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FIRMA National Risk Management Training Conference

Conduct Risk & Sales Practices Breakout

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Agenda – Topic Areas

Polling question

Where do you sit within your respective organization?

A. 1st Line of defense (e.g., business, in-business risk/controls)

B. 2nd Line of defense (e.g., Risk, Compliance, Legal)

C. 3rd Line of defense (Internal Audit)

D. Other (e.g., attorney, regulator, consultant)

Conduct and sales practice risk

Conduct risk is the risk that a firm's employees or agents may harm customers, other employees, the integrity of the markets, or the firm itself.

One type of conduct risk is ***sales practices risk*** – inherent conflicts of interest between employees and their customers are exploited or unmitigated in the pursuit of business strategy or personal remuneration targets

The goal in managing these risks is to foster a ***culture of compliance and ethical behavior*** that supports fair treatment of customers and that allows the firm to execute on its business strategy consistent with any applicable regulatory standard and without adversely impacting the marketplace

Conduct risk can manifest within financial institutions in a variety of ways

Sectors

Illustrative examples

	Asset & wealth management	Banking	Insurance
Illustrative examples	• Compensation structures that incentivize allocation into specific funds or products by sales professionals • Incentivizing allocation to proprietary products over other more suitable investments	• Trading strategies that ignore market integrity rules and longer-term performance, as the individual's bonus is based on short-term trading profits • Recommendation of products driven by highest commission or incentives, rather than best fit for the customer	• Inadequate training around understanding of products that lead to sales inconsistent with suitability • Product design, marketing, sales, advice and complex techniques such as teaser rates, add-ons, product bundling, etc. increase the possibility of customer confusion

Summary of Recent Trends

Surveillance trends in the marketplace

- Reduction in silos across supervision, compliance, and surveillance functions
- Movement away from reactive controls toward predictive and preventative capabilities
- Continued digitization of firm records increases data available for surveillance activities

Regulatory expectations and trends

- Increased complexity of regulatory examinations due to the regulators' focus on big data and advanced analytics
- Movement toward near real-time regulation with enhanced data collection and analytical capabilities
- Increased transparency and data reporting requirements
- Detailed comparisons of data across firms will likely be possible in the near term

Investment management considerations

- Effective data strategies need to be adopted in order to meet the new regulatory requirements
- Organizational data and risks should now be viewed holistically
- New processes to view, validate, approve and store approved records before disseminating to regulators will likely become a leading practice

Technology and data enhancements

- Improved data quality measures in core systems and processes to ensure consistency and accuracy of data
- Utilization of company-wide data stores to hold information required by regulators, sourced from the right core platforms
- Creation of processes to validate, approve and store approved data before be delivering to regulators
- Adoption of advanced analytics to improve compliance

There are common themes behind global misconduct events

Specific areas of vulnerability

Insufficient Governance, Oversight & Supervision

Risks arising from insufficient governance and oversight

Lack of integrated risk indicators in supervision

Information provided to Board and senior management does not provide actionable insights

Inadequate control framework (including monitoring & surveillance)

Manual controls and lack of ability to sufficiently monitor trends due to disparate data sources

Insufficient design of monitoring and surveillance routines to detect misconduct, such as transaction and communication

Culture

Limited evidence suggest that customers are at the heart of the business or that there is a key emphasis on compliance

Subcultures which identify first with their business unit rather then with their firm

Advice inconsistent with regulatory standard

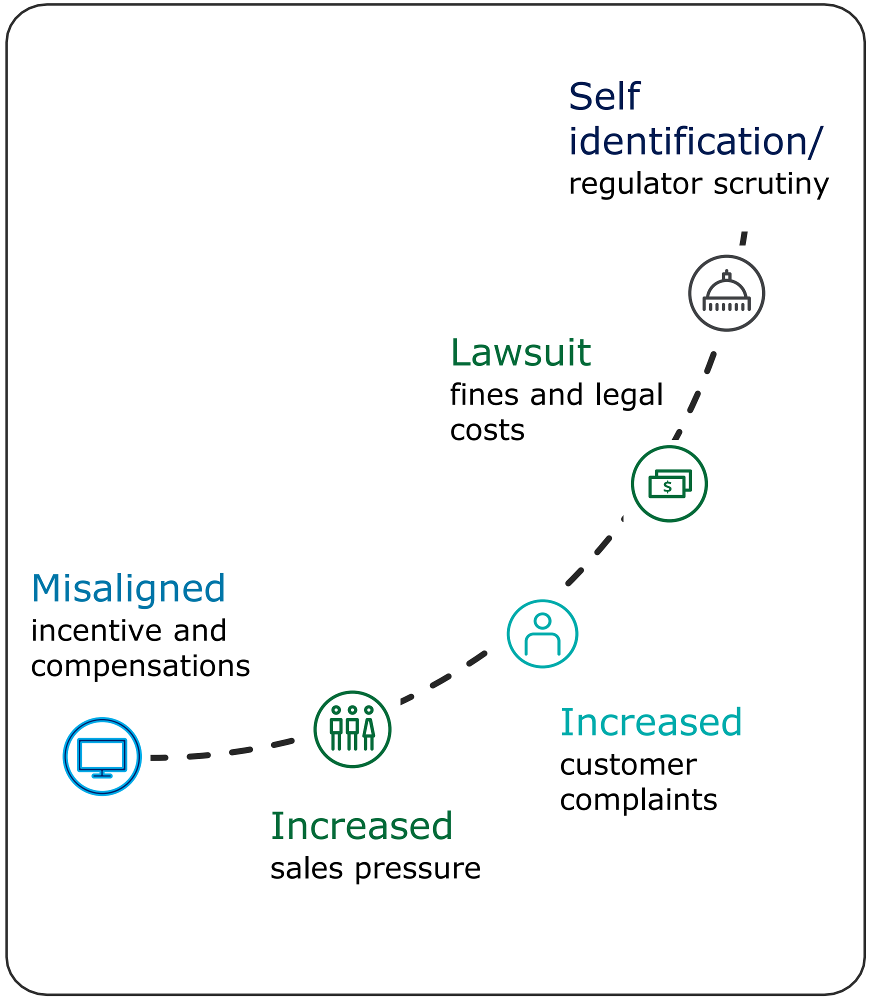
Advice that meets suitability and fiduciary requirements

Misaligned remuneration and incentive schemes

Staff of financial services organizations incentivize sales volumes or products rather than fair customer outcomes

A firm with mis-selling practices faces significant risks and costs

Illustrative Example of a mis-selling incident



Financial impact

- Multiple lawsuits, legal fees and possible payback to clients
- Fines and penalties from regulators
- Drop in market capitalization
- Costly multi-year remediation program(s)

Regulatory impact

- Increased regulatory scrutiny
- Sanctions from regulators
- Breach of regulatory standard
- In egregious cases, potential impact to ability to conduct future business

Reputational impact

- Ratings downgrade
- Bad publicity
- Services and operations negatively impacted
- Loss of client trust, inability to retain client base

Organizational impact

- Overhaul of senior leadership, including experienced sales staff
- Claw back of pay from former executives
- Regulator action against oversight failures
- Potential elimination of jobs

Many organizations continue to experience failings in sales practices

UNITED STATES

UNITED KINGDOM

AUSTRALIA

CONTEXT

- Investment Advisors, as fiduciaries, failed to make full disclosure to clients of material conflicts of interest per SEC Share Class Selection Disclosure Initiative
- A major UK insurance intermediary mis-sold insurance policies to 69,000 customers[2]
- Wealth and Financial Planning firm charged clients for services not provided[4]

CONSEQUENCES

- 79 Investment Advisers to return >$125 million to clients, primarily to retail investors[1]
- Financial Conduct Authority's investigation found that the insurance intermediary profit-driven culture incentivized sales agents to over-sell policies irrespective of customers' needs and fined £30.6m[3]
- Approximately AUD $9 million returned to customers; significant remediation program put in place; and independent monitor requirement by regulator

[1] SEC Press Release: https://www.sec.gov/news/press-release/2019-28
[2] FCA. "HomeServe Fined £30 Million for Widespread Failings." FCA, 13 Feb. 2014,
[3] FCA. "FCA Fines Interactive Brokers (UK) Limited £1,049,412 for Poor Market Abuse Controls and Failure to Report Suspicious Client Transactions." FCA, 25 Jan. 2018
[4] Australian Securities and Investments Commission. 18-102MR ASIC accepts enforceable undertaking from Commonwealth Bank subsidiaries for Fees For No Service conduct

How can you mitigate impact on your customers and marketplace?

Regulators want to understand your capabilities to identify and mitigate negative impact on your external parties, customers, counterparties, and the broader marketplace

Know your areas of vulnerability

- Retail banking, asset management, wealth management is a predominantly **sales-focused culture**
- **Performance management** programs may increase the risk of mis-selling and breaching market conduct obligations
- Certain products, business practices, and distribution channels present **higher sales practices risk**
- **Governance frameworks** do not manage sales practices risk effectively
- **Controls to mitigate risks** associated with sales practices are underdeveloped
- **Incentive compensation structures** misaligned with customer protection and regulatory standards

Commit to enhancements

- Prioritize financial **consumer protection**, fairness, and product stability
- Establish a formal sales practices **governance framework** with clearly defined roles and responsibilities
- **Enhance your monitoring and reporting** of mis-selling and other sales practices obligations
- Improve **oversight, management, and reporting** of consumer complaints
- Motivate employees to work in the **best interests** of their consumers through financial and non-financial incentives
- Develop a forward-looking framework to manage sales practices with **enhanced surveillance and supervision**
- **Leverage tech-enabled solutions** to aggregate, analyze, and have better insight into data and sales practice risk

Supervision and surveillance functions have typically not been integrated or designed to work together in a deliberate way

Effective supervision and surveillance should:

Help firms to meet policy and regulatory expectations efficiently

Serve as an asset to the business in identifying and managing specific and emerging risks

Today's landscape

Unsustainable controls

- Incremental and band aid solutions implemented as quick-fixes without ongoing support to meet changing business-as-usual requirements
- Manual and ad-hoc processes lacking consistency, scalability, and auditability
- Resource constraints leading to approval-type tasks being pushed to the second line

Disparate and siloed functions

- Significant duplication of tasks across Supervision and Surveillance
- Misalignment of tasks between functions due to undocumented, informal, or misunderstood roles and responsibilities
- Tactical controls implemented that conflict with the functional or enterprise control framework
- Disparities across regions resulting from new or changing local regulations and business practices

Unknown, unused, or unusable data

- Unclear, undefined or inconsistent data strategy
- Data types and volumes increasing at rates overwhelming current operating models
- Unstructured and unusable data creating data "swamps", which create unknown risk

The current state of supervisory processes

Illustrative supervision landscape

Supervision, Surveillance & Control Functions

Business Activity (Supervision)

Trading	Sales	Banking	Research
• Licensing • Activity review • Best Ex / Fair pricing • Limit approvals • Client / Counterparty approval	• Licensing • Account approval • Pricing /Commission review • Activity review	• Licensing • Commitment approval • Due Diligence review • Registration	• Publishing review / approval • Conflicts review • Disclosure management • Filing

Recordkeeping

Business/Client Communication

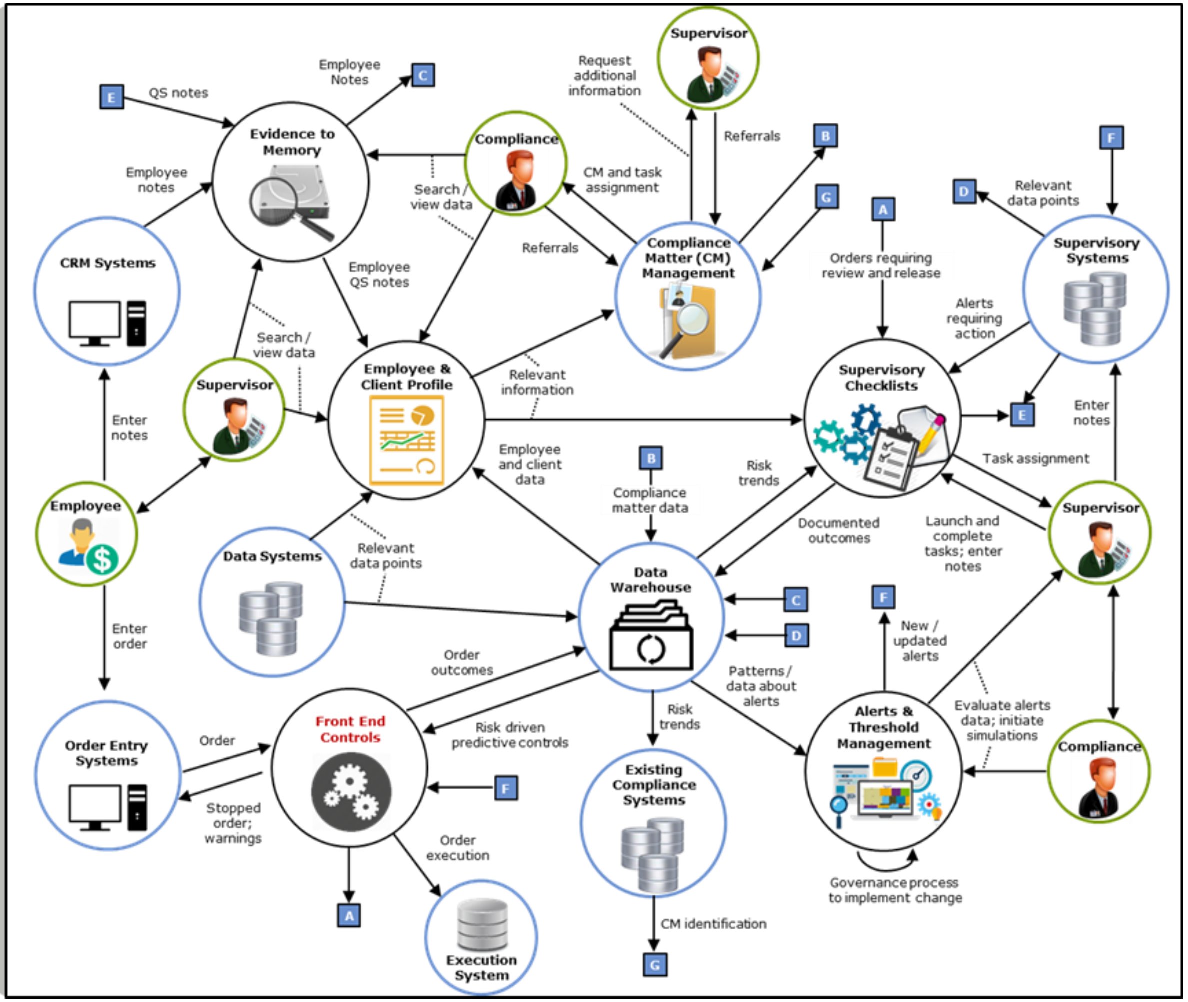
Internal Oversight/Compliance Operations

Internal Controls	Market Abuse / Conduct	Conflicts of Interest	Information Barriers	Employee Personal Trades
AML, Sanctions, Screening	Risk	eComms Surveillance	Branch Exams & Risk Assessment	Surveillance & Monitoring

Reporting

Trade Reporting		Non-Financial Regulatory Reporting		
TRACE	TRF	CAT	Blue Sheets	OATS
ORF	CFTC		LOPR	Large Trader

Illustrative interaction diagram



Organizations should be able to connect the dots between the different data sources that exist today throughout the enterprise

Illustrative use case:

Broker and customer **trade ahead in a listed security** with knowledge of an acquisition announcement

→

Internal control exceptions are identified across a number of areas (communications surveillance, investment account monitoring, etc.), however **alerts were dismissed and not-escalated**

→

Regulator identifies the trading pattern and **fines the firm for insider trading, citing failed supervisory and surveillance controls**

Where was the supervision …

150 **Supervisory tasks**

Dependent on

75 **Source systems**

Inconsistently feeding

50+ **Supervisory systems**

Inconsistently Viewed by

20 **Siloed functional areas**

Resulting in

10+ **Disconnected events that were flagged and viewed in isolation**

Beyond regulatory expectations, there are several other industry-wide trends driving supervision and surveillance functions to operate substantially different from today

Examples of trends impacting the industry:

Investment in "enabling" technologies and to reduce manual processes (e.g., end-user computing/controls (EUCs)

Increased sophistication in the front office and use of technology and data by regulators

Increased pressure on fees and pricing, driving need for better cost efficiencies

Growing supervisory and administrative workload on the business (e.g., financial advisors, sales/trading desk)

Examples of pain points:

- Need for a better experience for the customer and business
- Pressure to decrease manual processes that result in human error

- Inability to scale controls with business innovation inhibiting time and cost to market
- Regulators identifying concerns that were missed by control processes

- Effective communication and use of off-shore teams
- Talent gaps in areas of increasing importance to control functions (e.g., technology, sales/trading)

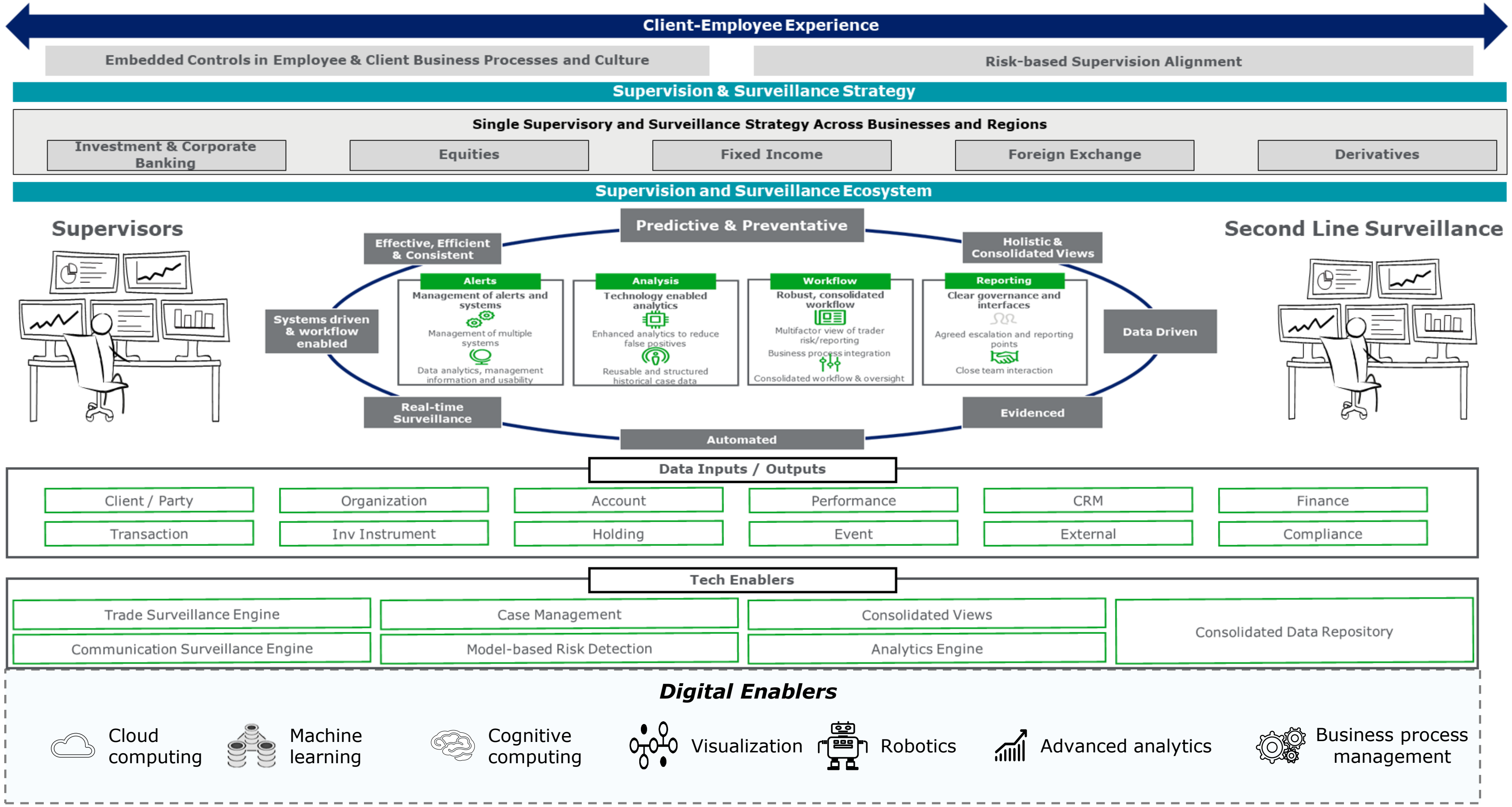
- Significant time investment by supervisors reviewing false positives and other ineffective supervisory output

The future of supervision should be transformed not only through investments in technology and analytics, but also changes to processes, people, and risk prioritization

End-to-end process re-engineering to reduce manual work

Consolidated workbench for supervisors with core tasks, data, escalations, reviews, attestations, and insights in a centralized manner

Next-generation evolutionary data and technology architecture



State-of-the-art dashboards that provide enhanced transparency, real-time capacity management,

and proactive identification and mitigation of points of failure

Single sources of data that can be leveraged by multiple functions in first and second lines

There is a dramatic shift needed to leverage data and performance metrics to effectively mitigate sales practices and conduct risk

PAST	PRESENT	FUTURE	
DIAGNOSE	DETECT	ANTICIPATE	DETER

Reactive

Identification	KRIs
Assessment	Control implementation
Visibility	Reporting lag time

Proactive

Identification	Predictive analytics
Assessment	Control performance
Visibility	Real time reporting

Potential benefits of a proactive approach

- Volume and velocity of information
- Enhanced efficiency and accuracy
- Evidence-based decisions
- New insights

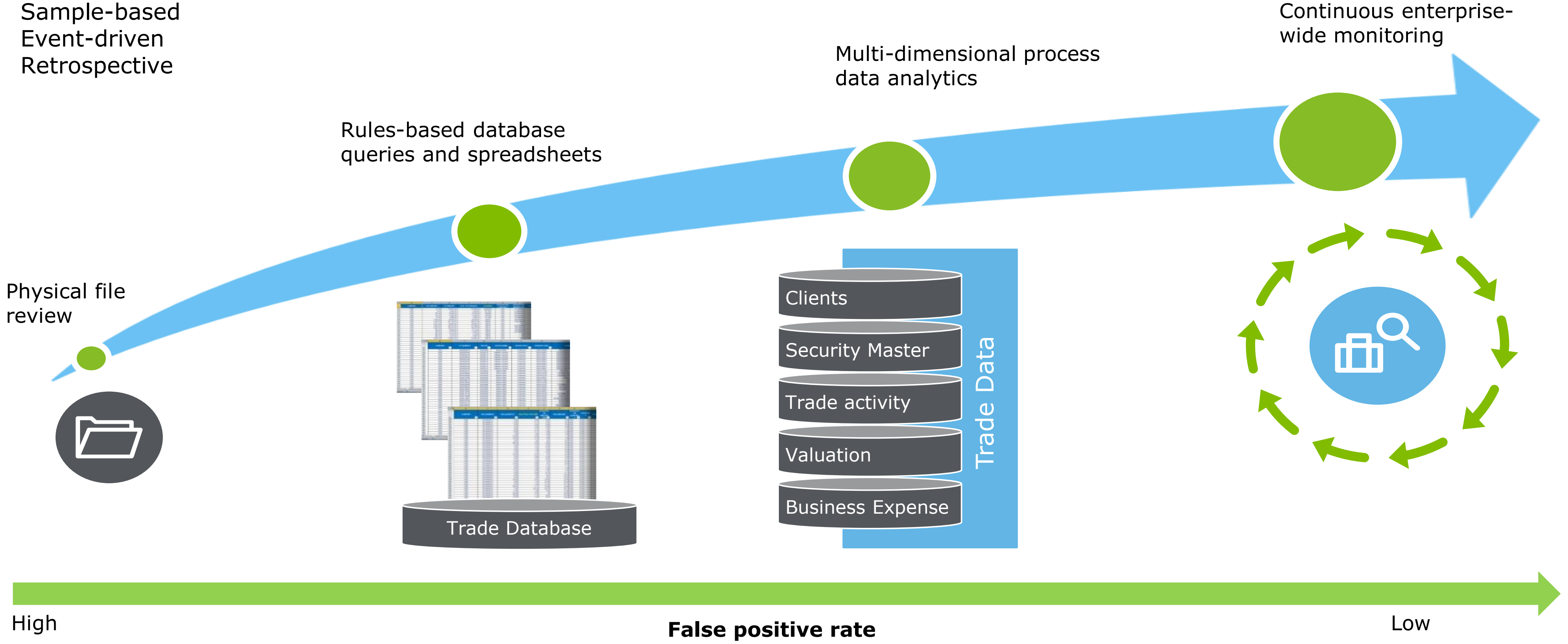
Movement toward continuous enterprise-wide monitoring

Deloitte Risk and Financial Advisory aims to take our clients on an analytics journey, to move beyond siloed, ad-hoc analysis to more comprehensive, continuous enterprise-wide monitoring

Data analysis continuum

Traditional analytic projects generally leverage a rules-based analytic approach which have the following constraints:

- Siloed
- Sample-based
- Event-driven
- Retrospective



Guiding principles for establishing enterprise monitoring

Guiding principles for establishing an analytics-driven risk detection program considers people, process, technology, and data.

Functional integration: collaborate regularly with business and IT stakeholders to align on objectives, requirements, and working plans to design company-specific analytics

Agile approach: develop flexible cross-functional capability with iterative, continuous improvement, and earlier delivery of insights

Data and information management: assess and prioritize data sources for effective issue detection and integration of internal and external information in a centralized environment

Business process and metrics: define key metrics to help validate the analysis outputs and to build business case for future scaling and adoption of inappropriate conduct and sales practice detection capabilities

Relevancy of analytic techniques: test the effectiveness of numerous analytic techniques, identifying and selecting the most relevant ones

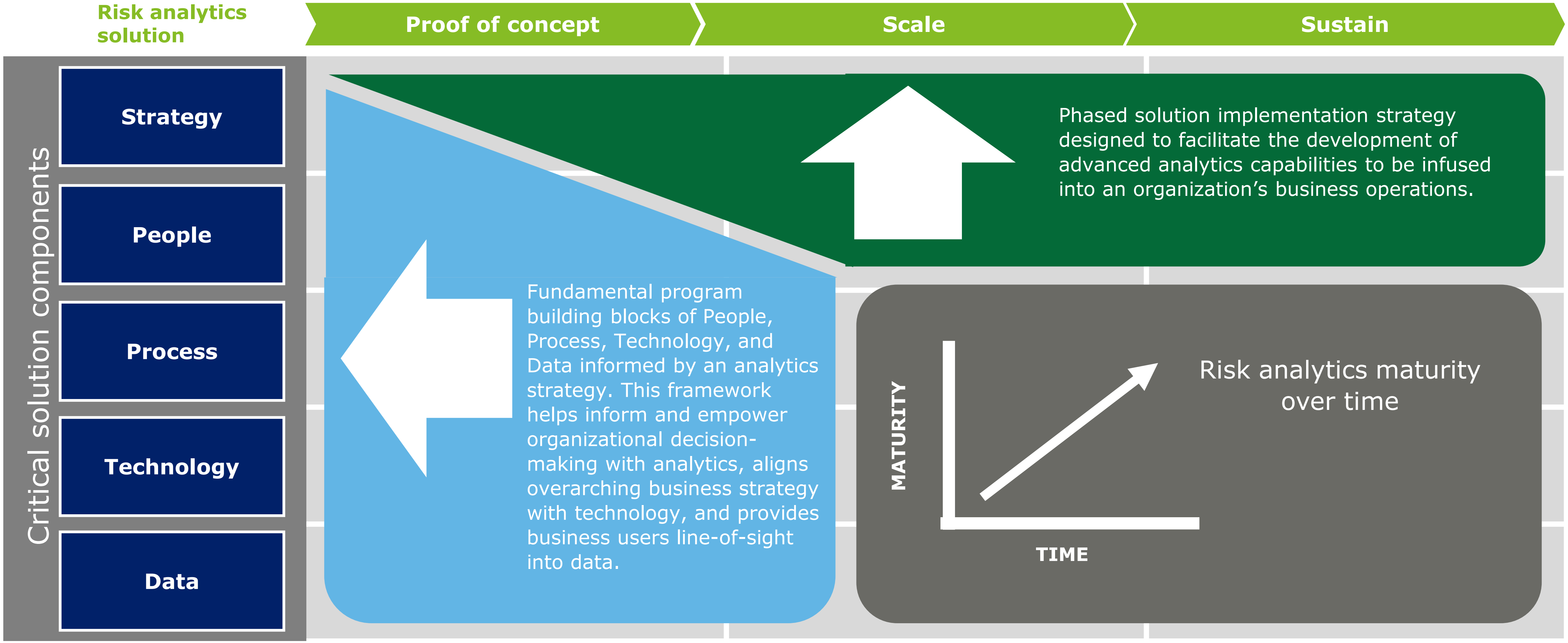
Program management: facilitate collaboration, mitigate risks and issues, and understand dependencies to drive progress and streamline executive reporting

Analytic insights visualization: develop a user-friendly, interactive visualization dashboard file and enable business users to effectively conduct research and investigations

Building a capability: Risk analytics solutions are not simply tools, but form an integrated capability with business processes defined for consumption and action on analytic insights

Strategic framework: Overview

A phased approach can help organizations formalize the overall value proposition for the proactive monitoring program early, while strategically building the solution for long-term sustainment.



Analytical approaches

A robust analytics methodology utilizes a **combination** of analytical approaches to look **across business processes** to identify risky **entities** and **transactions**. The combination of analytical approaches helps in identifying and quantifying both **known** and **unknown** issues

Rule-based –
Model known schemes and scenarios

"I know what thresholds and other controls my company deploys, so I'd like to design tests that explores manipulation there."

Business rules are generally written as Yes/No questions and requires intuition related to known data patterns

Unsupervised Learning –
You don't know what you don't know

"My company has collected massive amounts of data over the years, so I don't know where to start to find needles that may or may not exist in this haystack."

Unsupervised learning allows the data to define what is normal vs. abnormal and is utilized to identify unknown and emerging patterns

Supervised Learning –
Leverage known events for a "risk fingerprint"

"I know that my customers were harmed by a specific scheme, but I don't know if I found all instances of that act or if others were doing the same thing."

Supervised learning identifies multiple attributes about known cases of misconduct to identify other transactions or entities that are exhibiting similar behavior.

Case study

Sales practice misconduct

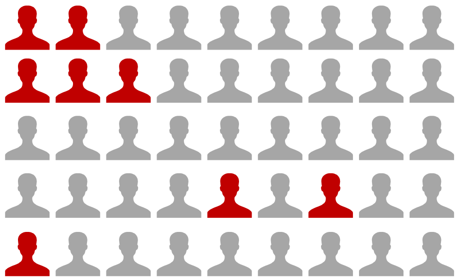
Case study: Identifying sales practice misconduct

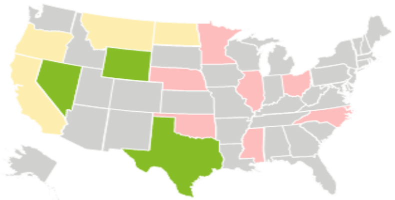
Challenge: A global financial services company engaged Deloitte Risk and Financial Advisory to develop a solution to detect **likely cases of employee bad actors, including activities related to sales practice misconduct**

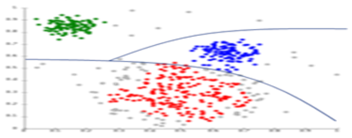
Approach:
Deloitte Risk and Financial Advisory designed an analytics solution based on **rules and machine learning to identify high risk employees.**

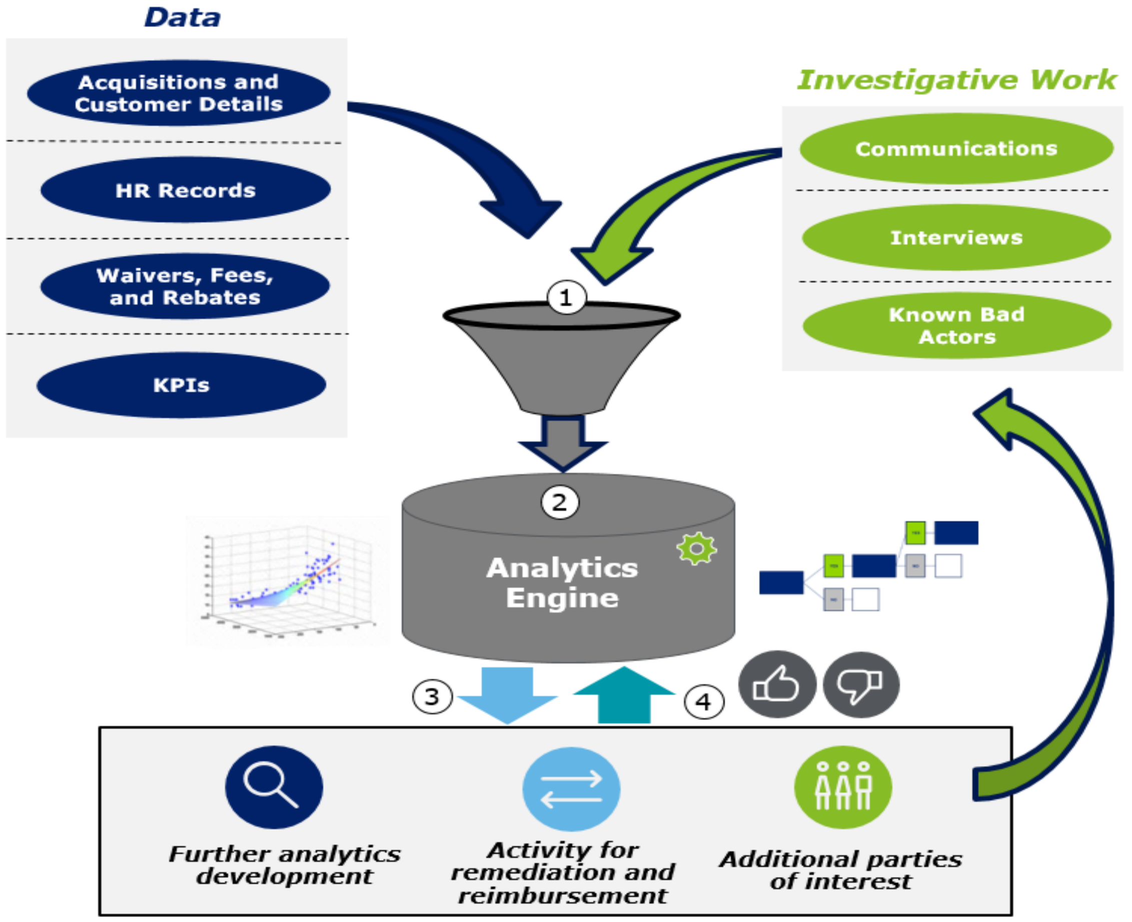
The solution links together **customer account details, employee performance indicators, employee compensation data, and complaint data**, in order to derive over **70 characteristics of interest.**

Clustering and **anomaly detection** algorithms were used to pinpoint **employees with suspicious activities**, as well as sales regions that experience above threshold levels of sales misconduct.







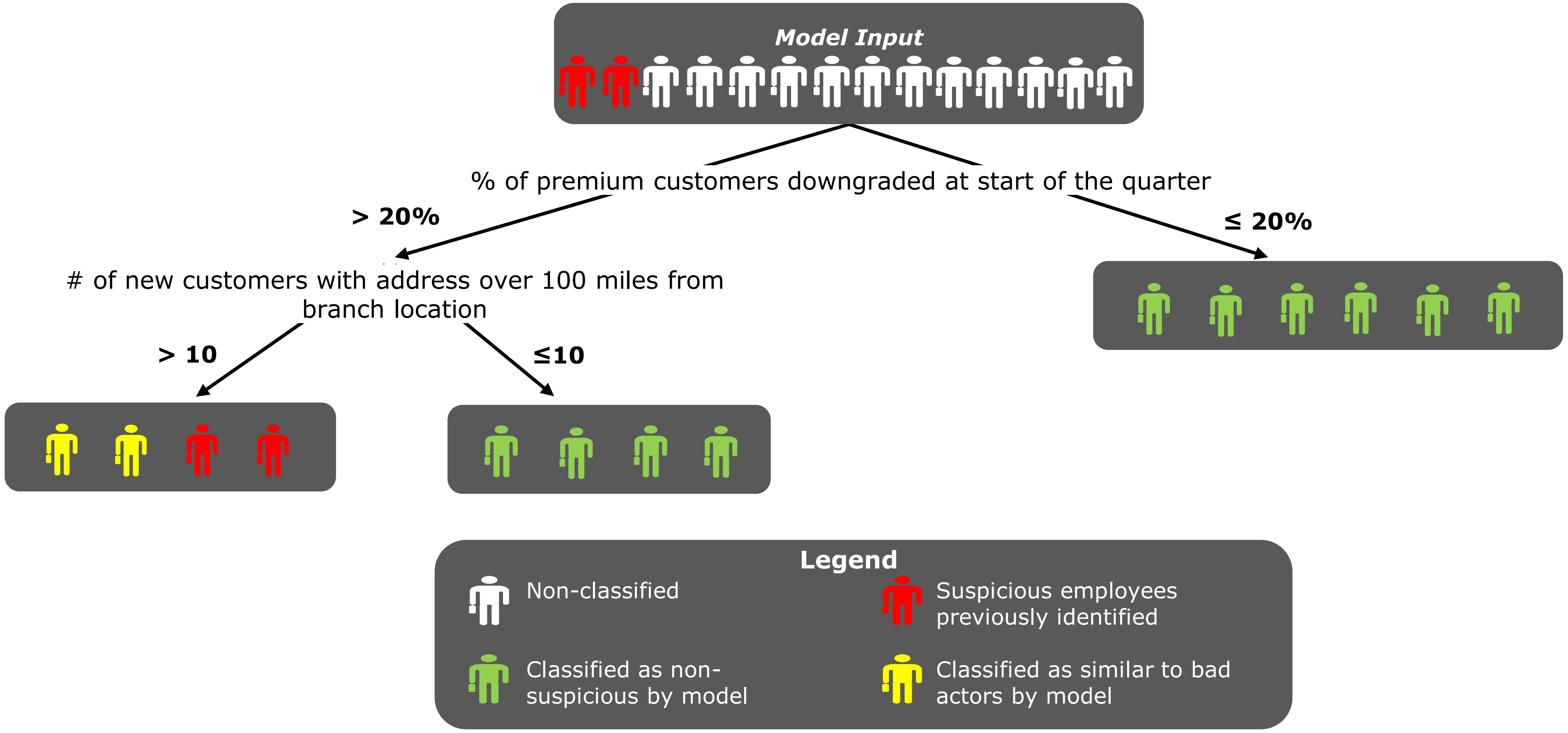


Case study: Using the "risk fingerprint" to identify other similar activity

Impact:
The solution identifies **risky employees among national retail branches in a four-year period.**

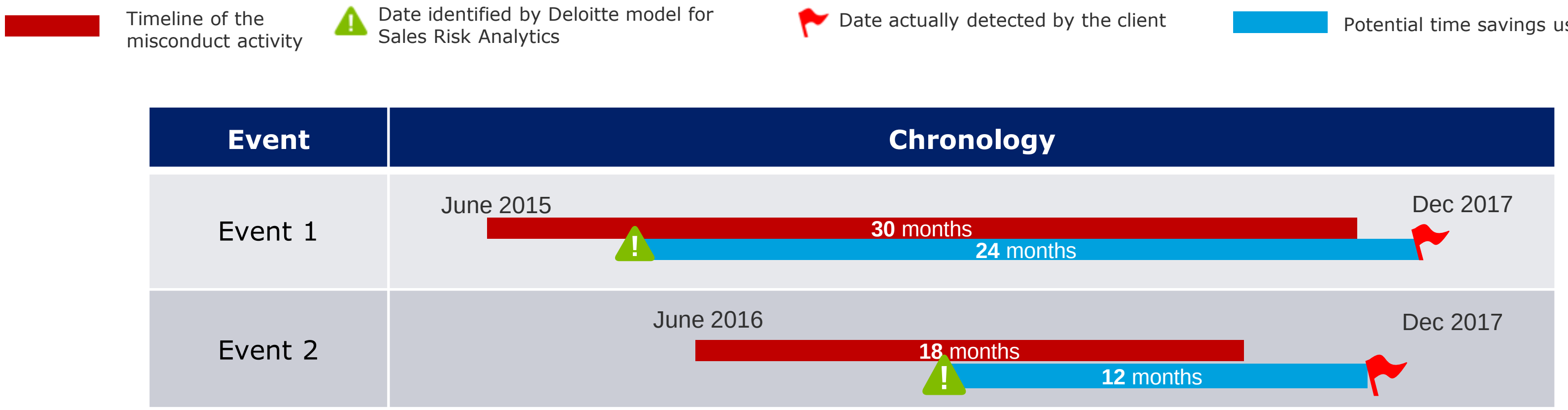
In only six weeks, the solution identified **eight employees with behavior similar to known bad actors**, which was then used for communication reviews and in-person interviews.

The statistical model identified employees similar to known bad actors based on over 70 metrics.

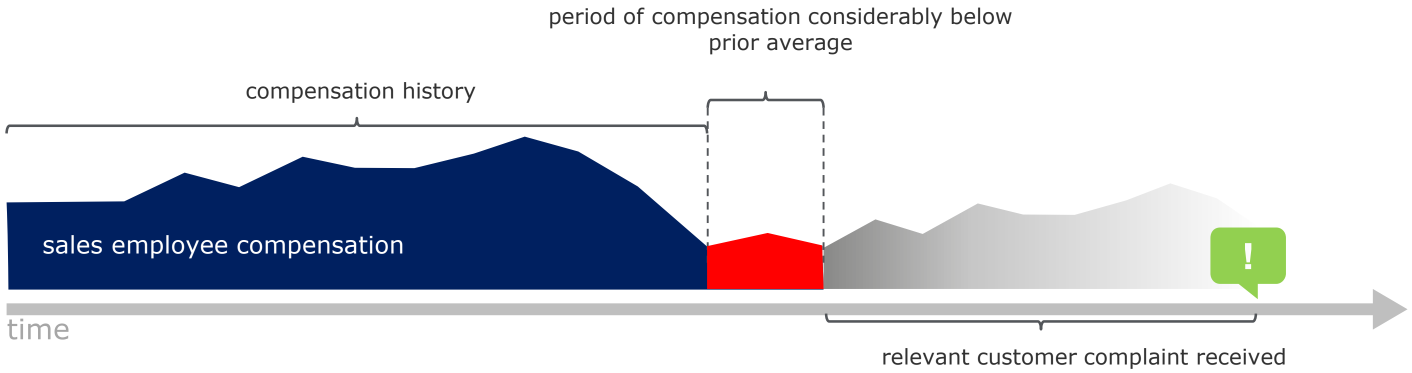


Case study: Earlier detection of sales misconduct

Impact:
As illustrated below, this project could have led to detection of issues years earlier than through the institution's prior controls



The project led to finding **emerging schemes and issues** (as diagramed below), **additional controls to be implemented**, identification of **similar issues**, and **enhanced company training**.



Key Takeaways

1 Understand the importance of managing sales practice and conduct risk in your organization

2 Standing up a forward looking control framework does not happen overnight and likely requires functional integration and support at an enterprise level

3 Leveraging emerging technology and analytics to harness the power of a proactive approach to mitigate risk and increase insights into your organization

Q&A

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