Compliance Function as a Pillar of Modern Corporation

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Conduct and culture have been moving up on the regulatory agenda and should be a prominent feature for the Board and senior managers at firms across the industry.

Multiple instances of misconduct in retail and wholesale markets have left the industry vulnerable to a series of commercial and regulatory pressures. The industry will need to recalibrate the way that it sets the tone and sets the culture and the way it measures and rewards people for the way that they deliver against the strategic objectives.

When it comes to conduct and culture, the industry is dealing with a combination of commercial and regulatory pressures. The commercial pressures include the need to rebuild reputation and trust; to establish commercial benefits from taking a more customer-centric approach; to respond to growing competition from challenger banks; and to avoid or minimize the financial costs of misconduct (criminal actions, fines, remediation and civil actions).

To address this, an integrated approach is being taken by some organizations in implementing a regulatory compliance framework through a compliance officer. This involves developing and establishing a compliance methodology, policies, procedures and a training program. The benefits include:

- corporate oversight and guidance for compliance activities;
- improved efficiencies and effectiveness;
- increased employee awareness of regulatory compliance requirements and issues, and
- the minimization or mitigation of legal, reputational, or financial risks.

Whilst the compliance function plays a second line of defence role within corporate governance, it also has a place in the first line of defence for its own activities with ownership, responsibility and accountability for directly assessing, controlling and mitigating risks.

Compliance vs Internal Audit

The first thing to be clear about is that they are fundamentally just titles. Compliance and Internal Audit have risen in prominence in the past few years, both representing critical control components of an organization's structure. Effective programs emphasizing both functions can reduce the incidence of abuse.

Internal Audit's objective is essentially assurance. The Internal Audit function is designed to monitor and evaluate the company's internal control environment as to its adequacy, efficiency and effectiveness.

Compliance's objective is predominantly operational. The Compliance function is thereto reasonably ensure that the company is complying with all applicable laws, rules and regulations, as well as internal codes of conduct, policies and procedures.

The report of Basel Committee on Banking Supervision specifically states that the compliance function and the audit function should be separate, to ensure that the activities of the compliance function are subject to independent review. The said report also stipulates that compliance risk should be included in the risk assessment methodology of the internal audit function, and an audit program that covers the adequacy and effectiveness of the bank's compliance function should be established, including testing of controls commensurate with the perceived level of risk.

To ensure an effective coordination of activities between these two functions, it is essential that the two functions leverage a common language of risk and control. A common methodology for compliance and internal audit leads to an agreement about the definition of risk types and risk thresholds. Additionally, organizations should manage compliance and internal audit using a common technology solution. The use of different technology solutions puts the organization at risk of inconsistencies and inefficiencies, and ultimately higher costs.

The two functions may share common grounds, yet arguably, it is the reporting where the two diverge. Traditionally, internal audit function (whether single-person internal auditor or audit committee) enjoyed greater independence in its operation- and rightly so. To put internal audit function under the command of body(ies) or officers, whose work is scrutinized, would defeat the whole purpose of internal audit review. Hence, internal audit typically reports to the Supervisory Board or directly to shareholder(s).

Compliance, by contrast, has not had the privilege of enjoying greater access to corporations' supervisory authorities or shareholders, primarily due to the nature of their function. As a matter of common practice, compliance function has long been viewed as part of business processes, as opposed to reviewer of those processes, hence was accountable to executive body. Another contributing factor was the subjection of compliance function to internal audit review, which ensured the principle of checks and balances. However, calls for greater independence for compliance function are becoming more widespread and this can be highlighted as one of the initiatives for improving corporate governance at companies.

Compliance Function Responsibilities

Compliance function responsibilities vary a great deal, depending on the industry and nature of corporation. Yet there are numerous directives, guidelines or recommendations, which outline the core of suggested compliance functions for businesses. The Basel Committeeon Banking Supervision, though for banks, recommends the following core responsibility areas:

- *Advice:* The compliance function should advise senior management on compliance laws, rules and standards, including keeping them informed on developments in the area.
- *Guidance and education:* The compliance function should assist senior management in educating staff on compliance issues, and acting as a contact point within the bank for compliance queries from staff members.
- *Identification, measurement and assessment of compliance risk:* The compliance function should, on a pro-active basis, identify, document andassess the compliance risks associated with the bank's business activities, including the development of new products and business practices, the proposed establishment of new types of business or customer relationships, or material changes in the nature of such relationships.
- *Monitoring, testing and reporting:* The compliance function should monitor and test compliance by performing-sufficient and representative compliance testing.
- *Statutory responsibilities and liaison:* The compliance function may have specific statutory responsibilities (e.g. fulfilling the role of anti-money laundering officer).
- *Compliance program:* The responsibilities of the compliance function should be carried out under a compliance program that sets out its planned activities (e.g. review of specific policies and procedures, compliance risk assessment, compliance testing)[1].

1. The Report of Basel Committeeon "Banking Supervision on Compliance and thecompliance function inbanks", article 7

The European Securities and Markets Authority (ESMA) in its guidelines recommends similar, in nature, obligations for compliance function, albeit designed for investment firms.
However, ESMA's guidelines put greater emphasis on compliance function's independence. Thus, guidelines stipulate that investment firms should ensure that the compliance function holds a position in the organizational structure that ensures that the compliance officer and other compliance staff act independently when performing their tasks[2]. The compliance officer should be appointed and replaced by senior managementor by the supervisory function. Equally important is for investment firms to ensure that the compliance function performs its tasks and responsibilities on a permanent basis. Investment firms should therefore establish adequate arrangements for ensuring the responsibilities of the compliance officer are fulfilled when the compliance officer is absent, and adequate arrangements to ensure that the responsibilities of the compliance function are performed on an ongoing basis[3]. These arrangements should be in writing.

Chief Compliance Officer

Chief Compliance Officers (CCOs) play an important and crucial role in fostering integrity in their respective organizations. They are responsible for making sure that their firms comply with the rules that apply to their operations. As part of that effort, CCOs typically work with senior corporate leadership to instill a culture of compliance, nurture an environment where employees understand the value of honesty and integrity, and encourage everyone to take compliance issues seriously.
Quite often CCO is responsible for compliance and ethics. This role is also tasked to build a strong organizational ethics and compliance program, which is a high priority in any organization, especially in listed ones.
Reputational Risk Management is becoming more and more important. Every compliance or ethics issue may lead to a scandal or a problem with the company's reputation that may weaken its brand value. In addition, supervisors, regulators, internal and external auditors try to ensure that CCO has built a good ethics and compliance program, and that he has the necessary qualifications and experience.
International Finance Corporation (IFC) in its Advanced Methodology for Financial Institutions breaks downs CCO's qualifications into 2 groups: personal and professional qualifications. Personal qualifications include: (i) integrity, understanding of duties of loyalty and care, (ii) communication skills and (iii) honesty and ethical behaviour.
Professional qualifications, essentially, require good understanding of laws and regulations governing the particular industry; regulations governing companies (and, if the bank is publicly listed, regulations and laws covering public entities) and AML requirements.
Nowadays, the need for senior leadership to support CCOs is not just good practice, but also a business necessity. Indeed, a recent U.S. Securities and Exchange Commission (SEC) enforcement case demonstrates that the Commission takes

2. Guidelines on certain aspects of the MiFID compliance function requirements, guideline 7
3. Guidelines on certain aspects of the MiFID compliance function requirements, guideline 6

seriously the importance of firms supporting the work of their CCOs. In the particular case, the firm's CEO was found not to have provided the CCO with sufficient guidance, staff, and financial resources, despite the CCO's pleas for help which contributed substantially to firm's compliance failures[4].

Global Trends

There have been numerous surveys conducted in this sphere. One such recent survey, objective of which was to analyse the structure and the area of responsibility of compliance functions in large international companies, identified the following findings:

1. The most common areas of compliance are anti-corruption compliance and compliance with ethical standards (100%), followed by compliance in safety, health and environment (91%), antimonopoly compliance (85%), human rights compliance in the workplace (67%), compliance in personal and confidential data protection (61%), compliance with trade sanctions (45%) and compliance in marketing products sector (9%);
2. 76% of the respondents stated that they conduct a compliance risk assessment; whereas 24% of the respondents cited that compliance risks are not singled out in a separate risk group and are assessed irregularly;
3. According to almost half of the respondents (46%), the Heads of compliance functions report directly to CEO or President. In 27% of cases, they report to either Vice-president or CFO. In another 27% of cases, the compliance function reports to a Head of Department (a third level of subordination);
4. 55% of the respondents stated that the compliance function reports to a supervisory body (the Audit Committee, Compliance Committee, etc.), in 15% of cases - to executive bodies (collegial or individual), in 30% of cases - to both supervisory and executive bodies;
5. The majority of the respondents (91%) indicated that compliance controls for different business processes are set out in different documents, and only in 9% of cases all compliance controls are set out in one document;
6. Most respondents (76%) with a separate and independent compliance function have this function in all its subsidiaries. In 24% of cases, Legal Department performs a compliance function;
7. The average number of employees in the compliance function is 4.5 times higher in the companies that have been under SEC/DOJ investigation for violating Foreign Corrupt Practices Act than in the companies that have not[5].

Compliance Function in Azerbaijan

Compliance function is not yet widespread in the corporate business culture of Azerbaijan. For two major reasons: (i) it is not yet mandatory by law, (ii) corporations are generally lenient towards establishing more advanced corporate governance standards, unless benefits are immediate and tangible. Arguably, financial sector is the frontrunner of acknowledging the importance of compliance function and integration of it into its organizational structure. This is, principally, dictated by regulatory demands to establish internal audit committees or risk management committees[6] in certain industries.

Recent legislative changes aim to promote the idea of having internal audit committee at companies in Azerbaijan, linking them to certain thresholds regarding the size and significance of company, with compliance function still appearing as a distant idea. Yet global corporate governance trends require faster and voluntary action.

4. http://www.sec.gov/litigation/admin/2015/ia-4126.pdf

5. KPMG's Global Compliance Survey 2016

6. "Corporate governance standards at banks" of the Central Bank of the Republic of Azerbaijan

Author's biography

Mr. Farid Isayev *is director at KPMG in Azerbaijan, heading law practice. His previous work experience includes: commodity trader- Glencore Xtrata (London), banking and insurance sector in Azerbaijan and another Big4 firm prior to joining KPMG.*

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