



complinet

www.complinet.com

Executive Whitepaper

The future of regulatory change: preparing for tomorrow, today

How to future proof your firm

This Executive Whitepaper discusses the challenges that the modern financial services firm faces in today's highly regulated market. It takes a look at the process of regulatory change and the indicators that act as early warning flags today, to the regulation and enforcement actions of tomorrow.

It describes the difficulty of detecting, tracking and understanding the volume of these change indicators and how firms have traditionally resorted to throwing more and more manual and costly resource towards trying to monitor change.

It concludes by presenting the way in which many proactive financial services firms today, are future-proofing their business for tomorrow.

By Alex Viall

"[A]n effective compliance program must continue to evolve and, to do so, the program must be able to identify, meet, and incorporate changes in your business and changes in your customers, to continue to identify conflicts of interest, to be responsive to changes in the statutory and regulatory regime, and to continually strive to find the best technology and the best people."

Lori Richards, director, office of compliance inspections and examinations, US Securities and Exchange Commission

Survival and success in a highly regulated environment

Financial services organizations currently face two significant challenges to their survival and success: continued revenue generation and regulatory compliance. The two elements are sometimes in conflict but the survival of the entity relies on sufficient compliance to allow the revenue earners to keep the business viable.

Some C-level executives have claimed that their business is now driven by regulation; this may be an exaggeration but there is some truth in this. There is no doubt that intense regulatory analysis is required in advance when organizations are assessing entry into new markets, whether by geography or product.

The reality of conducting compliant business in the current regulatory environment is particularly burdensome. In a perfect world, regulated entities need an appropriately experienced and well-resourced legal and compliance team, working alongside responsible senior managers and business lines.

This team must keep managers and the business informed of relevant regulatory changes, and advise on (and sometimes implement) required action as a result of that change. In addition, the team needs to be close to the way the business is developing internally so that changes in the business profile can be accounted for from a regulatory perspective. Ideally this level of communication and teamwork between the interested groups should ensure that adequate arrangements are in place ahead of external regulatory change or internal business change. This is not always the case in practice.

On top of this is the need to monitor existing business to ensure that it is compliant. This is not as simple as it sounds. The factors that really multiply the challenge for the legal and compliance practitioners are the complexity, diversity, and pace of regulatory change.

360 degree vision in a storm of regulatory change

The modern legal and compliance team has a tough task. It is the organization's regulatory barometer, testing the current temperature within but constantly looking without to identify potential regulatory storms ahead. This regulatory watch is only the first step in the workflow process; once the regulatory shift has been highlighted, it needs to be analyzed and contextualized so that appropriate action can be taken to inform and train the relevant personnel within the organization.

Other actions may also be required: An organization may need to inject more capital into the business, create new policies and procedures, and notify regulators. Once again, these shifts could have originated from the business itself, or they may have been driven by external factors beyond the entity's control. Both instances require the constant attention of those charged with the task of "watching the weather."

Regulators assess the ability of the regulated to stay ahead of, respond to, and cope with regulatory change. It is not unusual to hear regulators promoting a "holistic" approach to compliance; examiners are increasingly gauging the overall attitude towards compliance throughout the organization. This includes the knowledge and experience of senior managers, their engagement with, and attitude towards, compliance, as well as evidence of a strong and even compliance culture. Hand in hand with this is the inherent risk attached to the type of business done, the efficiency of the entity's systems, controls, procedures and supervision, and the resources used to satisfy regulatory requirements in terms of the quality and number of legal and compliance personnel, as well as the tools available to them.

The regulators want to feel confident that the firms they oversee are equipped to monitor the changing regulatory environment, and are close enough to the front line of their business to be able to apply that change proportionately.

When the mistakes of the past shape the present

Regulatory change in the financial services markets in the last ten years has been reactive and driven by various instances of market abuse, systemic weakness and structural failure.

To some extent, change is influenced at the highest level by the broad objectives of regulators, whose power is usually derived from government, but these objectives are often shaped by previous inadequacies in the overall regulatory structure.

The biggest challenges that regulators faced in this time period have centered on: the increasing complexity of financial services markets and products; easier access to retail investors with limited understanding of risk and financial literacy; the globalization of markets; the rise of financial fraud and crime; thinning margins and sectoral consolidation; and the constant development of new technology available to investors and regulated, as well as unregulated, organizations.

Examples of negative incidents that have led to significant regulatory change in the last 30 years include:

United States

1998 — Long Term Capital Management, a vast hedge fund group, implodes and requires a regulatory rescue effort to avert systemic risk after incurring losses of \$4.6bn in four months.

2000 — The dotcom bubble bursts. A slew of regulatory actions start because of claims that investment banks have "pumped" the market in tech companies at the expense of retail clients, despite muted reservations expressed internally by many of their analysts. Eliot Spitzer, then New York State attorney general, goes after the biggest Wall Street firms by subpoenaing e-mail records and negotiates a massive cumulative settlement of \$1.4bn. New rules on research and conflicts of interest follow.

2001 — The USA PATRIOT Act is passed 45 days after the 9/11 attacks to empower law enforcement agencies to pursue terrorists in the US and abroad. It expands the Treasury's ability to regulate financial transactions and places extensive new compliance burdens on financial institutions.

2001 — Fraud is uncovered at Enron, a largely unregulated energy conglomerate and one of the largest success stories in US company history. Its demise leads to extensive new regulation on corporate governance.

2002 — Frank Gruttadauria, a branch manager of SG Cowen Securities and Lehman Brothers, is found to have defrauded 50 of his clients of more than \$40m over a six-year period. Congress accuses the regulators of sleeping on the job. The US Government subsequently introduces stringent new supervisory rules for firms.

2003 — The widespread market-timing scandal comes to light; again Spitzer is closely involved in the discovery and the prosecution of hedge funds and mutual funds colluding in abusive late trading.

2005 — Reports emerge that the chief executive of Refco, a large commodities and futures broker, has hidden \$430m in bad debts from investors and auditors. The company files for Chapter 11 and its shell is later bought by Man Financial.

2006 — Amaranth Advisors, a multi-strategy hedge fund with \$9bn under management, bets on oil futures and gets it catastrophically wrong, losing \$6.5bn.

United Kingdom

1980s — Widespread pensions mis-selling: commission-hungry salesfolk encourage clients to switch from solid occupational schemes to unsuitable personal plans. Some 1.7m clients are affected and compensation of £11.8bn is handed back.

1988 and 1989 — Disasters such as the Exxon Valdez oil spill and Alpha Piper oil rig fire accumulate losses of \$8bn for Lloyd's of London names. Lack of investment controls and inadequate risk management at the exclusive London insurance market are exposed.

1991 — Robert Maxwell is found to have stolen more than £400m from 32,000 pension scheme members of the Mirror Group. This led to introduction of the Pension Act 1995.

1991 — The Bank of Credit and Commerce International collapses amid evidence of widespread money laundering and fraud. The allegedly \$20bn institution turns out to be worthless. Depositors and creditors lose \$9bn.

1995 — Barings Bank goes under after suffering excess derivative losses in Asia due to rogue trader Nick Leeson and insufficient controls.

1996 — A fund manager at Morgan Grenfell Asset Management abuses restrictions and invests in illiquid and unapproved securities. Due to suspect valuations and tardy management, unit holders are unprotected and the parent spends £200m to remedy the loss.

2000 — Split-cap investment trust mis-selling: retail investors lose millions when fund values drop as markets collapse in 2000. These were unsuitable complex investments sold as "low risk" by institutions.

2001 — Equitable Life, the life insurer, is found to have overstated the value of its clients' policies by £3bn compared with assets held.

But it wasn't all bad ...

Other influences that are indirectly connected to past mishaps include regulatory competition. This is a situation that is generated by international jurisdictions competing for financial services business; it fits in well to the new mobile global environment, where regulated entities can consider playing regulatory arbitrage in deciding where to locate and book their business.

A tension has arisen within this competitive framework, derived from larger institutions in the financial services markets that have demanded international regulatory convergence. This would reduce compliance costs and allow for the creation of consistent global standards in homogeneous business areas. Competition and convergence do not make the easiest bed partners.

This competition is often between national areas, but it can also extend to larger regions; a prime example of this is the European Union, which places the free movement of goods and services within member states as one of its main objectives. To achieve this, it is necessary for each state to implement a basic level of common regulatory standards. The Financial Services Action Plan, unveiled in 1999, aims to create a single market in financial services across the European Community through legislative acts, such as the Markets in Financial Instruments Directive. These directives must then be engineered into local regulation and often cause widespread regulatory change that firms and practitioners have to adapt to when they are made effective.

Traditional process and communication of regulatory change

Change is communicated formally through regulators' web sites and direct mail to regulated firms and informally through industry working groups, trade association communication, focused gatherings and vendor media services.

Formal regulatory change (in terms of black letter law) is very transparent and regulated firms are given considerable advance warning of its shape. They are given ample opportunity to declare their views on its direction during the consultative phases where initial thoughts are laid out in discussion papers and concept releases. Many larger organizations use their trade associations to shape the future regulation and regulators often pay close attention to significant bodies and firms that are most likely to face the largest impact. In addition, the trade associations will report to their members the results of their dialogue with the regulators. They will discuss the direction the regulation appears to be heading so that members can plan accordingly or change their stance so that this can be communicated anew to the rule maker. Smaller and some medium-sized firms cannot always afford trade association membership. This often puts them at a disadvantage in representing their views at consultative stages, as well as being aware of regulatory change ahead of its effective date.



Regulators have become more creative in communicating with regulated entities and interest groups. For example, the US Securities and Exchange Commission initiated its Mutual Funds CCO Outreach Program in 2005 to enable its staff to communicate and coordinate more effectively with designated chief compliance officers. This program includes regional and national seminars, periodic newsletters and compliance alerts e-mailed to CCOs. The UK's Financial Services Authority has an equivalent, called the Firms' Communications Programme, which consists of specific web site postings, conferences, surgeries, newsletters and a dedicated contact centre.

Following extensive consultation periods, regulators issue the final rules, drafted to reflect, where appropriate, comments made during consultation. The effective date is issued at the same time as the final rule, and the length of the transitional period depends on the complexity of the rule and to what extent regulated entities will need to change existing practice. These considerations account for collateral issues, such as updating policies and procedures, setting up new arrangements and training existing personnel around the change.

In an ideal world, and envisaging a fully informed legal and compliance department, the majority of these changes would have been prepared for, or at the very least scheduled, in advance of the effective date. This is, however, not always what happens in practice. In some cases, regulated entities are "surprised" by new rules and unprepared for their impact after the effective date. In more serious instances, firms are unaware of the existence of a new rule until a regulator points it out to them during a routine or "for cause" examination. We will look later at the damage that such scenarios can present.

When time is always against you

Rules change because regulators trail the dynamics of a constantly evolving market. The problem facing the legal and compliance teams is keeping up with the volume of guidance, occasional papers and updates, discussion documents and concept releases, official communications and speeches from regulators, trade association opinions, briefings from specialist law firms and consultants, and best practice updates gleaned from industry peers.

Viewed en masse, this volume of content and change can be overwhelming, becoming a persistent "noise" around regulatory announcements that can develop into a major frustration for firms where resource is tight or the team is inexperienced. Fear can mean that the practitioner is not able to keep up with regulatory change and apply it proportionately to the firm, or indeed that he/she is not qualified to analyze the change with enough confidence.

Legal and compliance departments as change managers

The legal and compliance department acts as an essential filter, sorting through all regulatory announcements and identifying those that will affect the firm generally or will affect specific areas of the firm's business. Most regulatory change tends to be incremental and should only necessitate changes to the firm's operating procedures, business practices or targeted training and educational initiatives. In most cases the legal and compliance department will carry out this transformational work as part of its normal remit.

Where the change is more substantial, the legal and compliance department will present senior managers with regulatory change impact analysis, opening up discussion of options for implementation and compliance, as well as some form of cost benefit analysis.

The implementation of MiFID in the UK, and the complexity and uncertainty around the merging of the NASD with the New York Stock Exchange to create the Financial Industry Regulatory Authority in the US, are perfect examples of instances that focus attention on the legal and compliance department's role as the main adviser to senior managers. Various integration teams have to digest the new rules affecting the business.

Regulators continue to increase the pressure on senior managers to take responsibility for the conduct of their firm and its representatives. This new vulnerability has in turn placed increasing reliance on the legal and compliance team.

The role of the legal and compliance department has gradually developed as regulated entities acknowledge that managing proactively, and being best prepared for, regulatory change is an integral part of the firm's overall risk management strategy. Firms now appreciate that regulatory risk can be exacerbated by inaction in a number of respects:

- ▶ By being unprepared to implement new rules
- ▶ By not following or understanding enforcement trends
- ▶ By failing to issue subjective comment at the consultative or conceptual stage of rule or policy change
- ▶ By not being properly represented by a relevant trade association or an industry workgroup
- ▶ By not altering the firm's risk assessment process to ensure accuracy and to allow prioritization of upcoming compliance work or deployment of appropriate resource.

To manage regulatory change and risk, firms need to be able to track and analyze regulatory announcements and change effectively.

When ignorance is no defense

To a certain extent, firms could ignore regulatory change for a period of time; this approach may go undetected while the entity is not subject to regulatory examination. Any examination would, however, undoubtedly reveal disparities between current rules and the firm's approach which could provoke more extensive investigation and, if significant rule breaches are found, a move towards enforcement.

Any censure or sanction from the regulator would have a number of potential negative consequences, such as: monetary penalty; suspensions for the business and individuals; bans for the business and individuals; personal liability for senior managers and compliance staff; stakeholder lawsuits; client lawsuits; remedial consulting; commitment to more resource to assist compliance; additional reporting; legal fees; and heightened scrutiny by auditors and examiners on future inspections.

The ability to see the future: an early warning system

Compliance nirvana is akin to having a radar, a systemic tracking tool that detects and monitors relevant change in the regulatory environment. Being armed with such a tool gives the regulatory practitioner the chance to be prepared for, and never surprised by, regulatory change.

This early warning system helps to create a compliance workflow based on the rulemaking process to ensure that applicable regulatory information receives the appropriate level of attention and regulatory deadlines are met by:

- ▶ Collating all regulatory information into a useable format
- ▶ Giving visibility to rulemaking actions from multiple regulators to see how information works together rather than adopting a regulator-by-regulator approach
- ▶ Following a rule through its lifecycle from proposal to effective/implementation dates
- ▶ Tying all related documents and information together
- ▶ Providing a searchable system to assist in accessing the most relevant information
- ▶ Including a notification system that lets the user determine the frequency of alerts
- ▶ Including the ability to e-mail information to others and put deadlines directly on the user's calendar
- ▶ Allowing the user to choose feeds and organize the information for optimum productivity (region, regulators, events/types of activity, topic, department, sectors, particular interest)
- ▶ Highlighting new information each time the system is accessed

If only such a tool existed...

Complinet I Tracker. Prepare for tomorrow today.

To find out more about a revolutionary new tool that is helping financial services firms future proof against upcoming regulatory change, visit:

www.complinet.com/tracker