-border rules and new local regulations

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# Conduct Management Principles - Our Blind Spots as Supervisors

**Self-serving bias / Anchoring bias**

- Supervisors may fail to notice corrupt behavior if it benefits them

**Outcome bias**

- Good outcome seen as more ethical than a bad outcome

**Endowment bias**

- It must work, we installed it

**Framing**

- Error messages for misdirection

Source: Sezer, Gino and Bazerman, 2015. Ethical Blind Spots

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# Conduct Management Principles

- Staff should understand how to raise concerns to relevant Supervisors and/or Compliance
- Ask questions, consult, take care to not pre-judge
- Communicate factually and clearly
- Consult with your manager in a timely manner if you have concerns
- Develop formal escalation procedures for your business
- Intent does not have to be present
  - Supervisors must create an environment that aligns to these principles and is supportive of “see something, say something”
  - Younger staff will tend to observe the behaviors and practices of their surroundings as appropriate

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Supervisors and Staff are exposed to conduct risks often in real time. Discussing real-life examples is an effective way to understanding the risks at hand and how to manage them

# Scenario 1:

A long, difficult fiscal year is coming to an end.  Your desk's revenue budget has been met, and presumably compensation targets are largely determined for your desk. A longstanding client of yours and the firm calls you on December 2 and asks about structuring a new, highly profitable trade (i.e. structured loan) in the last month of the year.

Your client is of the opinion that execution could be either in the current year or after year-end, knowing that the documentation and approvals processes will be complex. Your personal view is that having this trade in the new budget year would be most helpful in meeting next year's targets.

- What considerations should drive the transaction timing?
- Is the salesperson acting reasonably to consider pushing the deal to the next year?

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# Scenario 1:

**Disruptive Element**

The overall firm has underperformed against budget and is concerned about having to consider large compensation decreases in certain businesses, which are strategically core to the firm and must be kept intact. Booking this transaction would be very helpful.

- Would it be right for Management to “fast track” this deal to ensure completion by the end of the year, and help meet the budget shortfall?
- Maybe rushing the deal results in a sub-standard product?

In addition, the client is of marginal credit quality and this transaction would greatly exceed the firm’s allocated credit limits.

- Is it appropriate to exceed the pre-set credit limits, with no material change in the client’s credit profile?

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# Scenario 1:

**Things to keep in Mind:**

- Undue influences are all around - communicate with your managers on potential conflicts of interest
- Keep client interests at the center of your activities
- Act in the best interest of the firm
- Take a long term view when considering conduct-related decisions

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# Scenario 2:

Remote working has significantly impacted many of our lives, both professionally and personally. Among the positive aspects are that WFH arrangements can allow for more flexibility for family, friends, hobbies and new interests. Of course a dispersed workforce is more difficult to supervise on a day to day basis from a management perspective. Maintaining firm confidentialities is highly challenging in particular.

Sarah is a VP of Sales in the business unit which you are supervising. Sarah is an average performer so far, but is highly motivated and focused on her job and maximizing her opportunities. Sarah shares an apartment with several roommates who work in the same industry, but for different firms.

Over the last few months, you have noticed that Sarah has dramatically increased her level personal dealing transactions, and generally holding positions only for the minimum time period allowed. However, all trades have been registered and approved by the Compliance Department, and have complied with all requirements. And now that you think about it, Sarah seems to be less motivated about her day to day responsibilities, and her production has flattened.

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# Scenario 2:

As Sarah’s supervisor, what are your immediate next steps? What are some of the key considerations?

- Is it appropriate for you to just directly approach Sarah and inquire about her fully compliant trades?
- Do you check with Compliance first to review the trades, and speak with HR first to plan a conversation with Sarah?
- Do you escalate and consult with your manager first to inform? Are you expressing a concern?

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# Scenario 2:

**Disruptive Element**

You check with your manager and he tells you to just go and talk to her and ask about the trades.

In your thinking, you are concluding that Sarah is losing focus on her job, and could it be that she may be receiving inside information and is trading on this?

When you finally approach Sarah about your concerns, and after a few minutes, Sarah opens up and tells you that her family is experiencing some financial hardships, and she is trying to supplement her income to help defray costs. She is comfortable making and managing securities transactions, understands her risks, and thought it might be a faster way to make money.

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# Scenario 2:

- Be careful not to form conclusions prematurely
- Consult
- Ask yourself if as a supervisor you have created a culture of accessibility, where team members can escalate concerns without fear of impacting their job

# Scenario 3:

The firm has made a strategic decision to re-build its Credit Desk, by hiring senior salespeople to develop secondary customer flows in bonds. Colin is a new senior salesperson who has recently joined as a Managing Director, and brings several new hedge fund relationships to the firm. Colin is well known in the HF community, and has achieved great success over the last 5 years. Lastly, Colin joined the firm with an understanding that his compensation will be determined mainly based on his production, but also he is in a management role which will also contribute to compensation decisions.

One compliance requirement when joining is to declare outside business activities. Colin did not declare any. 3 months later a surveillance analyst identifies an email sent to Colin that contains a financial statement for investors from hedge fund A. It seems Colin is an investor in the fund. Hedge Fund A is one of the new clients that was onboarded when Colin joined, along with 10 others.

- Should the investment have been declared as an OBA?
- What are the potential conflicts of interest? Are they material?

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# Scenario 3:

**Disruptive Element**

The hedge fund in question is not very large in terms of AUM. Colin's investment is rather significant, but not at the level of a controlling interest.

Is it appropriate to consider a change in client coverage given the potential conflicts of interest?

Should Colin be forced to divest of his investment?

It turns out Colin has several investments in other funds that have not been declared, and some of which have also been onboarded to the firm.

- Are these investments determined to be considered outside business activities?
- Should he be terminated for not declaring his investments?
- Should Colin be forced to reassign coverage for all these funds as long as he is an investor?
- Can he continue to cover these clients with added oversight?

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# Scenario 3:

**Things to keep in Mind:**

- Conflicts of interest can be interpreted differently depending on your perspective
- Policies may not cover all eventualities - grey areas will still happen

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# The FCA '5 Conduct Questions' – Dear CEO,

1. What proactive steps do you take as a firm to identify the conduct risks inherent within your business?
2. How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?
3. What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?
4. How does the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation and, equally importantly, how does the Board or ExCo consider the conduct implications of the strategic decisions that they make?
5. Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?

END

# The consequence of poor conduct – example penalties US 2000 - 223

**Violation Tracker Parent Company Summary**
**Parent Company Name:**
NatWest Group PLC
**Ownership Structure:**
government-owned
**Headquartered in:**
United Kingdom
**Major Industry:**
financial services
**Specific Industry:**
banking & securities
**Penalty total since 2000:**
**$13,516,771,857**
**Number of records:** 33

**Violation Tracker Parent Company Summary**
**Parent Company Name:**
Deutsche Bank
**Ownership Structure:**
publicly traded
**Headquartered in:**
Germany
**Major Industry:**
financial services
**Specific Industry:**
banking & securities
**Penalty total since 2000:**
**$18,341,457,302**
**Number of records:** 76

**Violation Tracker Parent Company Summary**
**Parent Company Name:**
Goldman Sachs
**Ownership Structure:**
publicly traded (ticker symbol NYSE: GS)
**Headquartered in:**
New York
**Major Industry:**
financial services
**Specific Industry:**
banking & securities
**Penalty total since 2000:**
**$16,386,580,996**
**Number of records:** 66

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*For further information :*

*www.armstrongwolfe.com/coo-institute*


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