White paper

Facing the unknown:

Building a strategy for regulatory compliance in an uncertain landscape

Collaborating to reduce the TCO of compliance

Highlights

- The aim of the G20 was to achieve a harmonized approach to regulatory change post the financial crisis: in reality the picture is far from uniform
- It is not clear which firms will have to comply with what, by when, in which markets
- You need to monitor the situation, take a stance on how proactive you will be in shaping the regulation and make a plan for compliance based on what you do know
- Standard, open, flexible solutions are essential to reduce the total cost of ownership (TCO) of compliance efforts
- There is an opportunity to develop collaborative solutions to minimise industry-wide impact of regulatory change

Executive summary

We can debate whether the regulatory response the world's financial markets are putting in place following the international financial crisis is the right one. Are the regulators fixing the right problems to ensure nothing like the crisis could ever happen again? Or are they just tinkering with the mechanics when actually the whole car is no longer roadworthy?

Whatever the answers to these questions, the fact remains that the G20 response is what the industry has to work with. Analysis of how this is progressing, and of where and how the G20 response is being implemented and according to what timetables, reveals that there is no uniform picture today – and nor is it clear what the end state will look like.

So where does this leave your firm, given your obligation to comply with all this new regulation? How can you plan for a situation that isn't clear? **How can you build a strategy for regulatory compliance when you don't know exactly what you will have to comply with, where and when?**

This white paper argues that you need to explore **collaborative solutions** with your peers to address key regulatory challenges – in particular, to **exploit open, flexible, standards-based solutions**, to ensure you can **reduce the total cost of ownership (TCO) of your regulatory response**, while achieving your compliance goals in the most efficient way possible.

Future regulation: a moving target

Increased regulation was an inevitable consequence of the financial crisis. In many countries a variety of measures are now taking shape, all designed to ensure our financial markets operate more safely and transparently. At the macro level, questions may well be asked about the cumulative effect of such a concerted wave of regulation, and whether it will actually address the causes of the financial crisis and really help to prevent the next one. But on the ground, financial institutions have no choice but to accommodate the regulatory change that is coming – and it is significant.

Much of the regulatory development is taking place under the umbrella of agreements reached by the G20 leaders at summit meetings held in 2009 and subsequently. But while the G20 agreements are intended to foster a global approach to ensuring the soundness of financial markets (the G20 covers markets representing more than 80 per cent of global production), in reality differences are emerging across markets around the timing, scope and content of regulatory reforms. The picture is not uniform, and it is not clear what the end-state will look like.

For financial institutions, this means negotiating a period of high uncertainty in terms of regulatory compliance requirements. It is likely that the regulatory onslaught will require significant changes in operational practice and business structure from many market participants. But how can you effectively build a strategy for regulatory compliance when it is not clear exactly what you will have to comply with and by when?

The driver for change: examining the G20 response to the crisis

What is the G20's focus?

The agreements reached by the G20 leaders have been necessarily high level but are nevertheless broad ranging. The overarching aim of the G20 is to make the markets safer and more transparent, and to ensure a more co-ordinated global approach to regulation.

Areas identified for regulatory attention include:

- Capital and liquidity standards for banks
- International accounting standards related to the need to find an agreed measure of 'fair value'
- Remuneration policies at financial institutions
- The role of credit rating agencies
- OTC derivatives trading and associated activity
- The role and operation of the shadow banking industry

In all of these areas, existing practices were found wanting to a greater or lesser extent during the financial crisis. The G20 also concluded that the structure of financial markets supervision was in need of review in some countries.

Which bodies will enact the regulatory change, and how will they do it?

The G20 had limited mechanisms for progressing action to address these issues. It agreed to the setting up of a global systemic risk watchdog - the Financial Stability Board (FSB). This was established in April 2009 as the successor to the older Financial Stability Forum, and given a much broader mandate to promote financial stability.

The FSB coordinates at the international level the work of national financial authorities and international standards-setting bodies. Its mission is to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.

Hosted by the Bank for International Settlements (BIS) in Basel, the FSB has worked particularly closely with the Basel Committee on Banking Supervision (also hosted by the BIS), which has updated its longstanding recommendations for bank capital and liquidity standards, creating new global standards known as Basel III. Basel III stipulates that banks set aside higher levels of capital, and requires the creation of a global liquidity framework. Basel III will be phased in during a number of years (finishing in 2019), and is designed to reduce significantly the probability and severity of banking crises in the future.

Other priorities for the FSB include creating measures for the identification and enhanced supervision of financial institutions regarded as having a globally systemic impact (G-SIFIs), pushing for accountancy standards convergence, and generally enhancing global supervisory standards. On G-SIFIs the FSB (assisted by the Basel Committee) has developed requirements for higher loss absorbency capacity that such institutions will be expected to attain going forward. In November 2011 the FSB published a list of an initial group of 29 G-SIFIs. This list will be updated annually, and the additional loss absorbency required of such financial institutions will be phased in starting in January 2016 through to 2019. The 29 G-SIFIs will, however, have to step up to new resolution planning requirements by the end of 2012. During 2012 the FSB and the Basel Committee will be extending the framework out to all SIFIs, thus adding to uncertainty.

The FSB is also working very closely with the Committee on Payments and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO). In 2011 IOSCO produced recommendations on safer OTC derivatives trading, whilst CPSS and IOSCO have jointly produced a consultative report on the updating of recommendations for the stability of financial market infrastructures. These reports endorsed the use of market infrastructures as mitigants to risk, but emphasised the importance of the infrastructures themselves operating in accordance with key principles to ensure that they themselves were robust.

In the main, however, the responsibility to progress the G20 aims at a practical level (including the implementation in nation states of recommendations such as the Basel III standards) falls to the individual states themselves and in the case of the EU, also to the EU institutions, the Commission, Council and Parliament.

In which regions is the regulatory focus strongest?

Since 2009 a certain amount of progress has been made to tackle the G20 agenda, with the most intense activity having taken place in the US and the EU (the regions most impacted by the financial crisis: the upheaval of 2007-8 had far less impact in Asia).

While progress has been made, there is much still to do. The regulatory response is far from complete. Co-ordinating financial market regulation and designing it for the reality of global financial institutions operating across borders is proving to be a significant challenge and a number of disconnects are already emerging. There are also doubts as to whether all markets will be able to make key reforms in accordance with the deadlines set by the G20 (something that the FSB has highlighted during 2011).

The EU

As a result of the development during the past 10 years of the EU single market in financial services through the multi-measure Financial Services Action Plan (FSAP), some measures and structures were already in place to facilitate supra-national regulation of financial markets and banking activity. Measures such as the Markets in Financial Instruments Directive (MiFID), which deals with securities trading in the EU, and the Capital Requirements Directive (CRD), which provides a framework for bank capital and liquidity standards, have brought some level of harmonisation to EU cross-border regulation of financial activity during recent years.

The EU also already had an embryonic structure of supra-national regulation via the so-called level three committees, such as the Committee of European Securities Regulators (CESR), which provided a forum for co-ordination and for the exchange of information among the 29 EU and European Economic Area (EEA) regulators.

Of course, neither the supra-national financial regulation already in place in the EU, nor the structure to promote regulatory co-ordination, prevented the EU from being badly impacted by the financial crisis, with significant bank failures taking place in most of the larger EU member states.

As a consequence, the EU decided it had to consider new measures and needed to optimise its regulatory and supervisory structure. Achieving this was dependent on the EU's rather tortuous decision-making process, including preparation of legislation by the EU Commission, followed by agreement of the EU Parliament and by the nation states represented in the European Council.

Europe needs a single, integrated, low risk and low cost post trading infrastructure as an integral part of the European single market vision, for the benefit of its users and to be globally competitive. This objective has been shared by the securities industry and public authorities since the beginning of the last decade and should now be achieved without further delay and in a comprehensive manner.

The recent financial crisis has underscored the importance of developing a more resilient financial system to minimize systemic risk. Although the clearing and settlement components of the financial system have proved resilient and robust, we believe that a move from the current fragmented structure towards a more effective single European market in post-trading services, with the elimination of all material restrictions and barriers, will make a significant contribution to a safer financial system. To this end we advocate a targeted cooperation between public authorities and the private sector combining thus authority and professional experience and expertise toward the common objective.

Dr. Werner Frey, Managing Director, Association for Financial Markets in Europe / European Securities Services Forum

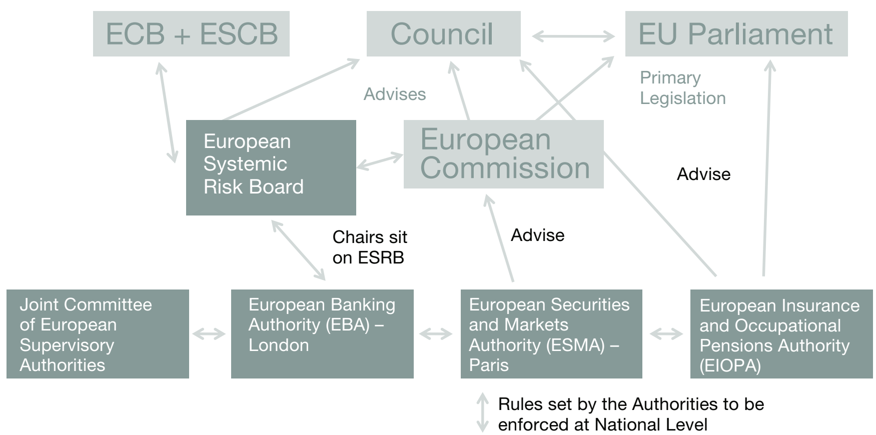
Structural change

In the end, the EU response to the crisis was to first tackle the structure of supervision and build upon the existing single market regulatory structure to design a more robust and harmonised regulatory approach at the EU level. The way forward on this was set out by a committee under the former French central banker and IMF official Jacques De Larosiere, which the EU Commission set up in late 2009. This committee recommended a new EU supervisory structure to be built on the existing single market level three structures, with the creation of new market authorities covering banking, capital markets and insurance (the European Banking Authority (EBA), ESMA and the European Insurance and Occupational Pensions Authority (EIOPA), together with a new European Systemic Risk Board (ESRB) to monitor macro threats to the EU economy and produce the appropriate warnings to policy makers. The three authorities would, via their member state individual regulators, develop and implement a single rule book for the EU, and ensure compliance with new regulatory measures developed by the EU. The ESMA will have a direct role in the regulation of credit rating agencies, which will be regulated for the first time.

The ESRB is chaired by the President of the European Central Bank (ECB) and its Board contains the Governors of the European System of Central Banks (ESCB) and the Chairs of the new European Supervisory Authorities. All of these new bodies have been slotted into the existing EU governance structure but operate independently of it.

This structure, illustrated in the diagram below, was largely approved by the EU legislators in late 2010 (following much discussion on the scope of the powers of the new authorities). The new authorities and the ESRB started work in January 2011.

New EU Supervisory Structure from January 2011



European System of Financial Supervisors (including National Regulators)

The new European system of financial supervisors includes a system of supervisory colleges comprising the relevant national regulators with active involvement by the new authorities, for the supervision of the larger cross-border financial groups.

The new regulatory model and structure are designed to better meet challenges of the post-crisis environment (and to more effectively enable the long-standing EU single market agenda at the same time).

New legislation

With the supervisory structure dealt with, the focus moved to legislation, which is being developed to tackle many of the individual issues identified by the G20. A number of key measures are now at various stages of completion:

1) The Alternative Investments and Fund Management Directive (AIFMD) – designed to regulate this shadow banking sector for the first time and passed by the EU Parliament after much deliberation in autumn 2010. The process of developing detailed implementation measures by ESMA has continued during 2011. Some of the measures in the AIFMD will also flow to the UCITS collective investment legislation in the EU – particularly in the area (post-Madoff) of fund depositaries, where UCITS will be brought into line on the responsibilities and requirements in respect of fund depositaries contained in AIFMD.
2) New capital requirements regulation and update to the Capital Requirements Directive to bring it into line with the increased capital and liquidity requirements of Basel III published in July 2011. The new measures are scheduled for implementation in various stages from 2013 onwards in line with the Basel timeframe (although there are differences in approach in this legislation from the original Basel III recommendations). European Market Infrastructure Regulation (EMIR) the EU's main response to the requirement for greater control of derivatives, entailing a push for centralised clearing of OTC derivatives and for reporting to trade repositories for the purposes of transparency.

Legislation was published in 2010, and this legislation completed the EU political process at the start of 2012. Implementation measures will be developed during 2012, with the target for implementation being the end of 2012, in line with G20 commitments in this area. In reality implementation is likely to be delayed until the second half of 2013 because of a longer than planned political process, and even then this legislation may be phased in.

3) MiFID II and MiFIR (Markets in Financial Instruments Regulation) – a revamp of the MiFID legislation to bring more derivatives into exchange rather than OTC trading, and with the extension of transparency measures across asset classes, was published in October 2011. Very wide reaching in scope this revamp of MiFID is divided (like the Capital Requirements Directive changes) into a revamp of existing legislation coupled with a brand new Regulation. This measure will be actively debated in the EU political process over 2012 and into 2013, and is unlikely to be implemented before 2014 or possibly 2015.

4) Crisis management and resolution - proposals for the winding up of banks and financial institutions were delayed but will appear in 2012.

5) Central Securities Depositories Regulation - not really a G20 priority, but seen by the EU as necessary to increase the robustness of the securities post-trade infrastructure and to prepare the ground for harmonised securities settlement cycles. Legislation will appear in early 2012. This is closely linked with the separate proposed Securities Law Directive aimed at harmonisation in the EU of the legal status of securities held by book entry transfer in dematerialised accounts and the legal treatment of corporate actions.

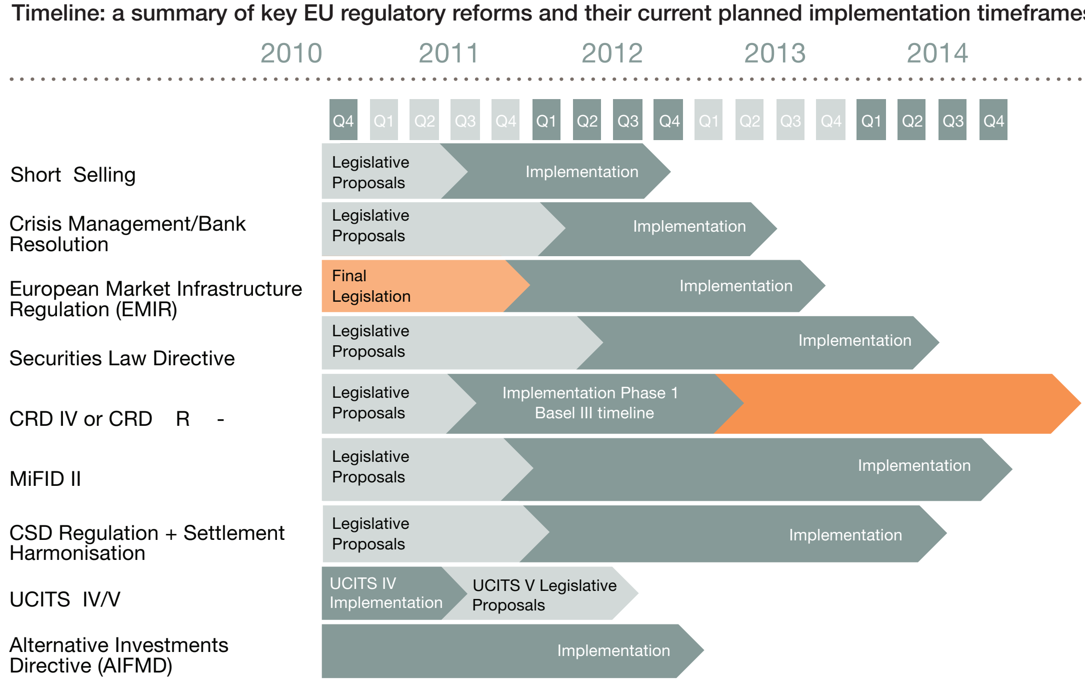
6) Short Selling and Credit Default Swaps (CDS) – In October 2011 the EU agreed to a new measure that restricts short selling and also bans naked sovereign CDSs. This is due to come into force in November 2012.

Change is also coming to other existing EU regulations - in addition to the major areas highlighted above - as the EU seeks to update legislation in the aftermath of the crisis.

A word of warning on timing

The planned timing of the various EU reforms is designed to enable delivery to a schedule aligned with international commitments. But the piecemeal process of legislative development, coupled with the numerous moving parts at the EU level – Commission, Nation States, EU Parliament, National Authorities et cetera - puts the timing of the implementation of this legislative agenda in some degree of doubt. During 2011 there was already slippage in the progress on key measures (the notable example being EMIR).

Timeline: a summary of key EU regulatory reforms and their current planned implementation timeframes



The US

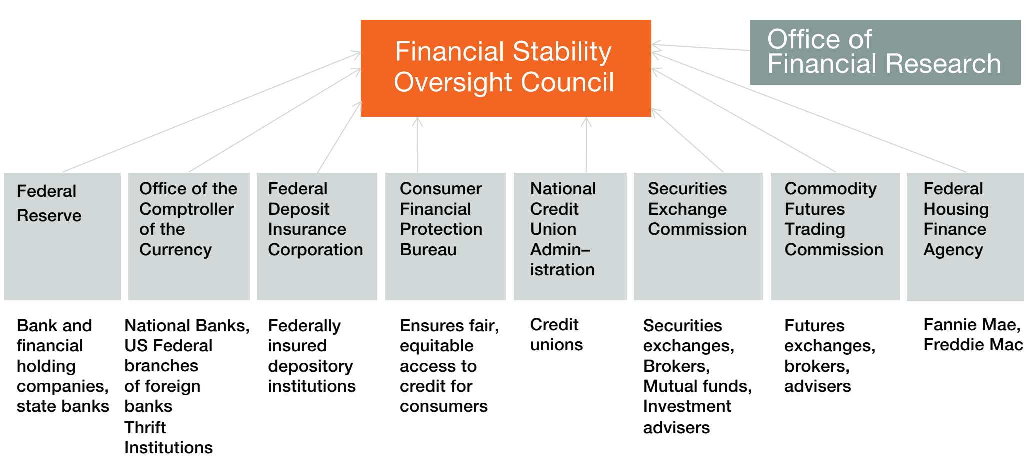
In the US, a comprehensive financial reform package was passed by the US Congress in July 2010. This Dodd-Frank bill extends to thousands of pages and includes the entire US regulatory response to the financial crisis and the G20 agenda in one act of Congress. The bill is now in the midst of rule writing by US regulators. The rule writing process was scheduled for completion by July 2011, but many rules were still not in place at the end of 2011, which means that implementation looks set to be later in many cases than the original deadline of the end of 2012.

The Dodd-Frank bill also includes a revamp of the US regulatory structure, bringing many strands (and domestic regulators) together with the creation of a Financial Stability Oversight Council (FSOC), which will be fed with data and analytics by another new body, the Office of Financial Research (OFR). The structure is illustrated in the diagram below:

The FSOC will play a vital role in maximising the effectiveness of a US regulatory structure, which continues to comprise largely pre-existing bodies covering very distinct parts of the industry. The FSOC will have the following functions:

- collect and analyse data to identify and monitor risks to the US financial system.
- provide recommendations on capital, liquidity and prudential standards for large complex companies that could threaten the financial system. Here there is an increasing momentum for the US to adopt the Basel III capital and liquidity standards for the first time and co-ordinate the US approach to banking prudential standards internationally.
- work with a new Office of Financial Research (OFR) within the US Treasury which will collect financial data and conduct economic analysis. The OFR is charged with standardising the types and formats of data reported and collected. The OFR will draw on an associated data and analytics centre.
- designate non-bank financial companies and financial market utilities as systemically significant and to be regulated as such.

New US regulatory structure from 2010



Other aspects of Dodd-Frank cover areas of concern in the original G20 agenda. So for example, on derivatives the bill includes:

- Greater authority for the main US securities regulators (SEC and CFTC) to regulate over-the-counter derivatives.
- Central clearing and exchange trading for derivatives, with the development by regulators of clearing parameters.
- Greater market transparency with “real-time” publication of trade prices and volumes via clearing houses and trade repositories.
- Swaps (whether cleared or not) to be reported to a registered “swap data repository” charged with maintaining centralised records.

Dodd-Frank also tackles the shadow banking industry. It establishes a register of advisors to hedge funds and private equity players and a system for the sharing of information with the FSOC for the assessment of systemic risks.

In addition, credit rating agencies are targeted for tighter regulation (as is the case in the EU as well).

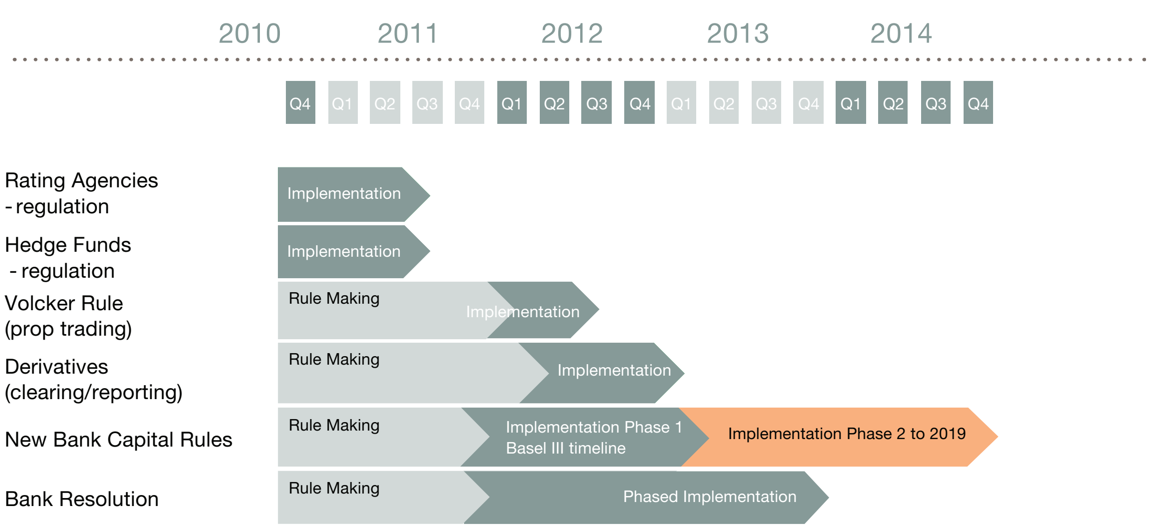
One aspect of Dodd-Frank which is unique to the US measures is that it includes the so-called **Volcker Rule**, which requires US regulators to implement regulations for banks, their affiliates and their holding companies, to prohibit proprietary trading, investment in and sponsorship of hedge funds and private equity funds, and to limit relationships with hedge funds and private equity funds.

So the US is moving to implement the core of the G20 agenda in parallel to making changes to financial regulation that reflect the particular circumstances of the US itself. The process in the US is somewhat different from that in the EU in that, in terms of legislation, there is one high level and all-encompassing measure which then requires detailed rule-making to fill in necessary detail. By contrast, the EU approach is based around far more detailed individual legislative proposals which tackle specific areas of financial activity.

Another word of warning on timing

As mentioned above, the US rule-making to flesh out Dodd-Frank was targeted for completion by mid 2011. Progress in 2011 was much slower than anticipated such that the completion of the key regulatory changes by the G20 target date of the end of 2012 is now in question.

Timeline: a summary of key US regulatory reforms and their planned implementation



The rest of the world

The financial crisis was largely a US and EU phenomenon, and it is therefore to be expected that the most intense regulatory response is occurring in these areas. In Asia there were no tax payer bail-outs, and the nature of the markets is somewhat different – for example, derivatives trading is less prevalent.

However, there are some changes under way in Asia. Japan is introducing centralised clearing for OTC derivatives traded there. Singapore is introducing a trade registration system for interest rate swaps. Central counterparties (CCPs) are also likely to be introduced in Hong Kong, China and South Korea.

More generally, the Asian members of the G20 - China, Japan, Indonesia, South Korea and India, together with Australia - are all supportive of the general enhancement of supervisory standards agreed during the various G20 summits, and on co-operation on crisis management and the resolution of financial institutions - with a particular focus on those institutions identified as being of globally systemic relevance.

So changes of approach are happening in Asia as well, to enable alignment with the global approach of the G20. In Asia, change is taking place on a market by market basis, and there is an absence of the heavy and intensive legislative and rulemaking activity that is happening in the US and the EU.

What issues does regulatory change raise for you?

The biggest issue you face is the level of uncertainty which derives from a regulatory development process of unprecedented scope and complexity. How much of it will actually happen and will it happen on time? How will its application differ across markets, and will opportunities for standardisation and harmonisation on regulatory requirements such as reporting to trade repositories be grasped by regulators - or will they flunk the test?

Europe faces a dual challenge. It needs to reduce risk and improve safety in the financial markets in order to reduce the likelihood of another financial crisis. It should also continue to build a more integrated financial market to allow economic actors to raise the funds required for their development as efficiently as possible. As a result the financial industry is seeing a significant increase in the number of (regulatory) initiatives whose aim is to meet these two challenges. These initiatives impact market infrastructures, financial institutions, issuers and investors.

Two things are critical: all parties need to support the regulatory goals of increased systemic stability, greater market integration and improved protection of end investors; and there needs to be further work to eliminate market inefficiencies and barriers because these inefficiencies and barriers are often the source of additional risk. In other words, efforts to improve integration are compatible with initiatives to reduce risks: rule harmonisation and barriers elimination reduce complexity and as result reduce risks.

From a securities post-trading perspective, the challenges are especially great, given that much of existing regulation is embedded in very different pieces of law, regulation and market practice. Faced with this very complex environment, it is important that all parties remain focused on the need to tackle the underlying root causes of risk and inefficiency. In the post-trading world, it is rare that solutions to problems are both simple and easy.

As a global institution we are also impacted in other parts of the world. While we believe that the authorities, especially on both sides of the Atlantic, are cooperating in order to prevent major differences that could trigger regulatory arbitrage, the complexity of the securities industry and post trade world makes this cooperation particularly challenging.

Paul Bodart, Executive Vice President, Head of EMEA Global Operations, Bank of New York Mellon

How significant a challenge this wave of regulation poses for you will depend on the business you do, whether you operate cross-border, and whether you are classified by G20 as being of systemic or globally systemic significance (for such entities, the level of regulatory scrutiny applied will be even higher).

You need to monitor the situation

But your first challenge is to keep track of what is happening, and the progress being made in which areas, in what in many markets is an unprecedented level of regulatory development.

As we have established, markets are implementing G20 in their own way – and while bodies like FSB and IOSCO can make recommendations for co-ordinated action, real change is only implemented by legislative bodies operating at the national or EU level, followed by detailed implementation, and supervision, by national regulatory authorities.

So this means possible:

- differences between measures adopted
- differences in timing
- differences in scope
- differences in ongoing supervisory approach
- differences between information and reporting requirements and standards (where applicable)

Yes, the US and the EU are seeking to converge as far as possible on regulations covering, for example, the derivatives markets. But the possibilities for divergence are still significant. Exemptions from clearing requirements may differ between the US to the EU. Reporting standards or requirements may vary across markets.

On measures to tackle weaknesses in the OTC derivatives and commodity derivatives markets, for example, the FSB issued a warning in April 2011 that "differences in approaches are emerging that could weaken the effectiveness of reforms, create potential opportunities for regulatory arbitrage, or subject market participants and infrastructures to conflicting regulatory requirements". The FSB identified "divergent approaches to requirements for the reporting of transaction data to trade repositories" as well as inconsistencies in the "development and future application of clearing requirements and strengthened margining/collateralisation practices across asset classes, products and market participants". A further example of divergence has been around core capital requirements for banks, where the EU approach under the new capital requirements legislation has been to set a maximum level for this core capital, whilst under Basel III the approach is to set a minimum level.

Even within the EU, some measures could be implemented differently (or not at all) in different member states – particularly if the measure is a directive rather than a straight regulation. The new EU supervisory structure, coupled with the tendency for new EU measures to emerge as regulations, should minimise this going forward - but the issue is not entirely removed.

There is plenty of scope for individual markets to go above and beyond international regulatory measures and customise regulation for their own markets. In April 2011 and September 2011 the UK Independent Banking Committee reports recommended a ring-fencing approach for capital to protect the retail side of universal banks, together with higher capital requirements for some entities than those put forward in the Basel recommendations. The UK intends to push ahead with the recommendations of its Independent Banking Committee, which means that the UK is thus set to take a different approach to banking regulation to that of other EU states.

The combination of global regulatory change, coupled with national and regional variations on common themes, means that firms more than ever need a person or a function dedicated to monitoring the regulatory situation, assessing the impact of potential or actual developments on their business, and maintaining a dynamic timeline that charts what is likely to happen when, and in which markets.

You need to take a stance

You also need to decide if you want to influence the regulatory debate on the issues you have determined will impact your business. You can do this directly with legislative and regulatory authorities in relevant markets - but you may need to build up new relationships to do it. Alternatively you may decide to take a more low-key approach, and make your opinions known through trade associations, for example.

You need to make a plan

Once you have identified the measures that are likely to have the most impact on your business, and you have determined whether you intend to try to influence the debate or not, you need to start planning how to comply according to the timeframes being discussed. Given the vagaries of the process of developing, agreeing and implementing regulatory measures this is not easy, as timeframes change with a fair degree of regularity. And since some of the changes you will have to make will be operationally significant this is a real concern.

Will there be enough time to implement, for example, new clearing arrangements, if that is what is needed?

You may face a decision about whether or not to continue operating in certain businesses, based on an assumption about the new regulatory burdens you will have to carry if you retain your existing business profile. An estimation of the additional cost burden of the collateral and margin requirements linked to more use of CCPs for OTC derivatives, for example, might prompt a re-think for firms currently involved in these activities.

How can you minimise the operational challenges for you and your peers?

You need to step up to the challenges above. An essential first task to get a managerial grip on the process of regulatory change is to develop a strategic plan across business lines and regions in respect of the regulatory proposals currently on the table. You might not be able to create a complete plan, given the information that is still missing - but you should take as thoroughgoing approach as is possible at this stage.

Make sure you are up to speed on the regulatory developments in all the markets that could possibly impact any aspect of your business. There are numerous sources of information, but it is nonetheless a full time job to keep track of developments (one you could resource internally, or possibly outsource to one or more specialist consultancies). Some regulatory changes are almost certain to happen and within parameters that are already fairly clear. For example, on the banking side it is highly likely that Basel III will gain far more traction than its predecessor. A generous timetable has been outlined for implementation here, but in reality many banks are already geared or gearing up to comply with the Basel III standards, well ahead of the prescribed timeframe.

So, awareness of the direction of travel in key areas is essential - coupled with a constant process of review as to whether your firm should be making changes ahead of likely regulatory implementation timeframes. A well-planned response and implementation of changes to meet new regulatory requirements can have a significant mitigating effect on the impact on the business.

While you may, either directly or through your trade associations, decide to lobby for exemptions or substantive changes to regulatory proposals as part of your regulatory response, you should also keep in mind some lower-level practical issues as well. Here there is an opportunity to work collaboratively to minimise the operational challenges and impacts for the industry.

Collaborating to manage the process of regulatory change

A major aim of the new regulation is increased transparency – and this will be delivered, as we have seen, through more data collection from the industry by regulators, for example, via the reporting of derivatives trades to trade repositories. There is an opportunity for a quick win here, if firms come together to push the regulators to adopt open industry standards for the collection of this data, with a harmonised approach across markets. As we have seen above, the FSB is already worried this will not happen in the right way – so this is a perfect area for the industry to be proactive within the grain of the overall regulatory requirements.

Taking such an approach would actually help the industry itself, to reduce the need for the use of multiple formats and multiple identifiers for products and entities in reports submitted to global regulators. This approach would also make life easier for regulators in terms of data aggregation. In the past there has been confusion on issues such as this, as regulators in different markets have requested the same information in different ways and in different formats. There is a need for the industry to show how the open tools it has developed, or can develop, are the best solution for both the industry and the regulators themselves going forward, in delivering the increased transparency which is demanded by the post-G20 regulatory agenda.

It is indeed most unfortunate that it has taken a financial crisis to cause the financial industry, under direction from regulators, to now spend time, money and effort in order to eliminate the risks and inefficiencies that have been prevalent for many years in the post trade processes of many of the financial products that are traded daily around the world. Market associations and practitioners must now grasp the opportunities presented by this regulatory focus and should actively co-operate on many fronts and in particular the adoption of suitable standards in order to streamline processes which in turn will lead to the elimination of known risks and inefficiencies.

Arthur Cousins, CEO International Payments Framework Association

Standard, open, flexible solutions are essential to reduce the TCO of compliance

A key and tangible example is entity identification. In normal times this is a dull subject: the industry has muddled along for years with multiple identification systems, creating a bonanza for vendors offering data cross-referencing services. This situation now has to change, however, because the regulatory imperative for transparency dictates that more transaction-related information (especially about derivatives) must be supplied to regulators for risk management purposes (as well as the more traditional market abuse monitoring).

None of this reporting, in the US, the EU or elsewhere, will work effectively or be of any value unless there is a standard for the unambiguous identification of the entities involved in financial transactions - one that can be used in all the various reports which regulatory authorities across markets are now going to require.

There is a window of opportunity for the industry to work with regulators to come up with a viable solution - a solution that works equally well for both parties and which is capable of providing a global answer to this challenge. The US has been in the lead in formulating an approach to this, through a consultation process in late 2010 describing the characteristics for entity identification in respect of the new US financial data crunching body – the Office of Financial Research (OFR).

It is worth stating here some of the requirements the OFR set out for this legal entity identification (LEI) standard in its 2010 consultation document:
“A LEI acceptable for use with data reported to the Office should:

- be based on a standard developed and maintained via an international voluntary consensus standards body such as the International Organization for Standardization (“ISO”);
- be available for all eligible markets participants, including but not limited to all financial intermediaries, all companies that issue stock or debt listed on an exchange, all companies that trade stock or debt, infrastructure providers, all entities subject to financial regulation, and firms affiliated with such entities;
- not be contractually restricted in use;
- where possible, be compatible with existing systems, work across various platforms, and not conflict with other numbering or identification schemes;
- be readily accessible using secure and open standards;
- be capable of becoming the single international standard for unique identification of legal entities in the financial sector”

The importance of this extract from the list is that it shows that US regulators in this case have ‘got it’ in terms of the need to have a standard which is open, flexible (but in a controlled way) and with the capability to become truly international.

The industry clearly has an opportunity to play its part in delivering a solution which meets these objectives, and discussions are now underway between the industry and regulatory bodies to make progress on a solution for LEI.

What's good for LEI is good for reporting, clearing, pricing et cetera, et cetera.

This is not just the right way to go on the LEI. It is also a very good blueprint for the adoption of standards in the context of some of the other key areas of regulatory focus. So, for example, this open standards approach needs to be considered generally for the formats in which reporting will be made to trade repositories for derivatives contract reporting (something which is common to Dodd-Frank, the EU EMIR legislation and also now to some of the Asian markets).

It is also true for central counterparty (CCP) clearing. As already mentioned, this is a key area of regulatory focus on both sides of the Atlantic and beyond, with regulators actively pushing more transactions on to centralised clearing to mitigate against counterparty risk and for increased transparency.

While there are good arguments against this approach (for example, is it just moving risk around the system rather than eliminating it, and will there be enough high-quality collateral available to underpin the greater use of CCPs?), it is clear the regulators will move forward with the CCP agenda.

This being the case, it is important that the industry pushes for, and supports the development of, open messaging standards for access to CCPs, as well as to facilitate CCP interoperability for the clearing of straightforward products such as cash equities.

Such an approach will keep down the costs of interacting either directly, or indirectly via a clearing member, with multiple CCPs - although there is no getting away from the fact that the need to post dedicated collateral to underpin more central clearing will push up industry costs.

In the light of the above it is relevant to recognise here the recent CPSS-IOSCO report and consultation on Market Infrastructures (referred to earlier). Recommendation 22 of the report states that a Financial Market Infrastructure (FMI):

"should use, or at a minimum accommodate the use of, internationally accepted communication procedures that can support interoperability between the FMI, its participants, their customers, and other users (such as third-party service providers and other FMIs).

An FMI should use, or at a minimum accommodate, internationally accepted communication standards, such as standardised messaging formats and reference data standards for identifying financial instruments and counterparties.

An FMI that operates across borders should use, or at a minimum accommodate, internationally accepted communication procedures and standards".

The report goes on to note that:

"The ability of participants to communicate in a quick, reliable, and accurate manner is key to achieving efficient recording, payment, clearing, and settlement. The adoption of internationally accepted communication procedures and standards contributes to the elimination of manual intervention in clearing and settlement processing, reduces risks and transaction costs, improves efficiency, and reduces barriers to entry into a market."

This is a clear recognition of the importance of open messaging standards, not just in the CCP space, but around market infrastructures generally.

The regulatory-related changes for clearing are daunting and it is a relatively safe prediction that they will transform the industry. Central counterparties (CCPs) performed to expectations in the darkest days of the financial crisis – protecting trade counterparties to the default of each other. Regulators want CCPs to clear more, and at the same time, are raising the bar significantly on all aspects of their operation. The cost of compliance with new regulatory requirements will be significant.

Collaboration within the clearing industry to develop standards to face these new challenges is more important than ever before. Standardization of message formats, communication protocol and operational procedures among connected parties reduces long-term costs and operational risks for everyone. The sooner we accomplish this, the better. We must not miss the opportunity to do it right from the start.

Diana Chan, Chief Executive Officer, EuroCCP

Other areas that would be best served by collaborative industry efforts include the delivery of post-trade pricing in an open, standardised and accessible format that is inline with MiFID legislation which was published by the EU in October 2011.

Where you can, you need to make and use opportunities to show how you and your peers working collaboratively can come up with strategies and solutions to address the operational challenges you face in the light of the regulatory change being introduced post-financial crisis and in compliance with the G20 agreements.

In conclusion: collaboration is the way forward!

Clearly, we are entering a period of great uncertainty, although with the one certainty that there will be more regulation. This uncertainty is an inevitable consequence of an unprecedented attempt to co-ordinate an ambitious series of regulatory measures across all major markets - impacting everything from the capital structure of banks to the clearing and reporting of derivatives. This enterprise is fraught with difficulty because it depends to a large extent on changes to laws, market practice and infrastructures in multiple markets. Throw in the impact of new supervisory agencies, coupled with legacy supervisors in other markets, both struggling to transform high-level legal changes into regulatory rule books in their own way, and you have a recipe for uncertainty.

This comes from:

- Possible time delays in the formulation of legislation
- Inconsistencies in the timing of the implementation of new regulatory measures
- Regulations applied in an inconsistent way for the same business areas across different markets
- Differences in the scope of regulation based upon exemptions granted in some markets and not in others
- Operationally divergent approaches to the application of regulations and their ongoing supervision
- The unintended consequences of so much regulatory change (some of which is overlapping) taking place in a comparatively short period of time.

While there is no way of avoiding either the regulations that are coming or the consequences of this uncertainty around the application and implementation of new regulation during the next few years, you can take more of your destiny into your own hands by **supporting collaborative approaches to developing operational solutions to address important aspects of the regulatory agenda.**

Presenting to the regulators, alongside your peers, operational solutions that work for both regulators and for you and your fellow institutions is a better way of moving forward than either just waiting for something to be imposed or burying your head in the sand and hoping it will all go away.

As we have seen from the LEI example, there is no reason to believe the regulators will be unreceptive to such industry approaches. Undoubtedly there will be areas in which all parties can reach agreements that work for the industry and the authorities, as the larger regulatory brave new world takes shape during the next few years.

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Legal Notices

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