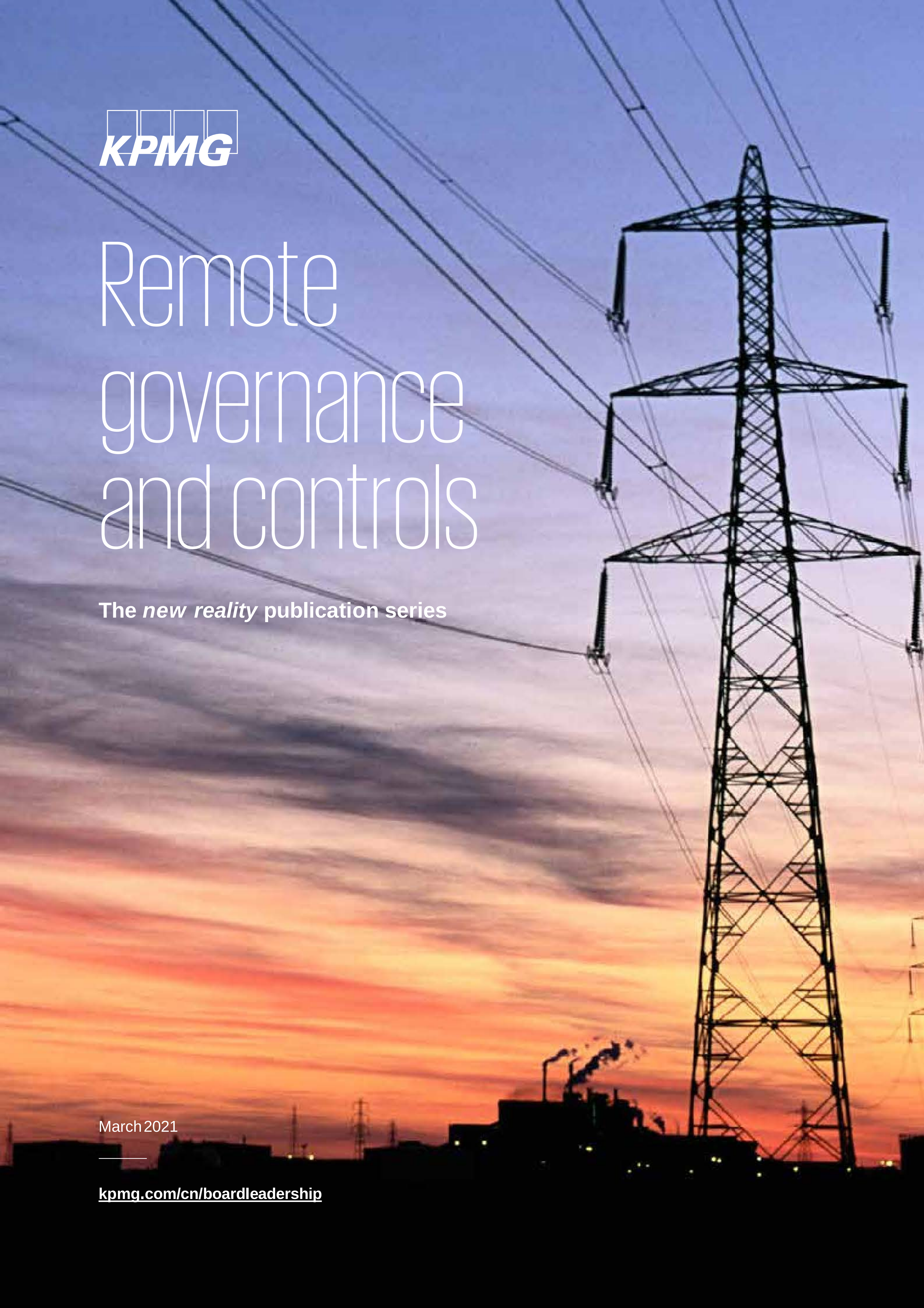

Remote governance and controls

The *new reality* publication series

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Contents

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Executive summary

The impact of COVID-19 lockdown measures on firms' existing governance arrangements and controls cannot be underestimated. There is unlikely to have been a stress scenario planned – or even envisaged – close to the upheaval caused by the pandemic. There is recognition that, overall, firms and regulators alike have fared reasonably well, in response to the immediate impact. However, governance arrangements and controls need to be reinforced and enhanced, and the pandemic has given firms and regulators an insight into how things could be done differently in the future, recognising that further, potentially more impactful, challenges may still arise. Both need to seize the opportunity being presented to them.

The key realisation and reassurance for firms has been the pivotal role that culture has had to play in how well they have fared in the transition from immediate response, through recovery and into the new reality. Regulators are increasingly making the link between a firm's culture and good customer outcomes. Traditional control mechanisms and oversight arrangements have been less efficient or unable to function due to large-scale remote working. A firm's culture can help to ensure that all lines of defence and governance arrangements follow the spirit of their intentions rather than the prescriptive letter of a policy or process, generating good outcomes and minimising reputational risk.

As some employees venture back into the office, a hybrid model of remote and office working is likely to be in place for a sustained period and could become a permanent feature. Firms will need to adapt existing controls so they can operate effectively and efficiently, including re-evaluating whether the risk acceptance agreed around immediate remote working procedures and controls remains appropriate. Firms with an existing culture of customer-centricity and employee empowerment will find it easier to maintain this remote way of working but will need to re-assess support for and monitoring of new recruits. Firms that are not used to adopting such a devolved approach may face a more significant challenge in trying to determine, cascade and embed the desired culture.

The need for change is not limited to firms – regulators will need to adapt too. Many regulators have been praised for their immediate response to the COVID-19 challenges, demonstrating both agility and pragmatism. Firms may expect this to be the new operating norm.

Governance arrangements

Strong corporate governance is the glue that holds a firm together and is placed under strain in times of crisis. The pandemic caused an additional challenge of connecting rapidly-deployed crisis management processes with governance and risk management arrangements. Existing conventions and controls required immediate attention to ensure they remained effective. Firms have had to deploy short-term fixes to ensure they can still meet customer needs and regulatory expectations.

The emphasis that has grown in recent years on go healthy and purposeful culture driving good conduct by firms becomes even more important where employees are operating more often in isolation. However, the ability for firms to build and embed their cultures is harder in a remote working environment.

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With necessity being the mother of invention, firms have identified some benefits of adopting a more technology-based focus to their governance arrangements. Firms are experiencing better quality meetings, and meeting packs are more focused and less cumbersome. Therefore, there are some positives that firms will want to embed going forward. Equally, regulators will be keen to understand how effective these tactical measures have been and how firms are maintaining robust and objective decision-making in the new environment.

> "Firms will need to adapt existing controls so they can operate effectively and efficiently"

Risk management and controls

All functions of the firm have been impacted as a result of the rapid increase in remote working. For risk management, the focus will have been on recalibrating risk and rethinking the associated controls. The consequent changes may have led some firms to revisit their risk framework or agreed risk appetites. Also, controls came under stress and some suddenly became less effective. Tactical solutions needed to be speedily deployed.

The risk management, compliance and internal audit functions have all been challenged by the lack of ability to perform physical oversight in the office. Firms will need to develop new processes, practices and controls to manage effectively new or heightened risks. Irrespective of any new controls, firms will need to remain reliant on the individual conduct of employees, to a greater extent than before. Where hybrid working arrangements become permanent, firms need to think carefully about how best to continue to encourage good conduct from their employees and whether old controls are still fit-for-purpose.

Considerations for regulators

Regulators will want to better understand many of the issues highlighted in this paper. They are interested in how firms have responded to the pandemic, whether they have coped appropriately, whether customers have been treated fairly, how firms have communicated to them and what lessons can be learned. Regulators have been consistent in their expectations that firms should balance their own commercial and operational interests with those of their customers.

We are also likely to see regulators revisit their requirements or expectations, and their supervisory approach and tools. Extensive use of guidance during the early stages of the pandemic allowed supervisors to be more agile and to give firms more latitude about how best to generate desired customer outcomes. The potential operational efficiency gains from being able to respond with agility and less prescription about the inputs could become increasingly popular among supervisors. It is an open question whether rule makers will follow suit.

The role of technology cannot be underestimated as regulators seek to become more proactive and led by intelligence. They may have identified some internal inefficiencies in their own governance and decision-making processes in the light of the need for agile responses to the market and consumer protection issues at the height of the pandemic.

Questions for CEOs to ask

Corporate governance	Are the design and operation of our corporate governance arrangements still appropriate, given our business strategy and culture? Are we able to make well-informed and well-evidenced decisions?
Individual accountability	Are we still able readily to identify individual responsibility and accountability without overlaps or gaps on specific topics? Have any senior responsibilities changed as a result of the response to the pandemic?
Risk management and controls	Have we recalibrated our risk management controls and associated metrics, and adapted them where necessary? Have we considered how well they will operate longer term?
Oversight arrangements	Can we evidence our decision-making process and justification for deferring or re-scoping reviews by the second and third lines? What are our plans to complete deferred and new post-pandemic reviews, and how will they be resourced?
Customer-centricity	Can we illustrate how our governance and controls have operated to ensure we have balanced our own commercial and operational interests with those of our customers? Can we evidence that we have reasonably identified all (potential) circumstances of customer detriment and remediated them, where appropriate?
Conduct risk	Have we proactively identified new or heightened conduct risks? Have we developed appropriate mitigation strategies to minimise the risk of harm to markets or customers (especially vulnerable ones)?
Audit trail	How robustly have we documented and how well can we evidence augmented governance, risk management and risk controls?

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01. Corporate governance

Although stressed and strained, firms' governance arrangements have generally stood up well to the test of full-scale remote operation and dealing with the unprecedented circumstances that the pandemic has created. Some key meetings will have been adversely impacted by the lack of face-to-face engagements – typically, when those engagements are more creative or investigative in nature. However, many firms are experiencing more positive impacts than negatives.

Firms will want to continue (in full or in part) the technological aspects of conducting meetings online where they help to make a firm's corporate governance mechanisms more efficient and effective. As a minimum, firms are likely to operate a hybrid model in the new reality – alternating between face-to-face and remote, as and when appropriate. There are legal and tax issues to address, though, not only in relation to governance arrangements but also if staff are working remotely from different jurisdictions.

Firms will also need to consider how their arrangements are viewed from an external perspective. Given the potential impact of the COVID-19 outbreak on market volatility and liquidity as well as credit quality, the Securities and Futures Commission (SFC) issued a circular[1] to remind licensed and registered persons on their suitability obligations under the Code of Conduct to act in the best interests of their clients.

Strategy and business model

Given the impact of the pandemic on economies, market volatility and customer behaviours, firms will need to re-assess and realign their business models and product offerings, with possibly broader strategic implications.

Insurers are a good case study where changes to expected behaviour patterns have impacted different business lines in diametrically opposed ways. Life insurance businesses, for example, have dropped considerably due to mainland customers are unable to be physically present in Hong Kong to complete the contracts as required by regulations. At the other extreme, accident & health business and employees' compensation business have improved due to lower reported claims resulted from the subdued economic activities and the deferral of medical care.

[1] https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=20EC25

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> Remote meetings are not a panacea

Board and committees

Most firms have experienced an increased level of activity within their Boards and sub-committees, with many calling extraordinary meetings. Internal management meetings were typically called more frequently and lasted longer, as firms devised both tactical and strategic responses. For example, when market volatility was especially high, asset valuation and fair value pricing committees had to meet daily to discuss asset values in even the most liquid securities markets.

As the initial response has subsided, firms are now using their experience over the last couple of months to re-assess the structure, attendees and frequency of governance meetings. Many firms have experienced positive impacts of remote meetings. They have provided greater opportunity for all to contribute and can be less dominated by a central actor(s). Although the meetings may take longer, there is a consensus that generally they are generating better outcomes. Whilst firms are unlikely to move to a completely remote arrangement, there is an expectation that firms will have a hybrid of face-to-face and remote meetings, depending on their nature and content.

Logistically, meetings are easier to arrange, as the cost, inconvenience and carbon footprint of travel to a central location can be significantly reduced, making meetings more straightforward to organise. Urgent agenda items are less likely to be carried over until the next meeting. For attendees, the experience has also become more efficient – rather than waiting outside a meeting room to be called in, they can continue to work until they are invited or admitted from the virtual lobby.

The ability to record meetings that happen entirely remotely provides a robust audit trail for the relevant considerations and discussions, which has provided firms with a valuable added benefit. Summary minutes are still used to record the key decisions, but the meeting recording can act as a future comprehensive and contemporaneous record.

Notwithstanding the changes to meeting dynamics, regulators will still expect to see evidence of robust challenges and questions in board meetings, especially from non-executive directors.

Remote meetings are not a panacea, though. There are some issues that firms and regulators will need to address. Connectivity problems, call latency issues and dropouts all adversely impact the quality of the discussion and can even result in key points being missed. Firms are investing in hardware and software configurations to make the virtual meeting as real as possible.

There will also be procedural issues to resolve. For example, the company articles of associations or committee terms of reference may need to be updated to reflect the ability for remote operation where they stipulate a minimum 'in-room' quorate. Finally, the ease by which remote meetings can be recorded as a complete audit trail could lead to regulators evolving their expectations of all board and committee meetings, face-to-face as well as virtual.

General meetings

The first step in considering virtual meetings is to check the Articles of Association to review if and how they allow for electronic meetings.

Section 584 of Hong Kong's Company Ordinance permits a company to "hold a general meeting at 2 or more places using any technology that enables the members of the company who are not together at the same place to listen, speak and vote at the meeting". While the Company Ordinance confirms that participants can join the general meetings virtually, holding the general meetings entirely virtually may not be recommended since the section specifies "2 or more places" which seems to suggest that having at least one physical venue is preferred. When holding virtual or hybrid general meetings, it is also important to make sure the virtual meeting platforms are able to hold the large number of participants and have proper mechanisms to count and record votes.

Individual accountability

Where regulators have implemented individual accountability regimes, over and above fitness and properness or qualification requirements, they have identified that these have been beneficial in terms of greater clarity. This may accelerate other regulators' thinking in terms of rolling out similar accountability regimes.

For example, the SFC has implemented a Manager-in-Charge (MIC) regime[2] where a licensed corporation must appoint an individual, either alone or with others, to be principally responsible for managing each of the corporation's eight Core Functions. The MIC regime is intended to add clarity as to which individuals should be regarded as members of the senior management of a licensed corporation and heighten their awareness of accountability, regulatory obligations and potential liabilities. The regime also aims to help strengthen the corporate governance of licensed corporations and better align senior management with the existing regime governing responsible officers.

[2] https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/licensing/doc?refNo=16EC68

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For jurisdictions with an individual accountability regime already in place, it will provide useful learning about how the regime operates in times of stress. Regulators will seek to use this as an opportunity to ensure that firms have fully embedded it into their approach, including associated governance and risk management processes. When a firm's organogram or allocation of accountabilities creates challenges for the firm to be able to respond appropriately, there is an expectation that changes will be made swiftly to ensure that the firm is better prepared for the next unforeseen challenge.

Management information

Given the extenuating circumstances, there has been an acceptance that firms have struggled to gather the optimum level of data to generate actionable MI. Firms with material data gaps have had to make broad assumptions (or rely upon external data as a proxy). Conversely, some firms are suffering from data overload and are equally challenged in terms of making informed decisions in an efficient and effective manner.

Meeting participants are increasingly using a tablet or laptop to review meeting documents due to inability to print large-scale packs remotely. This is having a positive impact on firms looking to reduce the length of meeting documents to a more manageable size and to develop a more intuitive format and flow.

As firms increasingly move away from large and paper-based meeting packs, they will need to explore how best to meet the information needs of the relevant members in a format that is comprehensive and engaging, but not unwieldy. The meeting pack needs more clearly to signpost the key messages and points to consider, while still allowing members to form their own view and to challenge or suggest other areas of priority. Striking the right balance is a challenge and is something that firms should reflect upon.

Clear presentation of information with appropriate hierarchies may help firms to operate more efficiently and effectively and to provide evidence to regulators regarding how the business is performing, the key risks they are facing (and addressing) and the customer outcomes they are delivering.

> "Clear presentation of information with appropriate hierarchies"

Decision-making

Using detailed meeting packs remotely (ordinarily via a shared screen) ensures that, once in the meeting, all participants are focussed on the same issue at the same time. The mechanics of a remote meeting lends itself to a more considered inclusion of all key stakeholders' views and the ability to present a specific section of a meeting without being interrupted. Quieter individuals may feel freer to express their view remotely compared to face-to-face. All these factors assist in more well-rounded and informed consideration of the issues at hand, thereby creating a more effective and efficient basis for firms to make more fully informed decisions. This could prove a useful approach for all future meetings – even face-to-face – to ensure they stay on topic and that the views of all parties are sought before a decision is made.

Perhaps counter-intuitively, industry commentary has suggested that people are generally more polite when communicating via phone or video conference. They are less inclined to interrupt someone when engaging remotely as the normal visual clues (hand gestures or body language) are less obvious. They tend to make their point and then wait for the response in a more disciplined manner.

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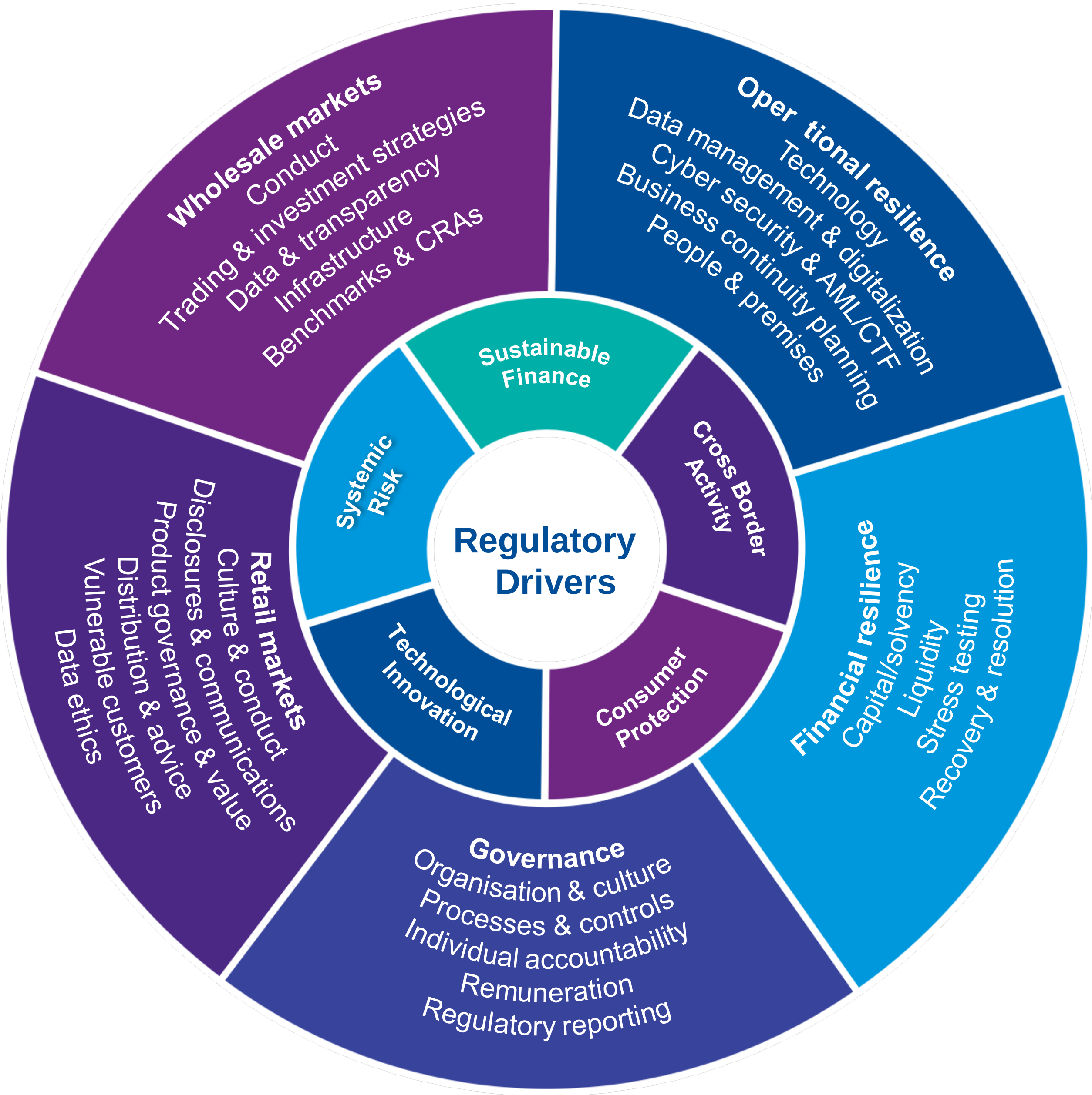
Five key drivers are influencing regulatory priorities



The governance of regulated firms remains one of the top priorities for regulators. Five key drivers are influencing this and other regulatory priorities. Consumer protection and financial stability are the bulwarks of much financial services regulation, but the impacts of the pandemic and lock-down measures have brought additional topics to the fore. Volatility in capital markets has led to a renewed focus on systemic risk in relation to computer-led trading strategies and certain types of funds. Also, the pandemic has accelerated trends in the use of technology and demands for sustainable finance, and there are new challenges to doing business across borders. These three trends are now equally prominent drivers of regulatory priorities.

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02. Oversight and control

Risk management, oversight and controls have been made more challenging, to varying degrees, by the lack of ability to perform physical oversight in the office. Traditional risk management processes and controls will have presumed that much activity takes place in the office and may not be as effective with large- scale remote working. Risk identification, mitigation and monitoring will all have been impacted, directly or indirectly.

The focus now will be on reassessing relevant risks, re-evaluating and re-calibrating the risk universe, and validating the appropriateness of associated controls, including increased use of technology. This exercise will likely impact all aspects of risk management (including all three lines of defence), take the form of both top-down and bottom-up analysis, and involve both business and control functions. The outcome could be significant for some firms and could reshape their business model or strategy.

Going forward, a more agile risk management framework will be needed. The new reality will take some time to evolve. Further changes to risk management and controls should be expected, alongside changing business models. Risk mitigation and control will take on a different emphasis. Firms will need to be more reliant on the individual conduct of employees. They may seize the opportunity to replace narrow controls with a greater emphasis on behaviours, to prevent bad actors.

The three lines of defence model

The Three Lines of Defence (3LOD) model tends to operate in constant tension as management seeks to maintain the optimum balance between the respective responsibilities of the three distinct lines: business, risk and compliance, internal audit. As observed elsewhere, we have generally seen firms respond with pragmatism and agility.

Staff have been fungible and have moved lines to help support where the need was greatest, regardless of their primary role. We have also seen the second and third lines defer or suspend reviews to give the first line the capacity to respond to the immediate challenges. The ability to challenge and question, which underpins the 3LOD model, has been challenged by large-scale remote working. The extent of the impact will depend upon a firm's approach to co-location of control functions before the pandemic. Firms need to consider this in the phasing of employees' return to the office. For example, if traders return to the office, do the compliance advisory staff also need to be present in the office?

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As the initial response phase subsides, both the second and third line are considering how to make up for lost time, and how to embrace a more remote approach to conducting reviews for a sustained period or as a permanent feature. Regulators will be keen to see how firms' 3LOD models have stood up to stresses and how firms plan to execute their monitoring or audit plans for the remainder of the year.

First line

Increased supervisory expectations have significantly improved the robustness and resilience of firms' first line – the business itself – especially where individual accountability regimes are in place. Compared to the 2008 crisis, which revealed serious conduct issues, the first line is more engaged, knowledgeable and appropriately resourced (both number of staff and expertise).

> Firms will need to learn lessons fast

The recent experience of many firms has borne this out. Whilst the first line has been significantly stretched, it has not failed. It has generally responded with cautious innovation in seeking to replicate, as far as possible, the operational processes and associated controls designed for a single or small number of office locations to large-scale remote working, with individuals in discrete and idiosyncratic locations.

As firms re-open office locations, a hybrid solution is likely to be in operation for a sustained period. Firms will need to learn lessons fast and implement required changes to procedures to ensure that they operate regardless of location.

Second and third lines

The second line has experienced a knock-on impact from the immediate and tactical responses being adopted by the first line. The area most impacted would have been on firms' existing policies and procedures, which are typically designed for in-office deployment. Special dispensation is likely to have been required to allow the business to continue to operate. Existing policies will have had to be updated quickly. Now that the immediate urgency has diminished, second lines will need to reconsider the raft of existing policies to ensure they remain appropriate for a hybrid model where several individuals, including in key control roles, are likely to remain working remotely for a sustained period. It will re-open the debate about whether the second line is sufficiently technologically enabled and yet is the one that could benefit from it the most.

Oversight functions received unprecedented demands for help and support from the business during the early stages of the pandemic, not only in responding to the volume of changing rules and guidance, and dealing with queries from the business, but also directly supporting the business. The broad skillset of oversight staff has seen them re-deployed into the first line to provide additional capacity. On the upside, this may have led to a stronger bond between first and second/third lines. On the downside, it will have put the demarcation between lines of defence under increased strain. Where this has involved internal audit staff, some regulators have emphasised that firms must put in place measures to manage the conflicts of interest of an internal auditor working temporarily in a business area and keep records of who was deployed where.

Compliance monitoring functions have seen reviews suspended or deferred to give colleagues in the business the bandwidth to deal with immediate priorities. Where firms had existing reviews in flight (where discovery had already been completed), agreement of drafting and recommendations has generally been more straightforward. However, conducting certain reviews effectively and entirely remotely presents a challenge. The same applies for the internal audit function. Beyond the simple practical realities of the inconvenience of not being able to print large volumes of documentation to review, there are more impactful barriers to an effective review that firms are trying to overcome. For example, making value judgements about conduct or culture without interacting with colleagues during the review, assessing body language or picking up on more subtle cultural indictors during those interactions could adversely impact the quality of the review.

Some internal audits have been re-ordered to reduce the burden on impacted departments, but firms have also been keen to carry out proactive reviews of the impacts of the modified BAU immediate responses on their risk profile, how new risks are being mitigated and how associated new controls are being tested. Some of these audit reviews have been conducted alongside second line to improve efficiency and effectiveness. For example, some retail banks have deployed "hot reviews" to help test (and support) while operations and processes are being developed to address the forbearance and access to loan initiatives launched by some governments.

As well as revisiting the plan for previously scheduled monitoring reviews, there is an expectation that oversight functions should be designing and executing COVID-19 focused reviews across first line within this review period, including audits relating to return to office working. Firms will have to determine how best to address these two challenges, for instance by continued deferral, deploying additional resources (including technology or external specialists) or rescoping existing reviews.

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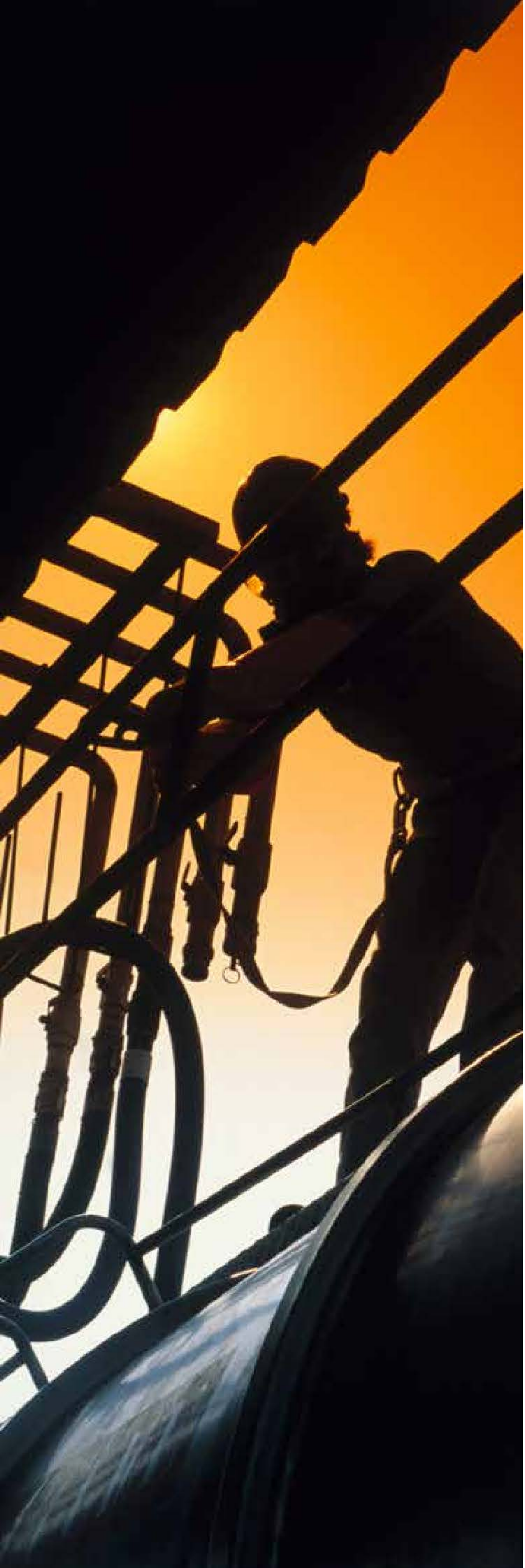

03. Areas of specific focus

Firms' risk controls have been put under significant strain as they seek to continue to deliver services while operating remotely and in volatile market conditions. There are specific topics or activities where the associated risks, controls and potential for consumer detriment have been pulled into sharp focus as a result of the pandemic. They may differ from sector to sector and firm to firm, but those discussed in this chapter are likely to be common to all firms.

In the absence of any publicised and significant detriment or downtime, regulators will be keen to understand whether the more flexible approach adopted by firms can deliver better outcomes for customers or the market more generally in the long-term. Firms and regulators alike will be keen to understand what lessons can be learnt in terms of new operating models and associated controls, with increased use of remote access and digital solutions.

People

HR departments have experienced challenges as they sought to maintain the wellbeing of existing employees and to manage the recruitment process remotely where capacity or capability gaps were identified. These factors could have an adverse impact on how policies and processes are operated in practice, with a consequential impact on firms' risk controls.

Staff were generally not fully set up to work remotely at such short notice and for a prolonged period, leading to health and wellbeing issues. These issues may be exacerbated where individuals have children to occupy and school, and elderly or vulnerable relatives to care for. This is likely to have led to some compromises in terms of productivity and focus, potentially leading to errors that may be more difficult to spot remotely without enhanced or augmented risk controls.

Recruitment has been made more challenging without the ability to interview candidates face-to-face. Trying remotely to convey to and instil in new joiners the firm's culture and processes is a more significant challenge. Linked to this, new joiners with undesirable character or behaviour traits could go undetected for a longer period because

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of the lack of close working and peer or manager contact time and oversight. There are challenges associated with the integration of new joiners, including risks of anxiety, weak motivation, development of poor habits and loss of opportunity to build relationships with the team.

Many of these challenges are equally applicable to existing staff. With remote working, it can be more challenging to make an objective assessment in relation to meeting objectives, performance management and reward decisions, especially where an employee's output is less tangible and quantifiable or where employee interaction is not as frequent.

> "Errors that may be more difficult to spot remotely"

The regulatory emphasis – which has grown in recent years – on the need for good culture to drive good conduct has become even more important in current circumstances, where employees are acting much more as individuals. However, the ability for firms to build, embed and monitor their cultures is harder in a remote working environment. As hybrid working is likely to be sustained, firms need to think carefully about how best to continue to encourage good conduct from their employees.

Firms with good overarching cultures, or strong risk or compliance cultures, will be thinking about what they can do to maintain good behaviours. Indeed, as mentioned in the previous chapter, firms with positive experiences with their staff during lockdown may seize the opportunity to replace narrow controls with a greater emphasis on using guiding principles and good behaviour.

Customers

Whether related to customer servicing or complaints handling, firms and regulators will likely be focused on the outcomes that have been generated by working differently. Crucially, it will be about determining whether firms seized the opportunity to simplify complexities that impact the meeting of consumer needs or that create barriers, intentional or otherwise, in dealing with queries from customers. New ways of working will have generated or heightened, conduct risks. Work may be needed to finesse risk mitigations or more fully embed revised risk controls for the longer term.

Firms experienced a significant increase in calls as customers sought to secure loans or overdrafts, make claims, discuss their financial circumstances or redeem or switch their investments. If such activities are not conducted in an accurate, timely and appropriately sympathetic manner, there is a significant risk of customer detriment.

To deal with the demand, some firms adopted technological solutions, such as specific pages on websites conveying information to assist in decision-making. Some designed and deployed chat-bots to address more straightforward queries and increasingly signposting customers to self-direct, either through online servicing or directly via apps. This helped firms to focus telephone conversations with more vulnerable customers. However, these digital and online tools would have been re-designed at pace and existing controls may not have been as effective.

Financial difficulties or general market volatility tend to generate an increase in the level of complaints from customers. The impact of the pandemic has caused both factors to occur in tandem. Firms continue to experience higher than normal complaint volumes while trying to remain operationally functional and handle complaints remotely and efficiently. Some firms have had to revisit their previous complaints playbook, considering the specific set of circumstances that the pandemic has generated. It has taken time to agree and train handlers to ensure continued consistency of outcomes that are aligned to regulatory expectations.

> "Requirements that presume face-to-face meetings or the provision of paper documentation will need to be revisited"

In response, many regulators have either remained silent or have merely reiterated the need for customers to be treated appropriately without providing any concessions on associated timelines. However, SFC has published the circular as a reminder to all intermediaries[3] regrading to the order recording requirements set out in paragraph 3.9 of the Code of Conduct[4]. Under COVID-19 pandemic, SFC emphasizes the importance of complete and accurate records to protect the interests of both the intermediaries and the clients.

More generally, regulators may wish to revisit customer-facing rules that have not operated as intended during the pandemic, from an operational perspective. Requirements that presume face-to-face meetings or the provision of paper documentation will need to be revisited. And some temporary concessions may remain permanent – for example, the MiFID II client disclosure requirement where a portfolio value drops by over 10% was temporarily disapplied as high market volatility resulted in multiple disclosures over a short space of time. The current review of MiFID II could lead to this requirement being removed or, at least, modified.

[3] https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=20EC26

[4] https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/20200901codeofconductforpersonslicensedbyorregisteredwiththesecuritiesandfuturescommission.pdf

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Data Protection

The increase in and expected long-term nature of remote working have placed existing data protection processes and controls under strain, which could lead to compromising of customers' data. Firms will have identified and deployed additional controls to address the new risk from long-term remote working while processing personal data (disabling memory sticks, for example).

Such additional controls may not fully compensate for the discipline imposed when physically present in an office environment. The fear of being spotted goes a long way in ensuring that individuals deal with data appropriately. In a remote setting, an employee is freer to copy and share sensitive data via personal devices, with a significantly reduced risk of discovery. Existing data risk controls were not designed for the current volume of remote working. Tactical solutions being deployed will need to be further developed to ensure they are robust in the longer term.

Wholesale Markets

In primary markets, the key conduct risk is around market sensitive information. Firms have in place controls around both physical and virtual access to this information, which should be available only to those who need to know it. Controls around virtual access should not change in the remote working environment, unless there are IT issues for staff accessing information through Virtual Private Networks (VPNs).

Controls designed for the physical environment are more difficult with remote working, which has heightened the risk that sensitive market information may be overheard by relatives or house-sharers working in the same room or passing by. Firms' ability to manage this risk relies on individual employees understanding the risks and taking measures within their home or remote location to manage them. Emphasis should therefore be placed on training employees to understand the risks and the implications of not managing them. This may feel uncomfortable for senior managers, but they have arguably always overestimated the amount of control they had over information once employees were out of the office.

> "Firms may also need to review surveillance methods"

The supervision of secondary market traders has also developed over the last few years, with many firms investing in technology that identifies and requires line management to review limit breaches, near misses or unusual behaviour. These systems should still work in a remote environment, although recent market volatility will have tested them. On the other hand, managers will have less direct insight into a trader's behaviour that might give an indication there is an issue, such as looking stressed, shouting, not answering phone calls etc. The ability directly to challenge or question an employee, by management or risk functions, becomes harder if they decide not to answer a video call. Employees may be less willing to escalate an issue or ask for help if it involves calling someone – although 'instant messaging' might help. All these risks need to be controlled and monitored.

Financial crime

Cybercrime, fraud, market abuse, money laundering, bribery and corruption are all heightened risks as firms seek to respond quickly to new processes, procedures and ways of working, without the opportunity to design, deploy and test appropriate control environments. Criminals have used COVID-19 and associated lockdown measures as an opportunity to defraud customers or other companies. Long-term remote working may also enable dishonest

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employees to take advantage of the reduction of controls (or their effectiveness). Firms will need to develop more sophisticated controls to identify and counteract such behaviour.

In the efforts to prevent money laundering and fraud, restrictions on non-essential travel and social distancing measures have impacted firms' ability to use traditional methods to verify a client's identity as part of the onboarding process. Regulators will expect firms to follow guidance on remote verification of client identity and the additional checks that may be needed. If firms' client onboarding processes are changed, they should be kept in line with their overall risk assessment and risk profile of customers.

Surveillance systems, whether used to monitor market manipulation or financial crime, will have been put under great strain during the pandemic. Increased volumes and volatility in the wholesale markets will have increased the number of alerts. Systems use algorithms and artificial intelligence based on expected customer behaviours and activity patterns. Abnormal spending patterns during lockdown have led to an increase in the number of false positives, which could increase the risk of a real fraud going undetected. As firms review their risk controls, they may need to recalibrate their surveillance systems to take account of changes in customer behaviour and possible further market volatility measures.

Remote working IT systems and telephones may not have fed into surveillance systems. Supervisors have emphasised that firms should continue to record calls, although accepting that there may be some scenarios where it is not possible in the short term. Looking forward, they are likely to require firms to develop or install technology to be able to record remote calls.

Firms may also need to review surveillance methods, given the high proportion of employees that will continue to work from home, the changes this will bring to customer communication and privacy challenges. This will include a re-evaluation as to whether the risk acceptance that firms agreed around immediate remote working procedures and controls remain appropriate with sustained remote working. One extreme would be to use technology proactively to monitor and supervise employees remotely. Whilst this may be attractive from a risk controls perspective, it may operate contrary to a firm's broader desire to build or maintain a culture of trust.

Specific focus areas will include:

People	How best to continue to encourage good conduct from employees? Should old narrow controls be replaced with a greater emphasis on good behaviours and outcomes?
Customers	How should risk mitigations be finessed or revised risk controls be more fully embedded? Are existing controls effective for digital and online tools that were re-designed at pace?
Data protection	Do additional controls fully compensate for the discipline imposed when physically present in an office environment? How can temporary solutions be made robust in the longer term?
Wholesale markets	What additional training is needed to ensure that employees understand the risks associated with remote working and the implications of not managing them? How can employees be encouraged to escalate an issue or ask for help?
Financial crime	How can more sophisticated controls be developed to identify and counteract criminal behaviour? How do surveillance systems need to be recalibrated to take account of changing customer behaviours and remote working?
Outsourcing & third party risk	How can initial due diligence processes be deep and robust despite limited access to suppliers' premises? What additional information sources can be accessed or developed to monitor suppliers and investigate concerns?
Technology	Are IT staff being recognised as key individuals? How well understood are the stresses and strains that the systems are under, how are the resulting risks being managed and how are lessons learned being factored in?

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For example, if it is impossible to stop traders working from home using their mobile phones for trading, how can that activity be monitored? Do interactions that would have taken place with customers in branches but are now taking place over the phone need to be monitored? Are online chats or bots feeding into surveillance systems? Similarly, regulators will have to adapt their market monitoring systems and deal with the likely increased volume of suspicious transaction reporting from firms.

> Overseeing an outsourced activity remotely is an extra challenge

Outsourcing and third-party risk management

Oversight of outsourcing and third-party risk management are challenging for firms at the best of times. Trying to ensure that outsourcing arrangements discharge the firm's regulatory responsibilities accurately and in a timely manner, while operating remotely, adds extra pressure. Firms typically outsource based upon capacity, capability and cost. Capacity is a significant challenge for firms while lockdown measures are in place. As noted above, this has led to fungible people resources being moved to areas of immediate need and potentially away from the oversight of third parties.

Like other activities, overseeing an outsourced activity remotely is an extra challenge. Supervisors have flagged issues and concerns about how firms have established and maintained relationships with third-party suppliers. This is likely to be an area of continued regulatory focus. Firms have been hampered by not having arrangements in place that allow them access to third parties' operational premises or by not being able to do so while COVID-secure restrictions are in place. This has made it difficult to verify that all is working as intended and to challenge management face-to-face. Firms using providers with offshore operations may encounter greater difficulties in assessing current service levels and risks.

These issues are especially important where firms have concerns about or are seeking to monitor the resilience of the third party. Firms need to develop alternate sources to gain this reassurance. This might include seeking new or additional MI and holding more frequent discussions with the third party. Some firms are adopting "customer outcomes" testing by engaging with end customers to understand their perspective and to measure the outputs being generated, rather than the specific inputs or process.

These challenges are exacerbated where the firm is in the process of seeking to establish a new outsourcing or third-party arrangement, with an obvious impact on the depth and rigour of the initial due diligence process, including assessment of capability, capacity and culture.

Use of technology

As firms closed their offices, the initial wave of direct impact was on the firm's IT department, ranging from sourcing and configuring laptops to adding bandwidth to servers to cope with the rise in remote users. Increased remote working creates new points of critical dependence on specific systems or puts pressure on bandwidth and scalability. The rise in the use of cloud services and remote networking has reduced the reliance on the physical building, but not everything can be done remotely. IT staff were amongst key individuals that may not have been immediately identified as critical.

The speed and agility with which new technology and online solutions had to be deployed will have put a strain on existing risk controls. With the immediate response quietening down, firms will need to understand better how resulting risks were managed, whether any material outages or issues occurred to the detriment of customers, the firm's financial position or its operational resilience, and how lessons learned will be factored in.

Notwithstanding how well firms have coped in the immediate response phase, there will be significant learning points for operating post-lockdown that will need to be reflected in firms' policies, procedures and risk controls. Regulators will expect that shortcomings and issues where controls have not operated as intended are remedied swiftly, especially where customers have experienced detriment.

The points covered in this chapter, and firms' own experiences and specific considerations, should also be fed into operational resilience modelling and planning. This will help to understand what lessons can be learned so that firms have the right balance of resilience for future shocks. For example, some firms are considering whether their existing disaster recovery/business continuity policies may now largely be defunct, given they have effectively been operating a "working-from-home" solution rather than moving to a warm site.

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04. Impact on regulators

Much has been made about the agility and pragmatism that regulators have shown in supporting firms during the immediate impact of the pandemic and lockdown measures. Responses to consultation papers were deferred and implementation dates for non-urgent regulatory change were pushed out. Regulators relaxed existing rules and published new guidance to help firms deal with these unique circumstances, to enable markets to continue to work effectively and to ensure firms treat customers fairly. The approach to engagement with regulated firms has changed and may provide a blueprint for a new approach.

Regulatory approach

The way that many regulators engaged with firms has been different – more collaborative, proactive and less prescriptive. They engaged very early on to understand the pain-points that firms were experiencing. Some discussed potential solutions with firms before making announcements or issuing short consultations on how firms could operate to address identified risks.

Regulators have not issued significant volumes of new rules. Instead, they have generally communicated with high level principles and stated outcomes they are seeking to achieve. Firms have responded well to this. It provides a blueprint for regulators to become more outcomes-focused and less prescriptive, to give firms more flexibility while ensuring they are accountable. Regulators have intervened much earlier than might ordinarily be expected. They have focused on innovative solutions and supervisory interactions, rather than waiting for risks to crystallise and following up subsequently with censure and enforcement.

Effective supervision

In challenging times like these for firms, supervisors tend to respond initially very well as they are focused on the core issue and, more so than in calmer times, tend to work more collaboratively with regulated firms. Supervisors have proactively engaged with firms to understand the pinch points and challenges, and then responded with agility and pragmatism in their supervisory approach.

Building on these constructive relationships, the onus is now on supervisors to transition from immediate response to a more collaborative and agile approach in the post-pandemic reality. For example, we have seen supervisors inform firms of the specific risk they are concerned about

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and ask firms what MI or data they have that can support or disprove that risk. This is arguably a more efficient and effective model than simply requesting data from firms and trying to draw conclusions from “cold” data.

> A more collaborative and agile approach in the post- pandemic reality

That said, there is a clear need for supervisors to be more intelligence- and data-led as a model for future effective supervision. Some regulatory reporting standards have been in place for over a decade and may not now be valid, given how markets and sectors have evolved and increased adoption of technology, including as a distribution channel. However, the flow of intelligence to regulators has been disrupted by the pandemic. Typical reporting of market surveillance and transaction reporting have impacted the ability of regulators to possess a complete picture of how the market is operating.

Although much of a supervisor’s workload is desk-based, a material aspect of effective supervision is physical visits and meetings with firms. While working remotely, supervisors will be hampered in how effectively they can supervise firms. As firms return to their offices, supervisors will need to develop an appropriate contact strategy to ensure that they can still obtain key regulatory intelligence, while not putting their employees or individuals in regulated firms at risk. Therefore, we expect that supervisors will be more strategic with their face-to-face engagement as this will remain an effective deterrent as well as a vital tool for effective supervision of a firm’s governance and risk management arrangements.

Resource implications

Supervisors tend to have relatively fixed headcounts and their ability to increase their headcount significantly in response to external factors is limited. Therefore, supervisors will need to develop their staff to ensure they are as fungible as possible, until the sectors most adversely impacted and the materiality of the number of firms in financial distress are fully understood. To respond appropriately, supervisors may come under pressure to move fungible resource out of non-urgent non-firm facing activities in order to supervise more effectively during these unprecedented times. As supervisors revert to business as usual activity, some functions may be identified as less relevant going forward.

Data strategy

As well as developing strategies to ensure that firms are using data in an appropriate manner, some regulators are seeking to use data to become more effective, efficient and intelligence-led, in both the making of rules and in supervisory activities. In direct response to the pandemic, regulators sought specific data from firms to understand and quantify the risk in the marketplace to drive appropriate regulatory responses. For example, almost all supervisors asked for more, and more frequent, data from fund managers about the liquidity position of open-ended funds.

Some regulators had already published data strategy plans, to use data more effectively, and COVID-19 is likely to accelerate this. There is certainly more that regulators could (and should) be doing with the existing data they receive. However, a more fundamental re-assessment is required of the data that regulators really need and for what purpose. Only by starting with a blank sheet of paper and seeking to understand why data needs to be collected, will regulatory reporting be generated that is proportionate to the new reality risks that regulators are seeking to assess. Regulatory returns are rarely routinely updated. Until regulators conduct root-and-branch reviews of their data needs, regulatory reporting will continue to be a growing burden for firms and a source of inefficiency and ineffectiveness for supervisors.

> A more fundamental re-assessment is required of the data that regulators really need and for what purpose

Enforcement

Enforcement, more so than any other supervisory tool, requires physical entry to premises and extraction of physical (and digital) items, such as hard drives and paperwork. Therefore, lockdown measures and remote working are even more of an impediment for effective enforcement investigation activity than for day-to-day supervision. Personal distance requirements have also limited the ability of regulators to conduct recorded interviews at their premises.

Firms may have breached regulatory requirements and expectations due to the pandemic. We do not yet know how regulators will view any significant rise in regulatory breaches during this period, whether the pragmatic approach will be sustained and, crucially, where regulators will draw the line in terms of breaches deemed outside their regulatory appetite. In determining enforcement activity, some regulators may choose to focus on outcomes generated rather than assessments based upon specific rule breaches. This will heighten the onus on firms to have designed, have deployed and be able to evidence the governance, risk management and controls they have relied upon in response to these unprecedented circumstances.

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