GLOBAL ENFORCEMENT REVIEW

2017

Exploring the impact of regulatory enforcement on the global financial services industry

Foreword: Regulation in Action

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Duff & Phelps' Global Enforcement Review looks beyond just the words, policies and intentions of the world's financial services regulators. Drawing from data published by the key regulators in the US, UK and Hong Kong, as well as commentary and insight from around the globe, this report examines those policies in practice: How they invest, when they act and what they do.

It comes at a time when insights into regulators' thinking are needed more than ever. Many jurisdictions face massive political uncertainty, with the Trump administration in the US and Brexit in the UK holding the potential for big changes in regulatory regimes. Moreover, from Hong Kong's Securities and Future Commission (SFC)'s focus on nepotism in financial firms to the Financial Industry Regulatory Authority (FINRA)'s action on corruption and money laundering, there is increasing evidence of a stronger alignment between regulator activity and government objectives.

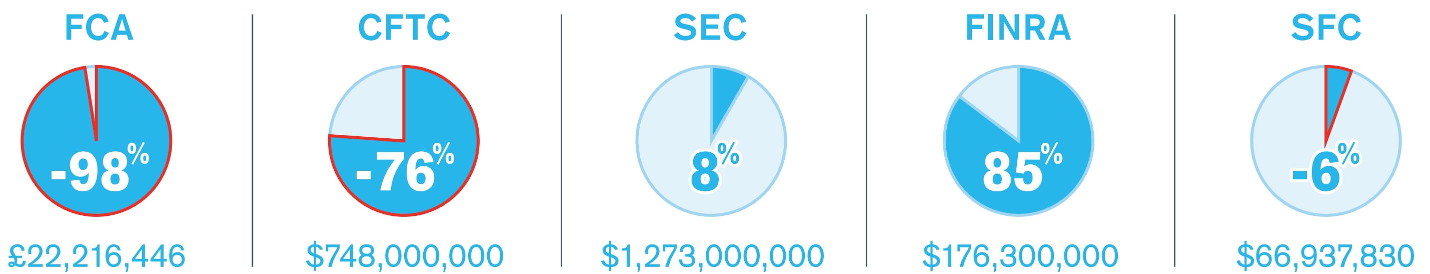
Even without this, though, regulators' priorities are always evolving. At the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) there are new chairmen. More widely, regulators are regrouping following the last of the big cases stemming from the Libor and FX rigging scandals. In most cases this has led to a substantial decrease in the number of enforcement actions and the size of financial penalties. But in their place new priorities and strategies are beginning to emerge.

These could bring profound changes to regulatory enforcement in the months and years ahead. In the UK, for instance, we see the Financial Conduct Authority (FCA) pioneering an agenda of cultural change supported by the Senior Managers and Certification Regime. That's reflected in the SFC's Manager in Charge Regime, and likely to be closely watched by others, too, such as the CFTC, which has made cultivating a regulatory culture in firms a priority.

Across regulators, meanwhile, the past year has seen a number of enforcement action 'firsts': it was the first charge from the SEC against a firm solely for failing to file suspicious activity reports and the first-ever FCA fine for a lack of appropriate controls over outsourced providers. Along with the other insights in this report, such cases tell us not just where regulators are bearing down today, but where they may be looking tomorrow and in the year ahead.

In a fast-changing environment, we hope the insights in these pages will help firms as they navigate their path ahead.

Figure A – Change in Total Financial Penalty Amount from 2015 – 2016



Executive Summary

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The resolution of benchmark rigging cases is giving the world's financial regulators space to pursue a widening range of enforcement priorities – and targets.

It's tempting to see the last year as the calm after the storm for the world's biggest key financial regulators. After the frenetic activity and massive fines flowing from the rigging of Libor, FX and other benchmarks, 2016 allowed regulators to take stock.

The UK's FCA issued fines of just £22.2 million in 2016 – a far cry from the £1.5 billion peak in 2014. Even at the CFTC in the US, where a couple of benchmark rigging cases were still among its biggest this year, the slowdown was felt keenly, with fines down by more than three quarters.

Overall, though, there's actually little to support the picture of a less active regulatory enforcement environment.

For a start, others have ramped up their activity. The SEC, particularly, has been hyperactive in the last year, with a record 868 enforcement cases, up from 807 cases the year before and 755 in 2014. Fines handed out by the regulator were up as well, increasing 8% to a total of $1.27 trillion. At FINRA they were up by even more, increasing from $96 million to $176 million as the regulator ramped up the size and number of penalties of more than $1 million.

Even in the case of the FCA, who imposed fewer of the very highest fines in the last year, there's little sign it intends to be less active Focused Resolution Agreements, which should encourage more subjects of investigation to settle in return for a discount in their pay outs, should in fact enable it to handle more cases in the future.

Certainly, there's little sign any of the regulators are planning to scale back their activities: both expenditure and staffing at most of the regulators for whom figures are available have continued to increase in the last year.

Everything, everywhere

The SEC frenetic activity is held by many to be evidence of the former chair Mary Jo White's 'broken windows' policy under which the regulator would pursue not only headline-grabbing frauds, but even small legal infractions to make firms feel that the regulator was everywhere.

The approach may or may not survive a change of leadership at the SEC and in the White House, but regulatory enforcement at the SEC and elsewhere remains expansionary.

On the one hand, traditional priorities remain AML remains a focus for many, for example. Enforcement activity may see a boost in the UK in the coming year from the New Annual Financial Crime Return introduced at the end of 2016; in the US the Trump administration's focus on national security should also see activity sustained; and in Hong Kong there has been a renewed focus following revelations in the Panama Papers, which showed jurisdiction was the most active centre in the world for the creation of shell companies.

Other issues, too, such as market abuse and fraud, will continue to be priorities. The SFC, particularly, has pledged to crack down on corporate fraud and misfeasance that it says has wiped billions from the value of listed companies in the country over recent years.

But added to these existing priorities, the last year has seen a number of first-of-their-kind cases in which the regulators have marked out new areas of focus:

- The first charges from the SEC against a firm solely for failing to file suspicious activity reports (SAR), without proof of any actual underlying abuse.
- The first SEC case against a private equity fund advisory group for acting as an unregistered broker.
- The first ever fine, and the biggest of the year, from the FCA for a failure to put in place appropriate controls over outsourced providers to ensure client assets were protected.
- The CFTC's first federal court action against a swap dealer for failing to comply with the reporting requirements of Parts 43 and 45 of the CFTC Regulations.
- Two actions at the CFTC charging employees of companies with misappropriating and using material non-public information in breach of their duties to hold such information confidential, marking a new focus at the regulator on insider trading.

Many of these cases are unlikely to remain unique and will serve as a precedent and warning for firms in future.

Personal interest

The pressure felt from regulators is further increased by another trend in enforcement that is not new, but is intensifying: the focus on individuals. The number of action against individuals outnumbered that against companies in the last year at all the regulators bar the CFTC. And even there in most enforcement actions individuals and firms were fined together.

At the FCA individual accountability is particularly likely to increase as the regulator focuses on the broadening implementation of the Senior Managers Regime. The SFC, too, seems keen to drive up the number of actions against individuals, with the implementation of the new Manager-In-Charge (MIC) regime announced in December 2016.

US regulators have yet to introduce anything similar, but have long had a better track record in pursuing individuals anyway. This is helped in part by its whistleblowers regimes for rewarding individuals who inform it of possible securities law violations. These continue to have strong support from the regulators: CFTC grew its program in 2016, making its largest award to date and launching a public-facing website, whistleblower.gov. The SEC, meanwhile, awarded over $57 million to 13 whistle blowers, more than in all previous years combined.

One way or another, the regulators are determined to hold those who make decisions accountable, seeing this as the key to changing cultures. Combined with an increasingly broad enforcement agenda the effect on those falling foul of these regimes is unlikely to feel very calm at all. In fact, it might just feel like the perfect storm.

What the Research Tells Us: The PRA and FCA

The PRA is not very active in enforcement. In calendar year 2016 it concluded only three cases (and only two in 2015) with a total of £4,248,016 in fines. Nevertheless, cases against individuals show its commitment to ensuring banks have effective risk management cultures and strong controls.

Banning a former CEO holding significant influence in PRA-authorised firms from future roles, it noted he 'was centrally involved in a culture within the Co-op Bank, which encouraged prioritising the short-term financial position of the firm at the cost of taking prudent and sustainable actions to secure the firm's longer-term capital position'.[1]

That resolve will continue in the coming year, and is likely to be made more explicit with a new commitment to transparency on the part of the PRA.[2] It has promised to provide more information about its investigations, including how it decides whether an issue is referred for investigation, why subjects of investigations are referred, and regular updates throughout investigations, among other changes.

This policy review was issued jointly with the FCA, which continues to be active in enforcement, despite the significant reduction in fines handed out in 2016. With the resolution of benchmark rigging cases, its biggest penalty this year was £8,246,800, for failures to have appropriate controls over outsourced providers.[3]

Whatever happens to the level of penalties, however, the adoption of Focused Resolution Agreements is likely to result in more cases this year. The agreements will allow subjects of investigation to agree with some aspects of the case, but disagree on others, while still retaining a proportion of the 30% settlement discount they get on penalties for reaching agreement early in cases. Whether the FCA has the human resources to handle any significant rise in cases remains to be seen.

1 http://www.bankofengland.co.uk/publications/Pages/news/2016/022.aspx
2 http://www.bankofengland.co.uk/pra/Pages/publications/ps/2017/ps217.aspx
3 https://www.fca.org.uk/news/press-releases/fca-fines-aviva-pension-trustees-uk-limited-and-aviva-wrap-uk-limited-8-2m

Many of these extra cases are likely to focus on individuals. In 2017, the FCA will focus on broadening implementation of the Senior Managers Regime, with a particular focus on culture, conduct and integrity; and on market abuse, following introduction in 2016 of new Market Abuse Regulation. Better access by the regulator to AML information with the introduction of new annual Financial Crime Returns at the end of December 2016, will also have an impact.

When it comes to pure compliance issues, these are likely to be less prominent in the coming year. Nevertheless, at least three are worthy of note:

- IT operational resilience, with the FCA looking at cyber security and beyond;
- Incentives, with the regulator viewing those contrary rather than aligned with regulatory compliance as at the root cause of many problems; and
- Price and value for money, where it is increasingly looking at whether high margins on products are the result of innovative features, market failure or regulatory breach.

A New Normal

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Smaller fines disguise the increased individual liabilities that are likely to define the FCA's enforcement approach going forward.

At first glance, total fines imposed by the FCA in 2016 show a massive fall from previous years. Over £900 million in 2015[1] and £1.5 billion the year before that,[2] the total in 2016 was much more modest: £22,216,446.[3]

With the resolution of the Libor and FX rate-rigging scandals, there were no mega fines bumping up the figures this year. The largest was just £8.2 million for failures in the oversight of outsourced providers.[4]

For the FCA, this appears to be the new normal. During the scandals of 2014 and 2015, the cost of its cases increased first to £246 million and then £325 million. In the year ending March 2017, enforcement action cost the FCA just £8.3 million, and that figure is forecast to remain roughly the same (£8.6 million, predicted) in the current financial year. That suggests we are not about to see any significant ramping up of activity.

Despite this, there's little evidence there will not still be real consequences for those that don't follow the rules.

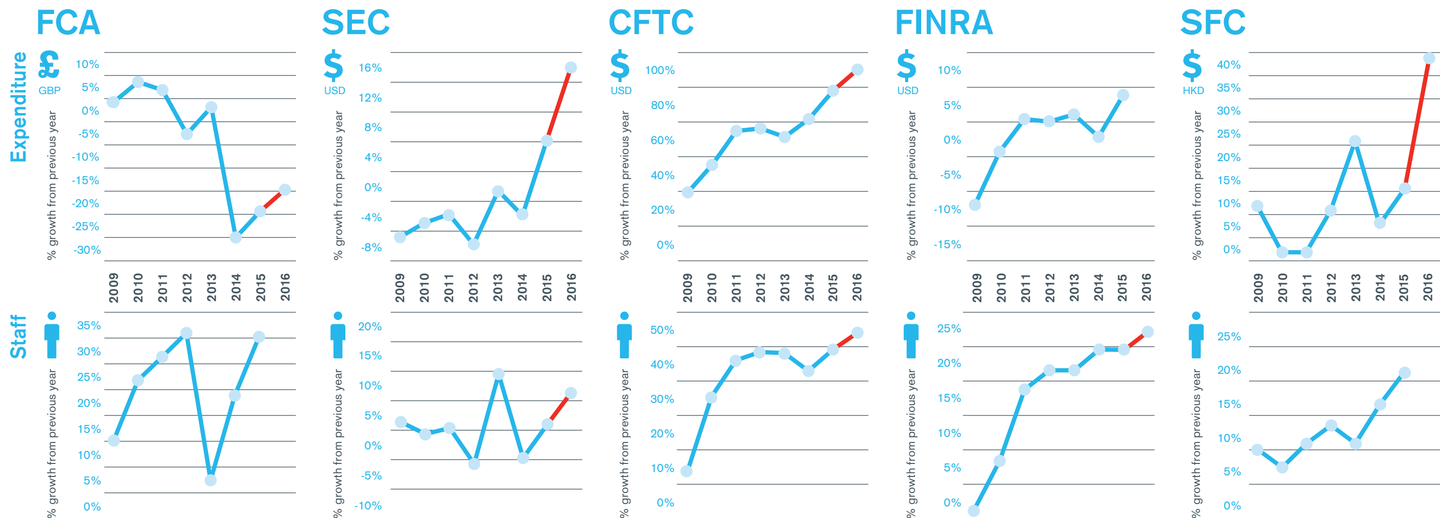
A Personal Journey

First, there is little evidence the FCA's willingness to impose big fines has declined. In January 2017 it imposed a penalty of £163 million for breaches of AML controls.[5] The discovery of another industry-wide scandal would quickly see penalty totals increase again.

The FCA also has a new chief executive from April 2016, Andrew Bailey, whose influence will be increasingly felt in the direction the FCA takes. And we have seen the introduction of requirements to file an Annual Financial Crime Report, with a promise from the regulator to impose business restrictions on firms with poor AML controls. That could be significantly more damaging to firms than fines ever were.

1 https://www.fca.org.uk/news/news-stories/2015-fines
2 https://www.fca.org.uk/news/news-stories/2014-fines
3 https://www.fca.org.uk/news/news-stories/2016-fines
4 https://www.fca.org.uk/news/press-releases/fca-fines-aviva-pension-trustees-uk-limited-and-aviva-wrap-uk-limited-8-2m
5 https://www.fca.org.uk/news/press-releases/fca-fines-deutsche-bank-163-million-anti-money-laundering-controls-failure

Figure B – Annual Expenditure and Staff Growth Rates by Regulator



2016 FINRA expenditures and staff figures for FCA and SFC were not available at the time this report was published.

Perhaps most importantly, though, the commitment of the regulator to target individuals persists. It sees this as central to changing culture. It is worth noting, the £22.2 million fines total for 2016 excludes an additional penalty on one individual of more than £13 million (money repaid to clients, rather than the regulator).

It is true that, in the past, the FCA's efforts to increase individual accountability have been met with mixed success. While fines against firms soared during the Libor and FX scandals, the total fines imposed on individuals remained fairly modest.

That is at least partly what the Senior Managers and Certification Regime is designed to address, however. As the regime continues to bed in, the pressure and penalties on individuals are likely to increase. If that is the case, the new normal could be even more uncomfortable for those who find themselves on the receiving end of the regulator's attention than the old regime.

Enforcement Focus on CCO Liability

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It says something about our times that the big name at this year's Academy Awards was not Emma Stone, Meryl Streep or Denzel Washington, but an obscure audit partner called Brian Cullinan. Almost immediately after the mix-up over the Best Picture award, a virtual mob began furiously demanding a head.

Cullinan endured nothing less than global condemnation – including death threats – with paparazzi surrounding his home. No one cared what the vote-counting protocol was, where the process may have been weak, or how it could be remediated; they just wanted someone punished. After several days of unrelenting uproar, the mob claimed Mr. Cullinan. The Academy announced that neither he nor his colleague that night would ever work at the awards again.

So, what does the global humiliation of an accountant for handing the wrong envelope to Warren Beatty have to do with the investment industry? If we look at the increasing clamour for individual responsibility in banking and finance, plenty.

Consider the words of former Fed Chairman Ben Bernanke on the financial crisis: 'Everything that went wrong or was illegal was done by some individual, not by an abstract firm.'

Or Senator Bernie Sanders: 'It is an outrage that not one major Wall Street executive has gone to jail for causing the near collapse of the economy.'

Senator Elizabeth Warren has demanded an investigation into the DOJ itself for its failure to bring charges against individuals responsible for the financial crisis. Even Jay Clayton, President Trump's nominee to head the SEC, agreed, at least with her sentiment.

'I firmly believe that individual accountability drives behaviour more than corporate accountability. And as we work together, that will be in my mind', he promised.

Figure C – Enforcement Focus on Companies and Individuals in 2016

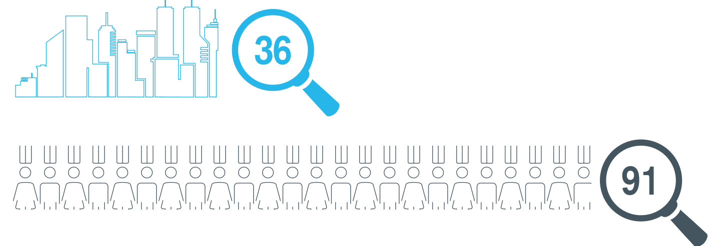
● Company ● Individual

FCA

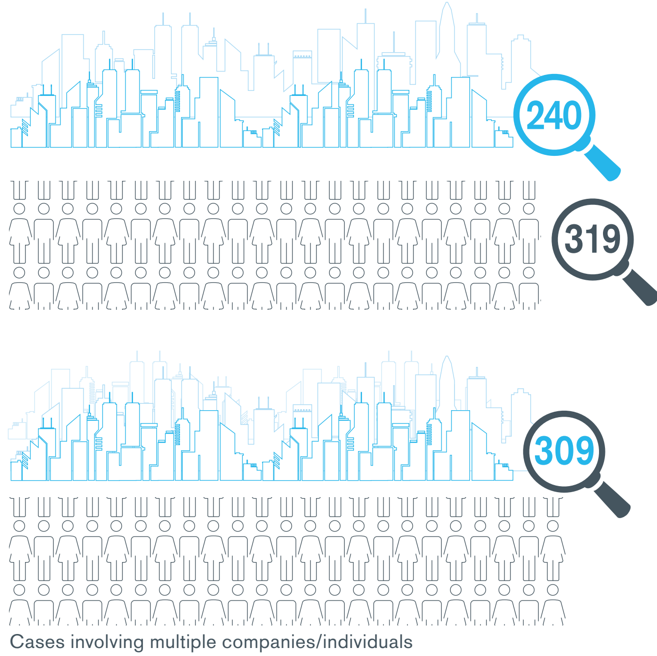
Cases relating to fines only

Cases relating to fines only

SFC

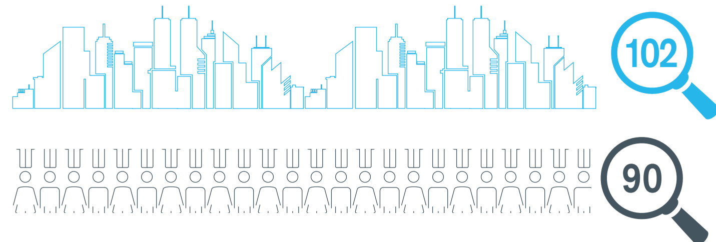


SEC

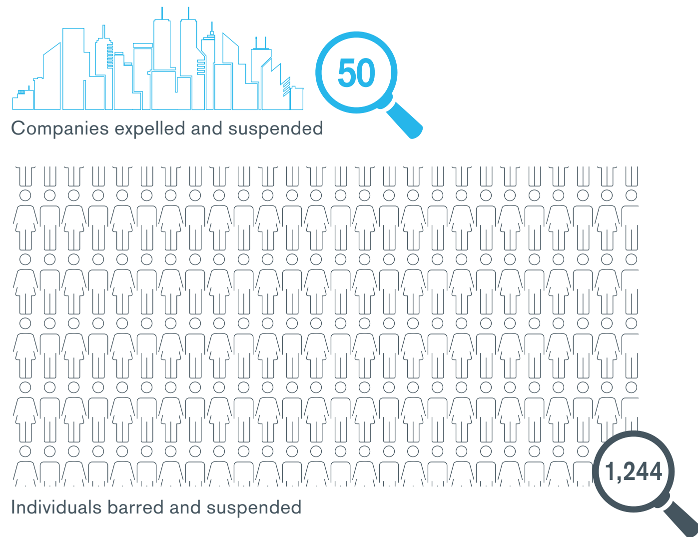


Cases involving multiple companies/individuals

CFTC



FINRA



Companies expelled and suspended

Individuals barred and suspended

Taking Aim

Let's be clear: There is no doubt that wrongdoers should be held accountable for their crimes. Many years ago in *The Wall Street Journal*, Arthur Levitt Jr. said 'hurt people where it hurts most, freedom or their pockets.' As Mr. Clayton correctly stated, '[I]ndividual prosecution, particularly in the white-collar area, has a significant effect on behaviour.'

However, in our zeal to wield the stick, we run the risk of whacking those whose only crime is to be in the vicinity. Several recent enforcement actions have been brought and financial penalties imposed against individual compliance officers for offences that were purely administrative – even where there was no claim of intentional wrongdoing or harm to investors. This should give us all pause.

Notwithstanding the government's best efforts to elevate compliance officers to positions of real authority, they are not yet truly part of the senior management. They do not typically report to the CEO, do not have a say in decision-making, and are not comparatively compensated for the risks they bear. Their role remains advisory, so holding them personally and financially responsible for decisions made by the true power brokers may be ineffectual. It may even be counterproductive, giving managers someone else to blame and potentially discouraging talent from assuming these important roles.

To avoid this and ensure we attract and retain people with the experience and skills necessary for an effective CCO, I offer a modest proposal – a safe harbor that would CARVE out liability by asking questions on five key areas:

Compensation – Is the CCO compensation comparable to other senior executives?

Access – Does he have access to information necessary to evaluate risk?

Reports – Does he report directly to the CEO?

Votes – Does he have a vote on the launch or management of products?

Executive committees – Does he sit on an executive committee or the equivalent?

If the answer to any of the above questions is 'no', then imposing personal liability may not be fair.

The CARVE rule would not require every compliance staffing arrangement to meet the test – quite the contrary; executives should structure the risk function and the personnel responsible for it in whatever way they deem best for the business. But the degree to which responsibility is shared should be commensurate with the degree of authority possessed. Otherwise we are left with the injustice of individuals being held responsible for decisions beyond their control, or immaterial transgressions resulting in irrevocable reputational penalties that few would say are proportionate.

Just ask Mr. Cullinan.

What the Research Tells Us: The SEC, CFTC, FINRA

It was a record year at the SEC, with 868 enforcement cases, up from 807 in 2015 and 755 the year before that: a reflection of former chair Mary Jo White's 'broken windows' policy, pursuing even minor infractions.

'An agency that…makes you feel like we are everywhere,' as she has put it.[1]

'Everywhere' includes an ever-widening range of cases, with the SEC breaking new ground as it has ramped up its activity:

- The first charges against a firm solely for failing to file suspicious activity reports (SAR).[2]
- Enforcement of new standards for municipal issuers and advisors created by the Dodd-Frank Act.[3]
- The first case against a private equity fund advisory group for acting as an unregistered broker.[4]
- A first case for auditor independence failures, predicated on close personal relationships with audit clients.[5]

Whether the broken-windows policy will continue under a new chair at the SEC and the new administration in the White House remains to be seen. There could be a retrenchment to its core focus on securities fraud. Nevertheless, the Trump Presidency's focus on national security should mean that AML continues to be a priority, and SEC's examination priorities[6] suggests a number of other areas will see increased activity. These include initiatives to assess risks to retail investors; a broadening of the ReTIRE initiative to designed to those with retirement accounts; an evaluation of money market funds' compliance with AML and the Regulation Systems Compliance and Integrity rule, as part of a focus on market-wide risks; and continuing examination of cyber security compliance procedures and controls, including testing implementation at broker-dealers and investment advisers.

CFTC and FINRA

There will also be changes at the CFTC. It is among the few regulators that continued last year to be heavily occupied with benchmark manipulation cases. This included action and a $175 million penalty for attempted manipulation of the London Interbank Offered Rate (LIBOR) and European Tokyo Interbank Offered Rate (Euroyen TIBOR), as well as false reporting of the Euroyen TIBOR.[7]

1 https://www.sec.gov/news/speech/spch100913mjw
2 https://www.sec.gov/news/pressrelease/2016-102.html
3 https://www.sec.gov/news/speech/speech-ceresney-10132016.html
4 https://www.sec.gov/news/pressrelease/2016-100.html
5 https://www.sec.gov/news/pressrelease/2016-187.html
6 https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf

Nevertheless, the resolution of such cases has seen the total value of penalties at the CFTC decline in 2016 to $748,000,000 in civil penalties (not counting $543 million in restitution and disgorgement orders), against $3.144 billion in 2015. The slowdown also allows the CFTC to look to other issues.

In this vein, the CFTC is demonstrating a new concern about insider trading and misappropriation of material non-public information, with two first-of-their kind actions charging employees of companies. It also brought its first federal court action against a swap dealer for failing to comply with the reporting requirements of Parts 43 and 45 of CFTC Regulations; and its first action under regulations imposing risk management program and supervision obligations for futures commission merchants.[8]

Finally, at FINRA the trend in fines has gone the other way, rising from $94 million in 2015 to $176 million in 2016. This is mainly due to a significant rise in the number of fines over $1 million, usually imposed on large firms with significant failures or reflecting FINRA's focus on key areas:

AML, including poor due diligence of high-risk customers and high-risk activities.

Reporting, with IT errors that affect large numbers of reporting events a particular concern.

Sales, and particularly complex products sold to retail investors without adequate understanding, share classes that are more expensive than identical lower-cost classes, and investments with an unusual degree of risk.

Nevertheless, as at the other regulators, the focus on individuals remains, with 27 cases over the year involving some type of sanction against a firm's compliance officer.

Top priorities this year, meanwhile, are likely to be driven by one of three factors: FINRA's own key areas of focus, which include senior investors, high-risk and recidivist brokers, and market manipulation; regulatory change in areas such as credit risk, with changes to margin requirements for cover under FINRA Rule 4210; and the rise of digital. Like the SEC, FINRA remains concerned by the cyber security risk to firms, and is also to review their compliance with supervisory and record-retention obligations with respect to social media and other electronic communications.

7 http://www.cftc.gov/PressRoom/PressReleases/pr7372-16
8 http://www.cftc.gov/PressRoom/PressReleases/pr7488-16

Reading Between the Lines

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The SEC's enforcement priorities are no secret, but for a full understanding of them, firms need to know where to look.

For firms that want to know where SEC enforcement actions will be targeted in the coming year, they don't even have to ask.

The regulator is pretty transparent. In January each year it publishes its new examination priorities, and throughout the year publicly states its areas of concern. And – as night follows day – each year the cases it brings largely bear these out.

The regulator's focus on material non-public information and insider trading, for example, is long-standing.[1] At the 'SEC Speaks' conference in February 2017, the regulator's chair Mary Jo White confirmed that it continued to be a priority,[2] as did the Deputy Director of Enforcement.[3] It should be no surprise, then, that insider trading cases were among some of the most significant enforcements of the last year.[4]

In the coming year, we can expect the SEC to continue to stress the importance of a broad range of issues: conflicts of interest, expense allocations and cyber security. The last is also among the new examination priorities highlighted for 2017, along with retirement investment advice and a particular focus on robo advice in the retail space.[5] Generally, though, it seems likely we can expect more of the same from the regulator.

These expectations can all largely be met through a rigorous commitment to continued assessment. Firms cannot simply disclose conflicts of interest or outside business on a form, for example, and then forget about it. It comes down to establishing a culture of compliance – another very long-standing preoccupation of the regulator.[6]

1 https://www.sec.gov/fast-answers/answersinsiderhtm.html
2 https://www.sec.gov/news/speech/white-speech-beyond-disclosure-at-the-sec-in-2016-021916.html
3 http://blogs.orrick.com/securities-litigation/2016/02/23/sec-speaks-what-to-expect-in-2016/
4 https://www.sec.gov/news/pressrelease/2016-212.html
5 https://www.sec.gov/news/pressrelease/2017-7.html
6 https://www.sec.gov/news/speech/spch042303lar.htm

Theory and Practice

Nevertheless, there remain limits on the guidance firms can draw from the SEC's public pronouncements.

Within the broad priorities the SEC sets out, there is still room for novel cases, for example. There also remain uncertainties as to exact expectations of the SEC.

Two other sources therefore should provide additional guidance. The first is its enforcement actions, which again are well publicised.[7] These show not only whether the regulator's rhetoric matches the reality, but the ways in which firms can fall short of its requirements.

Firms can also, through their advisers, learn from other firms currently undergoing routine SEC examinations. These examinations reveal the areas and questions preoccupying the regulator: valuable intelligence that can guide us on not only where the enforcement is focussed today, but where that focus might be moving to in the future.

7 https://www.sec.gov/enforce

Enforcement in Singapore

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Unlike 2016 which was dominated by AML enforcement related to 1MDB, 2017 is the year of market misconduct enforcement.

More, and sterner, market abuse enforcement is expected after 2013's 'penny stock saga' where share prices of three penny stock companies listed on the Singapore Exchange rose sharply from 2012 to October 2013 before dropping more than S$8 billion in combined market value in less than two trading days in October 2013.

In 2015, market misconduct investigations changed. Instead of separate investigations by the Criminal Affairs Department of the Singapore police (CAD) and the Monetary Authority of Singapore (MAS) for cases resulting in possible criminal and civil prosecution respectively, market misconduct became jointly investigated by the CAD and MAS with MAS officers provided with more investigation powers. In 2016, MAS established a dedicated Enforcement Department to focus its enforcement resources and efforts.

Indeed, following the above developments, market misconduct enforcement has heightened.

First, suspects have been charged in November 2016 for the penny stock saga, which authorities called 'the largest market manipulation case in Singapore's history'. In investigations, the CAD and MAS raided over 50 locations, interviewed more than 70 people and sifted through over 2 million emails, half a million trade orders and thousands of telephone records and financial statements. The suspects allegedly, by secretly controlling 180 trading accounts belonging to 59 individuals and corporate nominees, made thousands of manipulative trades in shares of the three companies from 2012 to 2013 that influenced the shares' prices before dramatic price slumps on 4 October 2013. Investigations against others who may be involved continue and more enforcement action may follow.

Second, in just the first five months of 2017, there have been six enforcement actions announced on the MAS website, including one action announcing prohibition orders being made against four individuals involved in 1MDB-related AML breaches. This is a marked increase given that seven enforcement actions were announced by MAS in the whole of 2016, with four of these involving high-profile closures of two private banks and fines imposed on two others for 1MDB-related AML breaches.

Third, 2017 has seen more 'firsts' – the first criminal conviction under the joint investigations regime was obtained in March 2017 and the MAS in May 2017 filed its first court appeal to seek a higher civil penalty award for market misconduct.

Beyond more and sterner market misconduct enforcement, MAS will employ more technology. MAS has announced that it will enhance its analytics and thematic studies of big data to detect indications of potential market misconduct and develop algorithms to scan suspicious transaction reports for higher-risk transactions and trading accounts suspected of syndicated activities.

Market abuse enforcement in Singapore has toughened. Given wide public interest in the penny stock saga, sterner enforcement is warranted to maintain investor confidence in Singapore's markets.

What the Research Tells Us: The SFC

The SFC adopted a more streamlined and specialised approach to enforcement last year, focussing on high priority cases posing the greatest risks to investors and market integrity. Nevertheless, overall activity levels still increased in the year to March 2017, with the regulator completing 591 investigations (up by 36% on the previous year), and HK$93 million in fines (against $87 million the year before).

This rise in activity was supported by a slight increase in both staff numbers (from 841 to 867) and, more substantially, in expenditure (from HK$1,586 million to HK$1,719 million, up). Priorities have been AML, with a number of high profile cases and relatively high fines against firms; internal controls, with the regulator showing it's ready to impose heavy fines for clusters of smaller breaches to ensure improvements in behaviour; and culture, being driven in future by the implementation of the new Manager-In-Charge (MIC) regime announced in December 2016.

The SFC has also sent strong messages to firms in a couple of other areas: irresponsible authorship, for which it banned a US-based activist short seller based from dealing in the Hong Kong market for five years; and nepotism, following a US$264 million settlement paid to the US SEC, DOJ and Federal Reserve Board of Governors over charges under the Foreign Corrupt Practices Act for allegedly offering internships to the children of Chinese government officials in exchange for lucrative business deals.

Many of these priorities will continue in 2017 and beyond. On nepotism, the SFC has promised to start a fresh investigation against a Hong Kong entity involved in the US case; AML, too, continues to be a priority, with the SFC having a dedicated team targeting customer due diligence failings.

The SFC's top priority, by its own statements, however, is corporate fraud and misfeasance, which it holds responsible for billions in market capitalisation wiped from Hong Kong stock markets in recent years. Two dedicated teams at the regulator have been established to tackle this. It also has concerns about the GEM, the alternative stock market to the Main Board of the Hong Kong Stock Exchange. It offers investors opportunities in 'high risk, high growth' companies, according to the market's own publicity.[1] The SFC has expressed concern regarding the rise in the number of shell companies created and listed on GEM and has formed a dedicated team to investigate suspected misconduct in this area.

1 http://www.hkgem.com/aboutgem/market/e_main.htm

Cleaning House

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As it clears its backlog of cases, the SFC is beginning to look ahead to bigger cases and increased action against individuals.

With a new head of enforcement, Tom Atkinson, who was appointed last May, there was a flurry of activity from Hong Kong's SFC in the latter half of 2016. A number of organisations saw enforcement action addressing a wide range of issues across a number of years, with a number of big banks hard hit.[1]

In part this reflected the new head's desire to clear a long-standing backlog, which has seen cases drag on for years in many instances. It's also probably a reflection of Hong Kong's inspection by the Financial Action Task Force (FATF) next year.

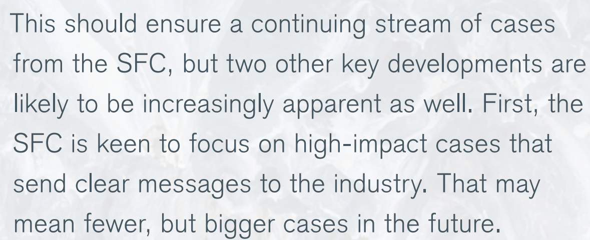
The FATF's assessment of Singapore's anti-money laundering and counter-terrorist financing systems last year identified a number of weaknesses in understanding and investigations.[2] Hong Kong, a long-time rival as a financial jurisdiction, will be keen to avoid similar criticism.

Already, a couple of recent issuances from the SFC have reminded firms of their responsibilities around AML. We've also seen the regulator increasingly prone to issue fines for systems and control failings even where there is no proof of illegality or losses as a result[3] – infractions that in the past would have resulted in little more than a private warning.

Making Enforcement Count

AML is just one area that's likely to see continued activity in the coming year. Atkinson has announced specialised teams to investigate cases across eight key areas. As well as AML, these will cover corporate fraud, corporate misfeasance, insider dealing and market manipulation, intermediary misconduct, sponsors, the growth enterprise market and specific products.

1 http://www.globallegalpost.com/corporate-counsel/hsbc-slapped-with-fine-from-hong-kong-securities-regulator-78894031/
2 http://www.fatf-gafi.org/countries/s-t/singapore/documents/mer-singapore-2016.html
3 http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=17PR48
http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=17PR32



This should ensure a continuing stream of cases from the SFC, but two other key developments are likely to be increasingly apparent as well. First, the SFC is keen to focus on high-impact cases that send clear messages to the industry. That may mean fewer, but bigger cases in the future.

Second, we're likely to see increased enforcement activity against individuals. The Manager in Charge (MIC) Regime is now fully in operation, and July sees the deadline for licensed corporations to submit MIC information and management organisational charts to the regulator. It may still be some time before the fruit of the new regime is seen in enforcement, but – sooner or later – there is little doubt that its impact will be felt.

Offshore Regulators Are Increasing Their Enforcement Powers

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Introduction

The global view on offshore financial centres remains as volatile as ever. With a seemingly growing concern on the legitimacy of previously accepted tax avoidance measures/schemes across the EU and US, as well as the introduction of requirements to maintain directories of beneficial owners for corporate entities incorporated within the EU[1] expected to come into force by the end of June 2017 (and the subsequent extension of such to the UK Overseas Territories and Crown Dependencies[2]), there is a renewed interest to see what the impact of these requirements will be in practice – particularly insofar as it relates to offshore financial centres.

The recent so-called 'Malta Files' leak in May 2017 is a further reminder of the vulnerability to criticism that offshore financial centres face. In this most recent attack, Malta is being accused of functioning as a 'pirate base for tax avoidance inside the EU'[3] following the release of a critical report by a group of investigative journalists who obtained access to over 150,000 documents showing how companies are taking advantage of the Maltese tax regime.

In order to help promote a positive outlook on the use of offshore financial centres, it is paramount that relevant authorities are seen to be effectively regulating and monitoring their jurisdictions and market participants (both as a legal entity, as well as private individual level). Against this backdrop, we highlight some recent enforcement approaches and activities offshore centres have taken to combat the negative perceptions faced.

Change in Approach and Increase of Enforcement Powers

Since our last GER review in 2016, there have been a few noticeable changes implemented by offshore centres. For example, the Bermuda Monetary Authority (BMA) has commenced publishing its enforcement actions as a way of increasing transparency. The BMA sees this as being critical to its reputation as it demonstrates that it does hold firms accountable for regulatory breaches.

1 As part of the 4th Money Laundering Directive
2 https://www.gov.uk/government/collections/beneficial-ownership-uk-overseas-territories-and-crown-dependencies
3 https://eic.network/projects/malta-files

In the BVI, there appears to be a renewed vigour by the BVI Financial Services Commission (BVIFSC) whose Enforcement Committee in 2016 reviewed more than double the amount of enforcement cases brought before it in 2015. That being said, this did not translate to additional actions being taken against firms, with nearly the same amount of actions being taken year on year.

Guernsey's regulator is in the process of gaining approval to have the limits on financial penalties it can impose increased (representing a potentially significant change in the amounts of individual fines that will be issued, with limits being increased from £200,000 to £4 million for licensees and an increase from £200,000 to £400,000 for relevant officers and personal fiduciary licensees.

In the Cayman Islands, the authority is seeking to gain the ability to issue administrative fines, recognising that the potential for fines will act as a deterrent for non-compliant behaviour. The level of fine that can be imposed will vary dependent upon the nature of the breach involved, ranging from CI$5,000 per breach up to CI$1 million.

Whilst the above developments should be closely followed given their potential implications for firms and individuals affected, it is worth noting that the relevant regulatory authorities will not want to be seen to be abusing their 'new powers' and will therefore only seek to use these in a proportionate and well-thought-out manner, and therefore minimise any potential for damaging their respective reputations. By way of example, the JFSC was granted similar powers to impose financial penalties on registered businesses of up to £4 million for significant and material breaches in 2015, however it is yet to impose its first civil penalty under this new regime.

Increased Fines

There have been a few notable fines, both at an individual amount and cumulative level. Specifically, in one of two of its only published enforcement actions, the BMA has fined a firm $1.5 million and restricted its investment business licence for AML failings. For a regulator that has only previously worked behind closed doors, the message being sent out to its regulated entities (and keen global observers) is clear.

The Commission de Surveillance du Secteur Financier (CSSF) too has had a year to note. In its 2015 Annual Report, it was indicated that total fines of EUR 1,335,000 were issued. This total has now been dwarfed by two fines issued against separate banks in 2017 – circa EUR 3.8 million and EUR 9 million respectively. For a regulator that has had a reputation of being quite secretive with its enforcement activity, these latest fines could represent a significant change in approach.

Potential Future Focus Points

Outside of the usual statements in annual reports indicating that AML is to be an area of focus for the year ahead, an additional area of potential interest to note relates to the development of beneficial ownership registers. The governments of the United Kingdom, Overseas Territories and Crown Dependencies signed agreements in April 2016 regarding the sharing of information in relation to beneficial ownership.

The arrangement requires each jurisdiction to establish (if not already in place) and maintain a central register containing accurate and current information on beneficial ownership for all incorporated legal and corporate entities. This information must be accessible to all other jurisdictions' law enforcement and tax authorities. The arrangement applies to the following jurisdictions (many of which are considered key offshore financial centres):

- Alderney
- Anguilla
- Bermuda
- British Virgin Islands
- Cayman Islands
- Gibraltar
- Guernsey
- Isle of Man
- Jersey
- Turks and Caicos Islands

The deadline for submission is approaching and all jurisdictions have until 30 June 2017 to make this information available. As such, the governing bodies within each jurisdiction have requested corporations acting as registered office for these entities to submit beneficial ownership information prior to the June deadline. There will also be a requirement to maintain these registers on an ongoing basis. Given the above, there is a real risk that corporations may not meet this deadline, or subsequent filing requirements for any changes. As such, there is a possibility that governing bodies will begin to impose fines for late submissions and take enforcement action against those with substantial failings.

Additionally, these agreements will allow the timely, safe and secure access for tax and law enforcement authorities to beneficial ownership information, providing greater transparency between jurisdictions. This could, in turn, lead to greater AML and CTF investigations by relevant enforcement authorities who may now have quick and transparent access to important ownership data that was not previously available.

The Way Forward

As part of the work we carry out at Duff & Phelps, we have seen a shift in the attitudes of not only the relevant authorities and their regulated entities, but also the underlying clients of these regulated entities. For example, clients of Trust and Corporate Service Providers are taking extra time to consider the global footprint of their corporate structures, with a view of moving operations to 'better quality' jurisdictions and those which have strong, yet pragmatic regulators. Even where there are particularly complex client structures involved, there is an averseness to the potential risk of setting up a business in a weaker regulated jurisdiction which could be the subject of unwarranted negative publicity and scrutiny by the world's regulatory superpowers who have combatting tax avoidance and wider financial crime clearly in their sights. The enhanced pressures that offshore centres face is likely to continue in the future, particularly amidst the elevated risk of terrorist financing facing the globe.

Key Offshore Financial Centres

Jurisdiction and Regulator	Characteristics and Insights	Recent Key Enforcement Activities
Bermuda Bermuda Monetary Authority (BMA)	• BMA is to continue its renewed focus on enforcement activity for 2017 (particularly in areas of AML and sanctions compliance) and on increased transparency by starting to publish enforcement actions taken. • Bermuda will be preparing for the upcoming Caribbean Financial Action Task Force (CFATF) review in 2018. It will also be undertaking several key initiatives to further strengthen its AML/CTF framework which could subsequently lead to further enforcement action being taken. • Finally, it is noted that corporate services providers are to be a focus point for 2017, with the BMA developing a supervisory regime for these businesses. This may in turn lead to further enforcement activity in the future.	• BMA has only published two enforcement actions since adopting its transparent approach. • Enforcement action published includes: - $50,000 fine and restriction of licence against one entity in 2016 for regulatory breaches. - $1,500,000 fine and restriction of licence against one entity in 2017 for AML failings. • The above is a clear message to the industry that the BMA will not simply adopt an approach of issuing 'administrative fines' and will be attempting to establish its enforcement capabilities where it feels it is appropriate to do so.
British Virgin Islands (BVI) British Virgin Islands Financial Services Commission (BVIFSC)	• Enforcement action is published and often takes the form of lower value fines for less material breaches. • All actions taken in 2016 have been imposed against firms, not individuals. • BVIFSC's Enforcement Committee reviewed 229 enforcement cases brought before it in 2016, versus 91 in 2015.[4] • Nevertheless, the number of enforcement actions published in 2016 is only 52, versus 58 in 2015 (indicating that whilst more cases are being reviewed, this has not resulted in an automatic increase in number of enforcement actions).	• Administrative penalty of $440,000 for AML/CTF failures represents the highest single penalty issued by the BVIFSC since it started publishing its enforcement actions in 2008. • BVIFSC published 52 separate enforcement actions in 2016, consisting of: - 37 administrative penalties. - 6 warning letters. - 6 lifting of restrictions previously imposed on firms. - 2 firms were issued with directives, placing restrictions on their business/ licence. - 1 appointment of joint liquidators.

4 As per the BVIFSC's Statistical Bulletins issued in 2015 and 2016.

Jurisdiction and Regulator	Characteristics and Insights	Recent Key Enforcement Activities
Cayman Islands Cayman Islands Monetary Authority (CIMA)	• CIMA does not normally disclose details of the information received or the findings or recommendations made during an investigation. • The Cayman Islands is preparing for the upcoming CFATF review later this year, which will assess the AML regime across the jurisdiction. Dependent upon the results, this may lead to further regulatory scrutiny and action taken against firms/ individuals if required. • The recent introduction of the Monetary Authority (Amendment) Law, 2016, will allow CIMA to impose administrative fines for breaches for non-compliance with laws, regulation and rules. Once enacted, there is a likelihood that CIMA will begin to impose and publish fines relating to its use of this new power.	• Enforcement activity primarily relates to cancellation/suspension of an entity's licence or an individual's ability to act as a director.
Guernsey Guernsey Financial Services Regulator (GFSC)	• GFSC's 2015 Annual Report stated that it takes 'great care to ensure that only serious enforcement cases are progressed. We have little appetite and lack the resources to take forward cases relating to minor things'.[5] • In the Annual Report, it was further stated that there remains a concern over trust structures in addition to concerns over the conduct of insurance intermediaries, trust companies, fund administrators and managers in respect of the protection of investors. • In response to a MONEYVAL finding, the Bailiwick of Guernsey has approved proposals to increase the maximum level of fines available to the GFSC from £200,000 to £4,000,000 for licensees and an increase from £200,000 to £400,000 for relevant officers and personal fiduciary licensees (not yet passed into law).	• Settlement agreed and penalties totalling £77,000 imposed upon a registered funds service provider and two directors after an investigation by the GFSC revealed that the firm had failed to provide its services with appropriate soundness of judgement and diligence in respect of an authorised collective investment scheme that was being administered by the firm. • GFSC took enforcement action against a registered trust company and two principals who it determined lacked probity, competence and soundness of judgement after an investigation revealed weaknesses in the systems and controls to ensure compliance with the AML Regime in Guernsey. Penalties totalling £70,875 were imposed on the firm and the two individuals.

5 https://www.gfsc.gg/sites/default/files/2015-Annual-Report-and-Financial-Statements.pdf

Jurisdiction and Regulator	Characteristics and Insights	Recent Key Enforcement Activities
Jersey Jersey Financial Services Commission (JFSC)	• JFSC is yet to impose its first civil penalty under the new regime, which came into force in 2015. The JFSC has the power to impose financial penalties on registered businesses of up to £4 million for significant and material breaches. • Whilst several enforcement cases arose during 2016, the JFSC expects that in 2017, investigation and litigation costs will remain the same as the previous years based on the level of enforcement activity. • The JFSC is focussed on cyber crime and its 2017 Business Plan states that cyber crime and attempts to gain unauthorised access to the JFSC information systems and data pose a significant risk and are expected to do so for 'the foreseeable future'.	• Three individuals were deemed not fit and proper by the JFSC and restrictions were placed upon their employment in Jersey's finance industry. • JFSC issued a public statement in relation to a regulated trust company business for corporate governance failings, resulting in a failure to have the highest regards for the interests of customers and a failure to maintain adequate systems and controls. In the same case, the JFSC imposed restrictions on the former partners of the company.
Luxembourg Commission de Surveillance du Secteur Financier (CSSF)	• CSSF's 2015 Annual Report stated that their on-site inspection department was strengthened during the year. This trend was reinforced during 2016 and is likely to continue in 2017. • The CSSF was involved in coordinated investigations involving other regulators as part of the SSM with the ECB. • The CSSF has the power to impose administrative sanctions (most common practice) which includes issuing warning or administrative fines. Where the CSSF is aware of facts which are likely to constitute crimes or offences or where the CSSF suspects acts of money laundering or terrorist financing, it can and does refer these matters to the State Prosecutor (the CSSF made eight such referrals in 2015).	• Limited information on enforcement action is made public. • CSSF's 2015 annual report indicates the largest single administrative fine issued was EUR 250,000 on an investment firm, and EUR 15,000 against a private individual. • In aggregate in 2015, the CSSF imposed an overall amount of EUR 1,335,000 of administrative fines versus 722,250 in 2014. • By marked contrast, recently announced enforcement activity in March and June 2017 have resulted in two significant fines being issued by the CSSF against two banking institutions, predominantly as a result AML failures. The fines amounted to circa EUR 3.8 million and EUR 9 million respectively.
Mauritius Financial Services Commission Mauritius (FSC Mauritius)	• FSC Mauritius takes a preventative approach to enforcement, attempting to identify issues early in the regulatory process. • FSC Mauritius continues to place focus on suspension, revocation and termination of licences. • It is worth noting that the FSC Mauritius has not issued any fines in relation to action taken against firms and individuals.	• While the suspension and revocation of licences is down from 2015 (27 to nine), there has been an increase in the disqualification of directors (five to 10), indicating a focus on individual accountability. • For the first time since the FSC Mauritius commenced publishing its enforcement actions in 2010, it has used its powers to terminate licences (six in 2016).

Lessons From an Enforcement Practitioner

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I believe enforcement is important to make sure that good quality firms are not undercut by those who are happy to break the law, to protect consumers and to deliver a form of justice to those undertaking white collar crime whom national law enforcement authorities in many jurisdictions find it difficult to tackle effectively.

In Guernsey my approach has always been that enforcement is only a tool to be used in the worst cases as 95% of matters of regulatory concern are much more sensibly dealt with through supervision. This remains our approach but in the practise of enforcement against the very worst firms over the past four years I have learnt a number of lessons:

Good quality firms support enforcement for all the right reasons but they require reassurance that we are using it against the bad guys. This requires a continual programme of outreach to explain, with regard to completed cases, what went wrong and why we took the approach we did.

Public statements matter. They are read very closely by all in industry, and short ones summarising the misconduct are not nearly as effective as long ones which can be properly analysed by directors and compliance officers to see what went wrong and why. Long public statements are a great source of learning and reassurance for firms which want to do the right thing.

Going after individuals who do wrong is important whilst being hard work. The common rule of thumb is that securing a public finding against an individual is about four times harder than securing one against a corporation. That does not mean it is not worthwhile. The deterrence effect of taking action against individuals (both through public statements and prohibitions) is very high. It stops enforcement being regarded as simply a cost of doing business (akin to a parking fine if you are a delivery driver) and makes people respect the law.

Delivering justice and being seen to deliver justice is vital to the commonwealth. Some of the people against whom you take action will have done bad things either with intent or recklessly, inflicting serious harm on investors, savers and other members of society. In situations where it is not possible to turn the clock back and make the victims whole again, prohibitions which force individuals to leave financial services go a long way to satisfy the almost universal human desire for fairness.

I like to think standards have risen by an appreciable degree since 2007. That said, financial services will always attract some who have a somewhat unhealthy obsession with transferring others' wealth to themselves. Faced with that enduring reality, there will always be bad apples who need to be dealt with robustly if society is to have confidence in the financial services sector. Enforcement should never be used to deal with petty matters, but it is a necessity if we are to protect both the public and the vast majority of good firms from those who seek to exploit both the sector and society.

‘GOOD QUALITY FIRMS SUPPORT ENFORCEMENT FOR ALL THE RIGHT REASONS’

Financial Grooming: A Ponzi Fraudster's Modus Operandi

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Following a number of investment fraud cases in the Channel Islands in the last ten years, Barry Faudemer, the Director of Enforcement for the Jersey Financial Services Commission, looks at the modus operandi of a Ponzi fraudster.

Several years ago I was sat in a meeting room with a group of ten people brought together by one thing: they had all fallen victim to a Ponzi fraudster. As these victims talked openly about their personal experiences of Ponzi fraud, I was struck by the similarities of each account. They had all been enticed to invest or, as they put it, 'groomed' by the same trusted professional.

Sharing their stories of how they had been defrauded, all the investors agreed that with the benefit of hindsight they now realised they had fallen victim to 'financial grooming'. Looking around the room it was immediately apparent that almost everyone fitted neatly into the retired with resources category, and the majority, if not all, were unsophisticated investors. Frustrated by low interest rates, they had all gone in search of higher returns and had clearly been an easy target for the skilful Ponzi fraudster.

In this particular case, the fraudster was an experienced client relationship manager who primed his victims to such a degree that they disregarded any attempted intervention from family or friends. Over time he secured their total trust and confidence, gaining unique insight into their vulnerabilities. He crossed the professional line by attending family weddings and funerals, helping with their personal issues and taking the lead in their financial affairs often following the loss of a partner. In short, the fraudster filled any void they might have had in their lives and ensured the fraudster was uniquely placed to exploit their vulnerabilities. Such was the level of trust and respect for his judgement that investors were content to place all, or a large proportion, of their life savings in the scheme he recommended. Many even recruited their family and friends to invest on his suggestion.

For regulators and law enforcement, engaging with victims of Ponzi fraud once they have been skilfully groomed presents unique challenges. Very often the person will be in complete denial that anything is wrong; they believe the fraudster over the authorities and feel irritated that the integrity of their trusted adviser is being questioned. Some

feel embarrassed that they have been deceived and will not discuss anything with close family and friends. Many blame themselves and are distressed, especially if they have encouraged others to invest. Elderly individuals in particular may be confused, suffer from memory loss or have become socially isolated. Others may have become dependent on social interaction with the fraudster.

Breaking down years of grooming can often be challenging but it is not impossible. In contrast to the extensive work, research and prevention methods put in place in relation to paedophile grooming, there still exists a significant knowledge gap on what constitutes 'grooming' by a Ponzi fraudster and more importantly how to spot it. Regulators and law enforcement agencies need to identify the early warning signs and learn new, swift intervention strategies. For example, if a victim has been groomed, the risk of past or future victims increases significantly so swift action is required to safeguard future victims.

The UK Financial Conduct Authority has conducted detailed research into the common characteristics of victims of investment fraud, and this material is available on their website.[1] Other organisations have undertaken studies on profiling fraudsters, and this research is also online. By way of an overview, these criminals are primarily male, aged between 35 and 55, charming and engaging, usually relatively senior in a company and typically motivated by greed. They are likely to be supporting an extravagant lifestyle, living beyond their means and driven to succeed at any cost.

With these character traits in mind, coupled with identifying the warning signs of grooming and understanding why certain investors may have been targeted, I believe you can significantly increase the chances of spotting a Ponzi fraudster. Sadly, with an ageing population and a surge in unreported and reported financial crime, we can expect to see further cases of unscrupulous individuals endeavouring to groom their (often elderly) victims for financial gain. However, by raising awareness more generally to ensure that the public understands how Ponzi fraudsters groom their victims, we have a better chance of successfully protecting the most vulnerable members of our society.

1 https://www.fca.org.uk/publication/research/quan-study-understanding-victims-investment-fraud.pdf

Settling In

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The French regulator is increasingly preferring settlement agreements to enforcement action and sanctions. That's good news for firms, but it doesn't let them off the hook.

Since they were introduced in 2010, settlement agreements have given the French regulator, the Autorité de Marchés Financiers (AMF), an alternative to enforcement action. It's one we are seeing more frequently, and it's likely to continue, with the AMF's head of enforcement recently publicly promoting the use of settlements.

That's largely good news for firms that find themselves being inspected. Settlements offer the opportunity of a quicker, cheaper and more flexible resolution to cases. It is not just that enforcement action is a more formal process; it is also far longer. Even once the Sanctions Commission is instructed to intervene in a case, firms must generally wait at least another 18 to 24 months for a decision. And cases rarely go their way.

A settlement agreement can usually be finalised in a third of that time.

It is also a negotiated document. In contrast to formal sanctions texts, most settlement agreements are short and are agreed between the regulator and the firm. They simply outline the failures the AMF alleges, any points the firm would challenge and the action being taken. All start with a statement that the settlement is not an admission of responsibility on the part of the firm.

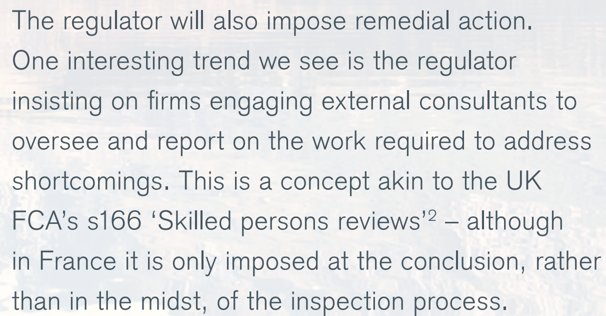
No Slap on the Wrist

While a settlement is almost always preferable to sanctions for a firm, increased use doesn't necessarily indicate a softer enforcement regime in France, however.

First, the settlement procedure won't be offered in cases of market abuse, whether insider dealing, dissemination of false information or price manipulation.[1] Enforcement and sanctions will be the route employed for these.

Second, settlements impose real obligations on firms. That includes substantial payments, even if these may be less than the penalties imposed in enforcement.

1 http://www.amf-france.org/en_US/L-AMF/Missions-et-competences/Transactions.html#



The regulator will also impose remedial action. One interesting trend we see is the regulator insisting on firms engaging external consultants to oversee and report on the work required to address shortcomings. This is a concept akin to the UK FCA's s166 'Skilled persons reviews'[2] – although in France it is only imposed at the conclusion, rather than in the midst, of the inspection process.

Finally, we should keep in mind the purpose of the settlement procedure: Ultimately it allows the AMF to pursue more cases. If anything, then, the rising use of settlements should encourage firms to be more vigilant, rather than less so.

2 https://www.fca.org.uk/about/supervision/skilled-persons-reviews

From Theory to Practice

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Brexit is thrusting Luxembourg as a jurisdiction into the limelight. We should expect increased enforcement to follow.

If the Brexit vote has created some worries for UK asset managers wanting to sell their funds in the EU, spare a thought for Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg. Luxembourg, along with Ireland, may be among the key jurisdictions managers look to if they end up requiring an EU presence to market and distribute products to European investors under the passporting regime.

If so, the CSSF is about to get a lot busier.

Making It Real

On one hand, the rules under which firms using Luxembourg to gain passporting rights are well established. The AIFMD regime has bedded in, and two broad operating models have emerged under which firms can meet the Directive's requirements for 'substance' – showing that their processes, procedures, staff and infrastructure in the EU constitute a tangible presence there.

Some non-EU firms have chosen to invest the time and money to establish a genuine operation in the country from which to serve EU citizens; others have chosen to engage a third-party management company with the necessary substance and regulatory licences – effectively a fully outsourced solution.

Both meet the regulatory requirements. The difficulty will be for those attempting something in-between. And this is where the regulator would be likely to intervene.

Laying Down the Law

There is little doubt we can expect it to do so with increasing regularity. The increase in the number and scale of firms expected to establish a presence in Luxembourg post-Brexit will only be manageable for the regulator through application of clear standards. And the regulator's – and jurisdiction's – credibility will only be maintained if those standards are properly enforced.

Enforcement is among the most powerful tools the regulator will have to both clarify its approach for firms and promote adherence to the standards it defines.

For firms deciding to locate their operations in Luxembourg, that means the question is no longer just one of costs and convenience, but also of robustness in the face of regulatory scrutiny. That's because it is no longer a question of if firms' choices in this regard will be tested, but when.

Developing a Culture of Compliance by Embracing the Impact of Emotional Contagion

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Recognising the impact of emotional contagion on risk could be the key to developing a true compliance culture. To achieve it, however, firms will have to look inside themselves.

Smile and the world smiles with you, goes the old saying. If you cry, though, it might not be alone. Emotional contagion is now a well-established phenomenon. Members within groups pick up and reflect the emotions – both positive and negative – of the others.

That is important in investment banks and other financial firms because we know that emotions drive behaviour, both good and bad. Negative emotions, such as stress, tend to make people become more task-focussed, for example, to the exclusion of other considerations.

In financial institutions, that increases the risk of compliance breaches. Attention can become focussed on the primary task of generating performance, potentially to the detriment of compliance requirements. And, due to emotional contagion, that attitude quickly spreads.

The emails and other communications between traders that came out in the aftermath of the Libor scandal[1] provide good evidence of this.

Acting Out

Understanding this mechanism – and how emotions drive behaviour – could be the key to fostering a true compliance culture.

Without this understanding, well-intentioned interventions by compliance departments can actually prove counter-productive. A stern warning to a trader for straying slightly over limits, for example, can add to their stress or annoyance. That, in turn, may just increase their focus on achieving performance targets, regardless of the limits firms want to enforce.

If compliance can use such incidents as opportunities to demonstrate an understanding of the pressures on the front office instead, however, it can mitigate stress, foster positive emotions and help traders think about factors other than performance.

1 http://www.amf-france.org/en_US/L-AMF/Missions-et-competences/Transactions.html#

Barriers to Implementation

Firms face three key challenges in adopting this approach, though.

The first is that compliance departments, and individuals within them, face pressure from regulators to show they take infringements seriously. They may feel the need to be seen to be cracking down on poor behaviour. If they are to take a softer approach to minor infringements, their strategy and reasons for doing so will need to be well-documented. There will also need to be clear lines dictating when a more forceful approach is appropriate.

The second challenge is that understanding the psychological triggers, motivations and behaviours that increase risk takes time and resources. The increasing burden on compliance departments means many do not have the luxury of being able to engage in this analysis.

Finally, they also need the right people. To respond effectively to the pressures driving potentially risky behaviours, compliance functions need people with wider experience of the business that understand them. If they can do that, it could be the key to keeping everyone happy – the regulators included.

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