Embracing the duties of market conduct compliance

Common challenges in applying FINMA Circular 2013/8 'Market conduct rules'

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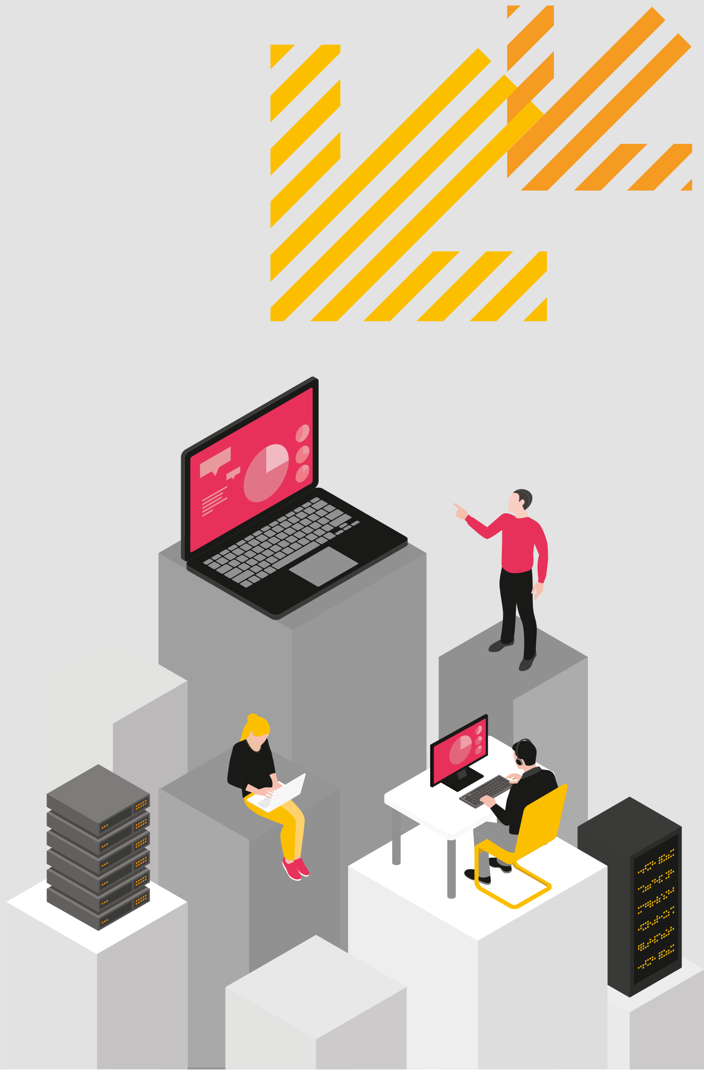


The Swiss legislator has stipulated limited principle-based legal provisions to ensure the compliant market conduct of the participating financial intermediaries. Whether in relation to the duty of proper organisation and the corresponding definitions, or respective criminal provisions of the exploitation of insider information (Articles 142 & 154 FinMIA) and market manipulation (Articles 143 & 155 FinMIA) as the cornerstones of the legislation landscape. Although stipulated in only a few legal provisions, the impact in case of non-compliance with proper market behaviour is significant. This includes financial, non-financial and, in particular, reputational risks for the offending party, the regulated entity and the Swiss financial market as a whole. To set clear regulatory expectations and guide financial intermediaries in developing an adequate framework for controlling risks related to market conduct rules, the Swiss Financial Market Supervisory Authority FINMA put the Circular on 'Market conduct rules' into force on 1 October 2013, with its latest amendment dated 4 November 2020 (FINMA Circular 2013/8 'Market conduct rules'). A little more than a year following the amendment and the corresponding extended scope of FINMA Circular 2013/8, challenges continue to be evident in the implementation of the stipulated duties and, in particular, in the application of the risk-based approach and the principle of proportionality.

What challenges are evident?

As part of the latest amendment of FINMA Circular 2013/8 'Market conduct rules', financial intermediaries that now require a licence under the applicable rules of FinIA are also fully included in the circular's scope. External asset managers in particular have to comply with FINMA's market conduct organisation duties. Although the extension of the scope of FINMA Circular 2013/8 also includes smaller financial intermediaries previously only governed by the principles and criminal provisions of FinMIA, no exceptions regarding organisational requirements have been added. As a result, the stipulated organisational measures of FINMA Circular 2013/8 are fully applicable. This means that FinIA financial intermediaries now requiring a licence must establish an appropriate governance and risk management framework and an institution-specific control system to address the specific risks the financial intermediary is exposed to. As these newly relevant regulatory requirements can have a significant impact on the existing organisation, the inherent principles of FINMA Circular 2013/8 for a risk-based approach and proportionality are extremely important. But how can they be adequately applied?

What's more, even financial intermediaries that were already subject to the scope of FINMA Circular 2013/8 are continuously faced with the question of whether the existing risk management and control framework is still sufficient to mitigate the market conduct risk by means of a risk-based approach and the principle of proportionality. This ongoing assessment is driven by the continuous development of regulators' expectations and the evolution of good-practice and best-practice understanding.

To support financial intermediaries in overcoming the challenges of adequately addressing the market conduct requirements, the following topics are discussed below:

- The importance of an individual risk analysis.
- The minimum requirements for the framework of organisational duties.
- Application of the principles of a risk-based approach and proportionality.
- Overview of known challenges worth assessing individually.

Why is the individual risk analysis so important?

Even though businesses might be similar in nature, there are always individual elements like complexity, size, risk factors, risk exposure, risk appetite or risk tolerance, which means that different risk mitigation measures are required for each financial intermediary. To design an adequate and tailored risk management and control framework enabling compliance with organisational market conduct duties, an in-depth market conduct risk analysis is the main management tool for identifying and assessing individual circumstances and defining mitigation measures accordingly. The basis of this risk analysis is explicitly defined by FINMA Circular 2013/8 'Market conduct rules', margin number 46.

Financial intermediaries have the option of establishing a stand-alone market conduct risk analysis or including the respective risk analysis with the required granularity in the overarching compliance risk assessment. Independently of the chosen approach, a yearly re-assessment approved by an appropriate management body enabling an adequate definition of the business and compliance strategy is mandatory.

So they can identify indicators, factors, weightings and rationale for the risk analysis, each financial intermediary should start with an assessment of its own business activities and the corresponding exposure, and map the identified risks to the existing control measures

The indicative risk factors below are not conclusive but are a good overview of factors to be considered when conducting the risk analysis. We recommend that this is based on inputs and interaction among various front, compliance and risk stakeholders. In addition, these factors are in a constantly changing, dynamic environment. To maintain effectiveness and appropriateness, the risk analysis requires regular challenges, reviews and revisions to address dedicated risks and adhere to the developed expectations.

The outcome of the risk analysis should be instrumental in making a management decision on the necessity to introduce new or additional control measures, or to decide on the execution of the risk strategy.

What are the minimum requirements of organisational duties?

The organisational duties and organisational control measures to address and mitigate the identified risks are at the centre of preserving market integrity. The implementation or adaptation of the stipulated obligations can have a significant impact on each organisation, potentially triggering a need for change. Depending on the maturity of the financial intermediary's compliance organisation, the size of the institution, the design of the internal control system and the available internal expertise, a different level of adjustment and strengthening is required.

As the individual risks of a financial intermediary are identified, assessed and measured as part of the market conduct risk analysis, the institution-specific organisational control measures have to be (re-)defined, balanced and (re-)calibrated accordingly, which can vary between financial intermediaries depending on their risk exposure, risk strategy and corresponding risk appetite.

The following organisational control measures should be carefully analysed and assessed as a minimum standard in order to introduce or refine an adequate risk management and control framework for mitigating risks arising from market conduct rules.

Organisational measures and internal control system

Organisational measures

Based on the risk analysis and the individual risks identified, assessed and weighted therein, the respective organisational measures must be implemented, taking into account the individual size and complexity of the intermediary. Each individual approach chosen for implementation of the following organisational measures must be aligned with the rationale of the risk analysis.

Independent compliance function

An independent compliance function acting as a second line of defence is a mandatory element of an adequate market conduct risk management framework. The roles and responsibilities of the compliance function within the internal control system need to be defined so as to enable an effective control landscape.

Information barriers and Chinese walls

Information barriers are implemented in order to monitor and control the use and sharing of material non-public information (MNPI). Employees within the financial intermediary, who are likely to receive MNPI and are therefore located on the private side, must be segregated from personnel on the public side who only have access to publicly available information. In order to share MNPI with people, departments or divisions from another area by means of a trust-based need-to-know approach, a wall-crossing process has to be established, including underlying responsibilities. The different responsibilities for controls and monitoring to ensure adherence to the defined process, the responsibilities for approval and rejection of wall-crossing requests as well as the reviews of corresponding frameworks and underlying processes must be assigned to dedicated team members or divisions.

Segregation of functions

The segregation of duties can be ensured with organisational, technological, functional, areal and/or personnel measures and is required for the functioning of the financial intermediary in regard to information barrier aspects. But even more importantly, it's the basic prerequisite for operating effective personal account trading monitoring, the function of the Watch List and Restricted List as well as for avoiding conflicts of interest. Certain functions and responsibilities within a financial intermediary may not interfere with one another to ensure independence and the capability to perform their daily business without conflicts. If the segregation isn't adhered to, daily business like trading and advising businesses could be infringed.

Watch List and Restricted List

Financial intermediaries are required to implement a Watch List as well as a separate Restricted List. A Watch List is a list of securities that, unlike Restricted List securities, generally do not carry trading restrictions, but whose trading is subject to close scrutiny by the financial intermediary's compliance department. The Watch List also differs from the Restricted List in that its dissemination generally is limited. Entries on the Watch List are known to a very limited group of employees, including the compliance or legal department (depending on the ownership of the Watch List), the head of investment banking, selected executives and research. Entries are added as soon as discussions between the financial intermediary and a contractual party potentially exposing MNPI show clear business interests.

A Restricted List is a list of securities, maintained by a financial intermediary, in which proprietary, employee, and certain solicited customer transactions are restricted or prohibited. The Restricted List requires entry for material transactions in which the financial intermediaries have a stake and for which material non-public information about the contractual party was obtained. Entry on the Watch and Restricted List need to be documented, stored, archived and monitored.

The respective contractual parties and their underlying financial products require an entry on the Watch List and/or Restricted List depending on the nature of information in order to monitor the execution of trades of the restricted employees, with a view to preventing, detecting and identifying market conduct breaches. The MNPI identification process as well as completeness and timeliness of the entry onto the respective lists are major challenges for which an institution-specific response must be defined.

Controls and monitoring of transactions

To detect and prevent potential violation of market integrity rules and mitigate the risks arising from them, a control landscape must be enforced by the financial intermediary. This control landscape and corresponding framework must address the regulatory requirement of monitoring and surveillance capabilities. Monitoring and surveillance capabilities aligned with FINMA Circular 2013/8 have the following input channels as a minimum basis: i) trade and e-communication surveillance, ii) management of the Watch List and Restricted List, iii) market conduct training execution and participation, iv) adherence to information barriers and areas of trust, and v) surveillance of the personal account trading of employees.

Those monitoring requirements need to be fulfilled in principle by any financial intermediary, although the approach can vary significantly in terms of the size and complexity of the institute, taking into account the intermediary-specific risks. The potential for a surveillance gap must be assessed and addressed on an ongoing basis.

Surveillance of personal account trading

Surveillance of personal account trading means monitoring employee trading based on an individual control framework. The goal is to detect and prevent the execution of transactions on private accounts for the personal benefit of the employee or related people, which are triggered by conflicts of interest and qualify as misuse of MNPI or even the appearance thereof. The approach of surveillance can be chosen individually, depending on the risk exposure and risk appetite, number of employees, transaction volume and available resources for controlling, but no 'one approach fits all' exists. Practice has proven that minimum holding periods, pre-deal clearance, ex-post surveillance, sampling of custody account statements, obtaining self-declaration or a combination thereof are effective.

Recording duties

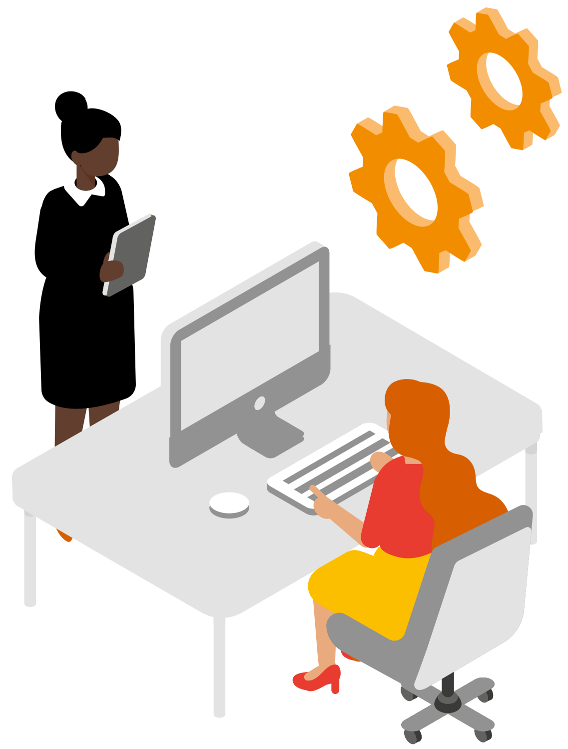
Employees in trading and trade-related areas pose an increased risk for violating the proper conduct for compliance with market integrity rules through executing and/or advising on transactions. Enabling the financial intermediary to adequately monitor, detect, identify and escalate respective breaches, the activities of such employees must be subject to control activities based on recording the various communication channels.

The internal and external calls of employees in trading and trade-related areas must be recorded. What's more, electronic communication including chat tools and e-mails must be systematically archived and subject to surveillance.

Training concept

To raise awareness for adequate conduct on market integrity rules and its relevance for the financial intermediary, an adequate training framework tailored to the financial intermediary's risk exposure and business activities is required. This training concept serves as one of many controls to ensure compliance with the regulations and internal policies. A thorough definition of the target audience should form the basis of the training concept. The periodicity and the content of the training may vary depending on the audience and should be aligned with the market conduct risk analysis.

The outcome of the risk analysis should be instrumental in making a management decision on the necessity to introduce new or additional control measures, or to decide on the execution of the risk strategy.



How can the principles of a risk-based approach and proportionality be best applied?

Principles of a risk-based approach and proportionality in the definition of a risk framework

Inherent in FINMA Circular 2013/8 ‘Market conduct rules’ are two very important principles defining the design of the organisational risk management and control framework with a direct impact on the underlying organisational measures. These are the principle of a risk-based approach and proportionality. Elements like the size, complexity, target operating model, service offering and risk exposure of the financial intermediary as well as the available resources significantly determine the design and professionalisation of the introduced organisational control measures. These principles allow the financial intermediary to define, within the policy given by FINMA, an appropriate, tailored control landscape. Nevertheless, the pure number of implemented controls as part of these organisational control measures is not a good indicator for assessing the effectiveness and completeness of a robust market conduct risk management and control framework. The priority lies in the proper functioning and harmonisation of a set of controls that proves its efficiency and effectiveness based on the specific needs of a financial intermediary.

It’s hugely important that the defined control measures are individually tailored to the speciality of the financial intermediary and are derived from all risks that were identified in the context of the market conduct risk analysis.

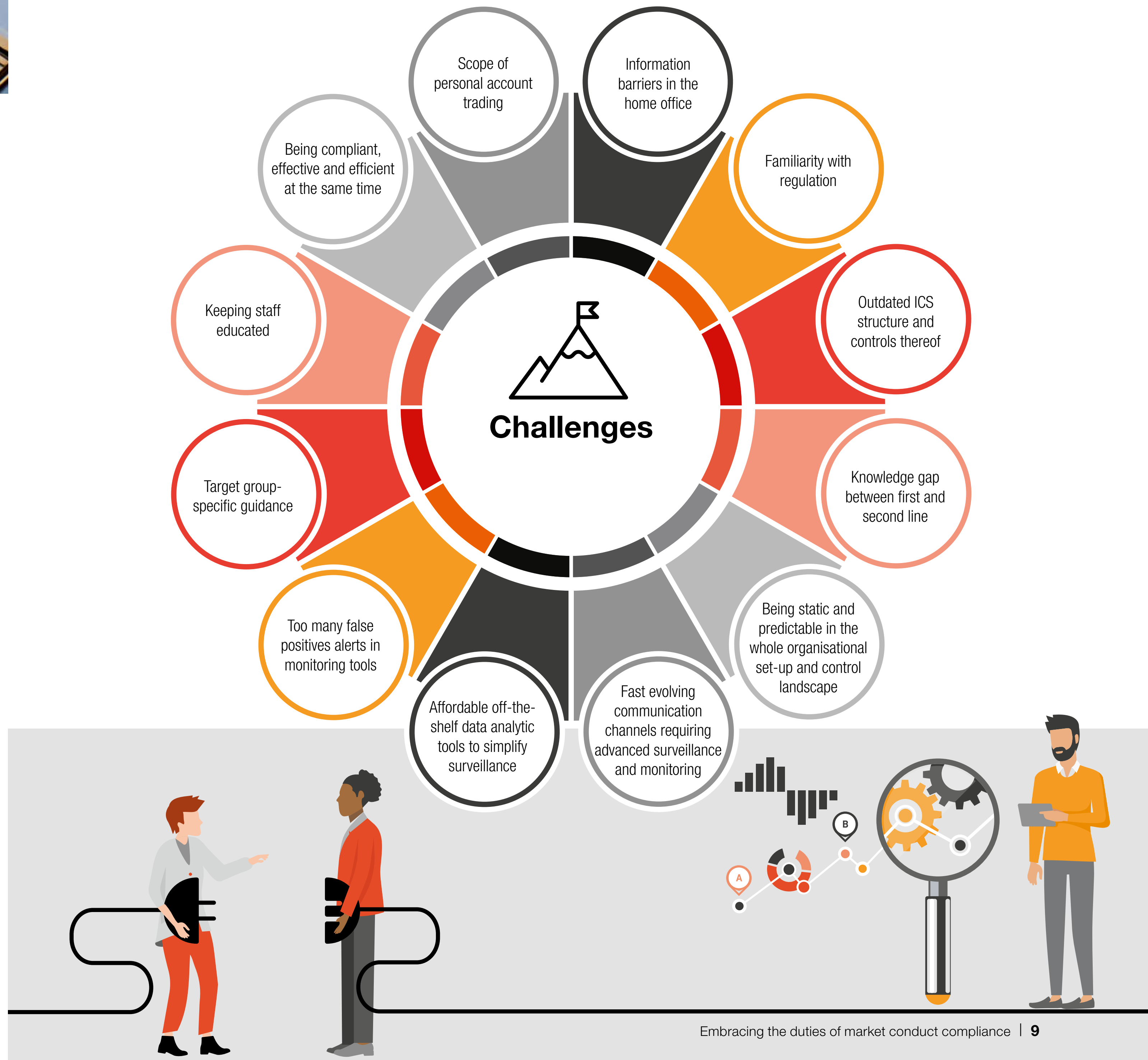
Only by taking into account the individual risk situation can the proportionality of the measures be determined and ultimately justified. For example, FinIA licensed financial intermediaries will generally not implement the same degree of control measures as banks. Similarly, within the banking sector, an investment bank and a retail bank will have significant differences, where each individual control measure should originate from the risks derived from the market conduct risk analysis. The appropriateness of the defined measures and controls based on the individual risk situation and the institution’s specific circumstances is determined on a case-by-case basis. It’s as individual as each financial intermediary’s business and target operating model.

The following example illustrates the above: Whether or not, in the area of monitoring the trading activities of employees, an annual compliance confirmation, a pre-trade approval, a comprehensive ex-post monitoring, a sample-based request for third-party bank custody account statements or a combination of these controls is justified depends, as already explained, on the institution’s individual risk situation. A final decision on the appropriateness of the specific control measure taken, which is also supported by the regulator or the auditor, requires a justification originating from the market conduct risk analysis.

Which challenges can be assessed throughout financial intermediaries? Have you considered them?

In implementing and applying the stipulated organisational measures and surveillance duties, challenges in the practice throughout financial intermediaries were identified. Some financial intermediaries are (re-)facing those challenges regularly and are frequently undergoing an assessment and review, while other intermediaries are currently experiencing these challenges for the first time. As part of our audit and advisory work and based on market expertise, we’ve summarised the following challenges which a financial intermediary should consider when assessing its adequate coverage and corresponding measures for its own organisation.

Further challenges may arise during the implementation of an adequate risk and control framework to ensure compliance with market integrity rules according to regulatory requirements and market good-practice, and there’s certainly no ‘one size fits all’ solution. As your trusted partner, we’re on hand for an in-depth discussion to address and assess your needs, so we can jointly develop a risk-based, tailored and proportionate solution to strengthen your organisation in a sustainable manner.



Contacts

Michèle Hess
Partner, Compliance & Regulation
+41 58 792 46 67
michele.hess@pwc.ch

Dominik Töngi
Director, Assurance
+41 58 792 26 98
dominik.toengi@pwc.ch

Luca Bonato
Senior Manager, Compliance & Regulation
+41 58 792 46 69
luca.bonato@pwc.ch

Thomas Güntensperger
Manager, Assurance
+41 58 792 10 42
thomas.guentensperger@pwc.ch

Florence Born
Associate, Compliance & Regulation
+41 58 792 27 34
florence.born@pwc.ch

For more information: www.pwc.ch