Sator Regulatory Consulting Limited

• Regulatory Risk Management • Technical Advice • Investigatory Assistance
• Resources Support for Business, International Standard Setters & Regulatory Authorities

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Corporate Governance – Lessons Learned…?

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Regulatory Requirements relating to corporate governance and risk management

- Why the Commission is interested in corporate governance?
- How the regulatory framework works?
- How you can evidence compliance?
- What are the benefits to business?

Commission and your corporate governance

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- Commission statutory remit:-
- To reduce risk to the public from suffering loss through fraud, mis-management, incompetence or insolvency
- To protect the reputation of the island
- To contribute to the fight against financial crime
- To advise government

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Corporate Governance

"The system by which organisations are directed and controlled" *Drucker*

It is immediately obvious that in fulfilling their remit, the Commission's first interest in a regulated entity is in how it is directed and controlled.

Corporate Governance

- Governance also generates the culture of an organisation

- Senior management sets “The Tone from the Top”

- Professionalism, integrity, prudence, work ethic, courteous and respectful behaviour – all set from the top – and ultimately affecting the culture and risk profile of the organisation

Latest Thinking

- Last 15 years has seen development of entire professions dedicated to risk management, compliance, corporate governance standards and regulation
- Sarbanes Oxley, Turnbull, Greenbury, Cadbury, Combined Code, Revised Combined Code, etc
- Yet same time frame has resulted in largest ever financial (and corporate governance) collapses

Why did it all fail?

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- Latest thinking seems to indicate an increasing tendency to believe in systems rather than judgement; automated matrices and exceptions reporting rather than careful considerations of the wider picture; a belief in avoiding values based judgements in favour of judgements based solely on data and legal liability
- A culture of “Can I do this?” not “Should I do this?”
- A belief that once a “system” was implemented that was the issue covered.

The Combined Code – was it inadequate?

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- Principle C.2 of the Code states that 'The board should maintain a sound system of internal control to safeguard shareholders investment and the company's assets'.

- Provision C.2.1 states that 'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that
- they have done so.

- The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

Revised Combined Code – raised other topics

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- Extract from Revised Guidance for directors published by the Financial Reporting Council (eg “an update on the Turnbull Report” 2005)

- “Establishing an effective system of internal control is not a one-off exercise. No such system remains effective unless it develops to take account of new and emerging risks, control failures, market expectations or changes in the company's circumstances , culture , ethical values, remuneration structures or business objectives.

- The Review Group wishes to emphasize the importance of regular and systematic assessment of the risks facing the business and the value of embedding risk management and internal control systems within business processes.

- It is the board's responsibility to make sure this happens”.

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Sound framework

- Although the Combined Code and the work of the Review Group apply principally to listed companies, the regulatory regime effectively applies a simplified version of it to all regulated entities with much the same objective in mind – increasing the likelihood of well run businesses of integrity, financial soundness, competency and transparency.

- Whereas governance for listed companies demands transparency with the public – a regulated entity may keep certain levels of privacy but needs to be transparent with the regulator, truthful to its customers and mindful of its obligations to them.

Primary Law, Orders and Codes of Practice

The Primary Laws (in keeping with international regulatory standards) ensure-

Initially and on an on going basis that licensed entities have:-

-suitable organisation and structure
-adequate financial soundness
-adequate competency to undertake its activities
-fit and proper owners, directors and other key persons

Laws also provide investigation, intervention and sanction powers and the ability to issue Codes of Practice outlining principles for the sound conduct of business

Orders

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Under each law sit orders which set further requirements dependent upon the risks of each sector:-

- Accounts, Audit and Reports
- Solvency and liquidity
- Advertising standards
- Overseas persons who might want to do business in Jersey
- Circumstances for the appointment of a Manager
- Client Assets
- Fees

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Codes of Practice

Set around seven Fundamental Principals, the Codes of Practice range in sophistication from straight forward rules, to some fairly high order risk management statements

Integrity
Customers ‘ interests
Transparency
Adequate financial resources and insurance
Deal with Commission and other authorities openly and cooperatively
Must not make false or misleading statements

Codes of Practice

"A registered person must organise and control its affairs effectively for the proper performance of its business activities and be able to demonstrate the existence of adequate risk management systems".

- Corporate governance
- Internal systems and controls
- Integrity and competence
- Continuing professional development ("CPD")
- Compliance Officer, Money Laundering Reporting Officer and Money Laundering Compliance Officer
- Complaints
- Record keeping

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Corporate Governance – senior management

An effective corporate governance system that must include

- adequate span of control appropriate to the nature of its business;
- span of control must comprise at least three appropriately skilled and experienced individuals;
- the relationship between the individuals must be such as to ensure they can all exercise independent judgement without duress or undueinfluence from one another;

Corporate Governance – allocating responsibility

- Responsibilities must be apportioned among a registered person's senior managers, directors and partners in such a way that their individual responsibilities are clear; and

- The business and affairs of a registered person must be adequately monitored and controlled at senior management and board level

Corporate Governance

A registered person must have documented procedures sufficient to facilitate the *effective management of risk* by the board of directors and senior management.

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Notes to Codes of Practice

Notes:

1. Corporate governance is the system by which an organisation is directed and controlled. A corporate governance framework specifies the distribution of rights and responsibilities among different participants in the organisation and sets out the rules and procedures for making decisions. *Risk management is an integral part of the corporate governance framework.*

Risk Management

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Most Jersey businesses are well advanced – even against the highest international standards – in risk rating their customers, particularly in AML/CFT area

Outside banking sector broader risk management is still relatively undeveloped in many organisations.

Business continuity, regulatory and AML/CFT risks are about as far as many firms have formally taken the topic to date. (Remember requirements are phrased in terms of “demonstrate” and “documented”)

Core Requirements

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The Codes of Practice provide an excellent reminder of the core requirements of the essential elements of corporate governance.

However, they do not elaborate on what risk management components should be – naturally, the Commission cannot know the risks in your business – that is for the directors to determine (as are the means you use to mitigate the risks and indeed your Board's tolerance to risk)

Typology of Risks

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Different writers present risk differently, but a typical categorisation for a financial business might be:-

Market Risk

Credit Risk

Liquidity Risk

Operational Risk

Legal and Regulatory Risk

Business Risk

Strategic Risk

Reputation Risk

Market Risk

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Market Risk does not refer to the market you are operating in, in terms of clients or competitors –

Market risk generally relates to financial markets – eg interest rate risk, equity price risk, foreign exchange risk, commodity price risk, and credit risk

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Liquidity Risk

Generally broken down into two:

Funding Liquidity Risk relates to the ability of a firm or structure under management, to raise the necessary cash to roll over its debt, to meet the cash, margin and collateral requirements of counter-parties (and in the case of funds and maybe trusts/companies under administration to satisfy capital withdrawals)

Asset Liquidity Risk is the risk that an institution will not be able to execute a transaction at the prevailing market price because there is temporarily no appetite for the deal on the other side of the market.

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Operational Risk

Operational risk refers to potential losses resulting from inadequate systems, management failure, faulty controls, fraud and human error. Regulators are likely to draw from international standards which define operational risk as:-

Internal fraud, intentional misreporting, employee theft, insider trading on employees' own account, external fraud, robbery, forgery, computer hacking, employment practices and workplace safety, discrimination claims; liabilities that arise from clients, products and business practices, eg fiduciary breaches, misuse of confidential customer information,

Operational Risk (continued)

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Money laundering and terrorist financing; sale of unauthorised products; damage to physical assets; business disruption and system failures, eg hardware and software failures, telecommunications problems utility outages; failure of execution, process and delivery management failures, incomplete legal documentation, unapproved access to client assets, counterparty misconduct or mis-performance and vendor disputes.

Human factor risk

Legal/Regulatory Risk

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Arising from a whole variety of reasons, it is closely related to reputational risk.

Another aspect of regulatory risk is the potential impact of a change in the tax law, or social tolerance to a particular arrangement or position (Philip *de Figueiredo*, Jimmy Carr)

This area of risk should not be considered only in the light of JFSC or other financial services regulators, but a wide range of rule setting bodies - according to the markets you or your client structures operate in, listing rules may be relevant, competition authorities, mergers panels, data protection authorities, FATCA, etc.

Business Risk

The classic risk of the business world, this relates to uncertainty about the demand for products or the price that can be charged for it, or making the wrong choices in channels, suppliers

The key matter affecting, maybe even driving, Business Risk is the firms Strategy and Reputation and these are dealt with separately.

Individual Business complexity would also enter this area and in the Jersey financial services environment the external risks which face all Jersey businesses could be considered, such as price competitiveness issues, OECD tolerances, etc.
Eg Reducing business risk on competitiveness might involve outsourcing to lower cost jurisdictions but this could increase operational risk.

Strategic Risk

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Strategic risk refers to the risk arising when a venture or marketing initiative /market positioning or product development, is simply not successful.

There are the costs associated directly with the failed venture (start up, advertising, promotion costs) there are also the indirect costs of lost opportunity (if you are doing one thing you may not have been doing something else that would have made money) and you may miss the market you were not attending.

Eg Nokia whose 1999 marketing strategy relied on bringing smart phones to market. They allocated 80% of their R&D budget to this project, fighting to be "first to market" but the project proved to be ahead of market demand. Hundreds of millions of dollars were lost with Nokia's market share of "ordinary cell phones" (ocp) dropping 29% from 35% by mid 2003. 2003 smart phone sales were 5.5m (target has been 10m) By 2004 Nokia's ocp market share had fallen to 2% in a market which had grown 40% by units sold. They backed the wrong horse.

Reputation Risk

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“The Essentials of Risk Management” published 2006 stated:

“The development of a wide array of structured finance products, including financial derivatives for market and credit risk, asset-backed securities with customized cash flows, and specialised financial conduits that manage pools of purchased assets, has put great pressure on the interpretation of accounting and tax rules, and in turn, has given rise to significant concerns about the legality an appropriateness of certain transactions. Involvement in such transactions may damage an institutions reputation and franchise value”.

The general public perception of financial services businesses has never been lower. Today the term “Bankster” is commonplace.

Reputation Risk

Reputation risk poses a special threat to financial services businesses because the nature of their business requires the confidence of customers, creditors, regulators and the general marketplace.

Reputation risk is probably the one most interconnected with the other risks as clearly failing to manage a risk under the other categories is likely to damage a firm's reputation.

How to Comply

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The Commission expects to see evidence that your Board has:-

1) considered the risks relevant to your business and the environment it operates within
2) how those risks can be effectively mitigated and that some form of monitoring is in place to ensure the mitigating actions are holding firm and being exercised regularly
3) re-examines the risks from time to time to add/remove or to note changes or update mitigating controls
4) determined the level of risk appropriate for your business and
5) set policies to ensure this risk appetite is respected and not exceeded (whatever it may be)

Advantages to Business

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Commercial

Many major clients and private equity firms now expect to see high levels of corporate governance and risk management in place prior to involvement with a firm

Requests for ISO3100 or FRAG reports are increasingly commonplace

Lowering the chances of regulatory intervention saves thousands – to quote the current Chairman of the JFSC when CEO of Citibank and speaking to industry - 2004

“Don’t like the cost of compliance? Try the cost of non-compliance”

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Conclusion

Law, Regulation and Risk are intrinsically linked:

Governance is the tool by which a firm's exposure to each is managed.

Corporate Governance – Lessons Learned…?

Lessons learned – Trust Company "A"

- "A" was authorised by the JFSC to conduct Trust Company Business ("TCB") as defined in the Financial Services (Jersey) Law 1998 ("FS(J)L")
- The JFSC investigated "A" and its Principals following concerns over "A"'s compliance with applicable laws and the Codes of Practice for TCB
- The investigation focussed mainly on business introduced to "A" by intermediaries based in the Far East.
- The Principals and "A" cooperated with the Commission throughout the investigation

Trust Company "A" – Summary of Findings

- Corporate governance was seriously deficient
- There was no effective span of control
- The lack of effective corporate governance was a significant factor, resulting in a number of key failings, including breaches of the FS(J)L and Codes, as follows:

Trust Company “A” – Key failings

- A failure to maintain appropriate accounting records for certain structures under administration

- Excessive reliance on intermediaries providing instructions on behalf of “A”’s customers

Trust Company "A" – Key Failings

- Serious conflicts of interest arose and were not managed appropriately – if at all. These conflicts were not documented or even acknowledged to exist
- Transactions were executed without reference to the constitutive documents governing certain customer structures

Trust Company “A” – Key Failings

- A lack of transparency in respect of fees charged by “A” on behalf of itself and certain intermediaries
- “A”’s compliance and AML functions for a period of 4 years were ineffective
- On occasions, “A” failed to demonstrate compliance with the requirement to keep adequate financial resources

Trust Company “A” – Further Breaches

- Breaches of the FS(J)L – unauthorised financial service business, pursuant to Art 7
- Breaches of the Codes – breaches of the Principles 1 to 5 of the 7 core principles

Trust Company “A” – the Principals

“The principals failed to act with fitness and propriety in the management and control of “A”.”

Each Principal was issued with directions under Art 23 (1) of the FS(J)L.

They were further prohibited from performing any function or service under Art 2 of the FS(J)L

Trust Company "A"

- "A" was deemed not fit and proper to be registered for the conduct of Trust Company Business
- The business was wound up
- "A"'s authorisation to conduct Trust Company Business under the FS(J)L was revoked

Regulated entity “B” and its Director “Mr C”

- Mr C contacted by English solicitor acting as attorney for Mr D who wished “the proceeds of the sale of a sauna to be kept offshore in the first instance”
- £850,000 forwarded and monies paid into client account of B
- The identity of Mr D never established

Regulated entity B and its Director, “Mr C”

- Immediately following receipt, instructions received to pay £825,000 to four unknown parties
- Discretionary trust established the following day with UK solicitor as sole beneficiary
- The day after that, the funds were paid away
- Facts discovered by the JFSC on inspection visit

Regulated entity B and its Director “Mr C”

- Subsequent trial resulted in the Royal Court fining the entity B a total of £65,000
- The Director “Mr C” was personally fined £35,000
- The defendants were ordered to pay the prosecution costs

Regulated entity B and its Director “Mr C”

Observations of the Royal Court:

- These were serious breaches of the Law, due to a serious breakdown in internal controls
- Mr D’s identity was never verified and it was Mr C’s unacceptable level of autonomy that was primarily responsible
- These failures were not recognised by entity B

Regulated entity B and its Director "Mr C"

The Royal Court's warning –

" Robust AML procedures and internal controls and systems must be in place and applied, including appropriate levels of supervision and audit, to ensure full compliance with the Law."

A Question…..?

Will I one day be using examples of corporate governance failings in YOUR firm in a presentation….?

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“The leadership team is the most important asset of the company – and can be its worst liability”

Med Jones

Any Questions?

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