



Treating compliance fairly: is compliance being asked to achieve the impossible?

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Compliance officers are being held out by some as the solution to many of the current shortcomings in the regulated financial sector. Numerous initiatives since the financial crisis have focused on reforming the compliance function, to the point where compliance officers now need to be part-banker, part-lawyer, part-economist, part-policeman, part-moral philosopher, and no doubt many other paragons besides. Recent regulatory and court decisions have criticised compliance failings, but it may be that the compliance function is not being given the tools necessary to play the role demanded of it. This article discusses some tips to prevent the compliance function from falling short in the face of an ever-growing responsibility.

A realistic role

The first step is to ensure the role is properly defined and capable of being effectively performed. The European Securities and Markets Authority (ESMA) has stated that the compliance function must be independent, be adequately resourced, and have the necessary expertise and authority to access to all relevant information about the company. While this may seem obvious, it may not be so easy to achieve. In banks and investment firms, senior management oversees the compliance function and also determines its budget. Hedge fund principals typically own the fund manager and also employ the compliance team. Compliance may sometimes need external regulator assistance to ensure it is adequately recognised and resourced within a business.

Support from the entire management team is evidently required if compliance is to have the necessary authority. It is generally advisable for compliance to report to the chief executive officer, either alone or through a combined function with legal, reporting through the general counsel. There should be a parallel reporting line to the board or a committee of the board. The board (or committee) needs to hear directly and regularly from compliance (or the general counsel, where the function is combined) as part of an ongoing dialogue, so that it is aware of any build-up of small compliance issues which, cumulatively, may indicate a failure in management. *In extremis*, compliance must have an easy avenue which it can use to raise concerns with the board about the conduct of senior management itself.

Compliance needs to know what is going on at every level of the organisation and to have a first-hand understanding of, and input into, strategy, whether on a standalone basis or through the general counsel. Giving compliance officers the right to attend senior management and board meetings would enable them to escalate issues to senior management and the board without undue formality.

Special notice also needs to be taken of any issues which arise from compliance officers' performance of their duties. If a compliance officer has significant concerns or is asked to leave, the facts, and the compliance officer's own reasoning, should be reported directly in writing to the board and copied to the FSA pursuant to a firm's overarching duty of disclosure.

Compliance needs to delineate carefully, with senior management and other departments such as risk, legal and IT, what it is responsible for and, more importantly, what it is not. The compliance function potentially involves the performance of a wide variety of roles and requires a similarly broad set of skills. It is important for compliance officers to have established, in writing, a clear description of their individual roles and responsibilities.

A fair approach

To a certain extent, businesses are entitled to assume people are operating in good faith, but they need to have systems in place to ensure significant breaches will be picked up in the absence of deliberate and coordinated fraud. ESMA has stated that programmes should be in place across all relevant activities to ensure that compliance risk is comprehensively monitored. Just as banks sometimes pay people to test their security systems and burgle their vaults, institutions should consider asking outside consultants to stress test every aspect of their systems to find flaws.

Particularly following the Libor investigations, recent breaches within an institution, or within other similar organisations, should be acted upon to ensure processes are modified appropriately. For instance,

banks' compliance departments should review functions that submit self-certified data, and practices that are self-driven.

Compliance needs to take ownership of creating appropriate processes and procedures so that the chances of compliance breaches are minimised, or that any which do slip through are identified straight away. Legal, IT and other input may be required to produce these. Compliance must arrive at a full understanding of where any potential gaps are, so that these can be dealt with at a human level or through the introduction of new systems. Processes which alert compliance to new practices, services and products need to be set up, so that their implications can be considered well in advance.

On a day-to-day basis, the role of compliance today is more that of a policeman than a commercial facilitator. The relationship with the business may need to become more arm's length than in the past. Compliance should, however, be careful not to succumb to a pure tick-the-box culture. Proper judgement and oversight is essential. For this, the compliance function needs to be integrated into relevant parts of the business and alerted to any criticisms or whistleblowing across all areas.

Appropriate legal advice

Regulation is a form of law and one aspect of the compliance role involves the exercise of legal judgement, interpretation and reasoning. Informal guidance from regulators or compliance consultancy firms does not provide sufficient protection; in any conflict or crisis scenario, rules and regulations will be interpreted by lawyers. Compliance should ensure it is armed with formal legal opinions on significant issues, and should have a budget for legal expenditure. Relationships with regulators must be formal, as cosy chats are capable of mis-firing or being mis-reported. Conversations should be planned and a contemporaneous, agreed written record taken.

Separately, consideration should be given to whether legal and compliance should be overseen by the general counsel and whether some compliance roles should require a legal qualification. There is a case to be made for this given that compliance essentially involves the application of law. The best defence against subsequent allegations of error is often a legal defence. At the very least compliance needs to work closely with internal and external counsel.

Carrot or stick

Regulatory discourse is now focusing on the alignment of incentives with compliance. At one extreme, some economists have suggested significantly reducing the compliance overhead, and replacing it with appropriate incentives for proper conduct. This ignores the commercial realities, for example that employees will never be rewarded for poor sales, however consumer-friendly their techniques, and also takes no account of decades of experience which have indicated the need for detailed rule-making and oversight in the financial markets. Compliance should not, however, be left as the only bulwark against misconduct, with remuneration and all other incentives pushing all types of behaviour towards breach.

Compliance needs to feed into compensation assessments, particularly where compliance issues such as culture and attitude need to be reflected. For instance, the UK Financial Services Authority (FSA) has recommended that bonuses and incentive schemes should reward good compliance with a sufficient deterrent to penalise poor behaviour. Claw backs need to be monitored against all aspects of an employee's performance, including, for example, cancelled trades and complaints.

Supporting compliance

This is just a brief outline of the complex issues that businesses must address to ensure an adequate compliance function in the current regulatory environment. There is no doubt that the role of the compliance function can be enhanced, but considerable management and legal support will be required to ensure the new structures are sound.

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