SLAUGHTER AND MAY

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Challenges and opportunities of the increasingly regulated world: the view from London

To say that financial institutions have a lot to think about at the start of 2012 would be a gross understatement. This is, of course, particularly so in relation to financial regulation. There is so much going on in this area, and so little time to pause and reflect, that there is a real risk that the sheer number and complexity of developments will leave financial institutions immersed in detail and missing the broader developments and trends that will have the more profound effects on their businesses.

Intense financial regulatory reforms, including changes to the regulatory architecture of the United Kingdom, the plethora of new regulatory initiatives in the European Union and the gradual implementation, through detailed rules, of the Dodd-Frank Act in the United States, provide regular opportunities to recognise, and hopefully address, this risk. It is our view that the style of new regulation provides as big a reason as its substantive content for institutions to reassess their approach to regulators and regulatory change.

The purpose of this paper is to explain our thoughts on the broader trends and developments. Looking back at the regulatory developments of the past three years and then ahead to those that are expected in the future in this broader way seems to us to indicate that the changing regulatory landscape is likely to have even more profound implications for the largest, most complex and most international financial institutions than the day to day minutiae of consultation papers and speeches would suggest. There are now significant threats to the business models of financial institutions that do not have sufficiently positive and proactive relationships with their regulators to influence the ways in which new regulatory principles and rules will be applied to them. We explain in this paper:

- why we think this is the case;
- how we think that some of the traditional responses of financial institutions to regulatory change are now outdated; and
- how a new approach to engaging with regulation within financial institutions can bring significant risk mitigation benefits and business opportunities, for small as well as for large financial institutions.

The new approach that we advocate could involve some quite significant cultural and organisational changes for legal and compliance departments, particularly within banking, investment banking and insurance groups. We hope to demonstrate that such changes are worth considering and may in some cases be the only credible approach for the most heavily regulated financial institutions to take.

We refer throughout this paper to “regulators” to mean financial regulators. We also refer broadly to “firms”, by which we mean entities regulated by those regulators or which are otherwise subject to their rules.

WHAT ARE THE ISSUES?

What are the "big picture" regulatory issues that large international financial institutions are facing and will continue to face this year? We suggest that amongst the most important are the following:

- **Complexity:** Most large international financial groups are now exceedingly complex, both from a structural and an organisational perspective. Many financial regulators have developed a strong dislike of complexity, however beneficial it may be to the group concerned. Can financial groups maintain the structures that they prefer to have and, if so, at what cost?

- **Transparency:** Regulators are pushing for ever more openness, transparency and co-operation from the firms which they regulate. At the same time, regulators are increasingly sharing large amounts of confidential information between themselves across borders, often as part of supervisory college arrangements. How can firms protect their legitimate interests regarding commercially sensitive, privileged or otherwise confidential information that regulators ask them to disclose?

- **Uncertainty 1: Anticipating change:** Rules are changing rapidly. How can financial institutions best anticipate what changes are around the corner?

- **Uncertainty 2: The focus on outcomes:** The gulf between what the rules say and what they can be said or made to mean in practice has never been wider. Regulators will increasingly focus on outcomes, reverse engineering the desired outcomes to frame the manner in which financial institutions should behave. How can financial institutions address the lack of certainty that is inherent in this approach to regulation?

- **Uncertainty 3: Product regulation:** Many financial regulators have, at least in the past 20 years, actively avoided prescriptive regulation of individual financial products. That is now changing quickly in many jurisdictions. How can financial institutions launch new products while the future development of the regulatory regime remains uncertain? How can they standardise products across borders when different regulators are applying different prescriptive rules?

- **Managing relationships with regulators:** None of compliance staff, legal staff and risk staff are, on their own, the optimal guardians of a group's relationships with its regulators. Whom should financial institutions appoint to lead the management of their relationships with regulators, how should that person (or those persons) fit in to the wider organisation of the institution and what does the role now involve? Why, by the way, do relationships with regulators need "managing"?

- **International duplication:** How should financial groups address these issues in multiple jurisdictions? Is this simply a question of duplication of effort or is a more sophisticated approach called for, particularly with the increasing relevance of colleges of regulators and international co-operation between regulators increasing?

- **Influencing the new rules:** What can financial institutions realistically do to influence new rules at UK and EU levels?

- The Board: What part should the board be playing in addressing these issues and what continuing engagement with regulatory issues is it appropriate for the board to have?

- The General Counsel: The approach of general counsel to these issues varies widely, but the key question for all general counsel remains the same: when and how might regulatory issues and developments create legal risk? How does the answer to this question differ now from a few years ago?

- Business opportunities: What, in broad terms, are the business opportunities that the new regulatory world may bring for well organised and far-sighted financial institutions?

We consider each of these issues below as they apply to the UK and wider EU operations of financial institutions. Our suggestions as to how they might best be addressed are based on our experience of how financial institutions are thinking about them or, to their actual or potential cost, failing to think about them. Some will disagree with our suggestions. We should, however, emphasise that we do not recommend a prescriptive or standardised approach to addressing any of these issues. The most appropriate response will vary from institution to institution and some of the most profitable business opportunities that might arise for the more astute institutions are likely to stem from constructive scepticism as to what others are doing (or failing to do).

1. COMPLEXITY

THE ISSUES

Most large international financial groups are now exceedingly complex, both from a structural and an organisational perspective. Many financial regulators have developed a strong dislike of complexity, however beneficial it may be to the group concerned. Can financial groups maintain the structures that they prefer to have and, if so, at what cost?

Rightly or wrongly, the view has spread amongst regulators in the UK and the wider EU that complexity carries risk. While regulators themselves have proven not to be particularly articulate in explaining this proposition, it can be seen that complexity in a financial services group can, at least potentially, give rise to a number of risks from the regulator's perspective:

- Effective supervision: If a regulator does not have an adequate understanding of a group structure then it is clearly less likely to be able to exercise effective supervision of the group. The more complex a group structure is, the more likely it is that the regulator's understanding of that structure is inadequate. From the regulator's perspective, ineffective supervision increases the risk of a group causing customer and/or market detriment.

- Crisis management: Complex structures will almost invariably be more difficult to deal with in a crisis than simple ones. This issue has, of course, been thrown into sharp focus in connection with work that is continuing in many jurisdictions to draw up recovery and resolution plans ("living wills"), particularly for so-called systemically important financial institutions.

- Lack of understanding in the group itself: Complexity in group structures is often an unintended consequence of many years of acquisitions and group reorganisations. Many groups lack the continuing institutional knowledge in their current management to be able to provide a coherent and comprehensive explanation to regulators of why their group is structured in the way that it is. Where this is the case regulators

may well see an inherent risk associated with a lack of understanding on the part of the group's management of the group's structure and, in particular, of how that structure would operate in a stressed or crisis scenario.

- **Management confusion:** Quite apart from complex group structures, regulators may well consider complexity in management structures as indicative of actual or potential management confusion, uncertainty and, ultimately a potential failure of controls where there is lack of clarity as to who is responsible for what and who reports to whom. This may particularly be the case in management structures in which many individuals each have reporting lines to more than one senior manager on different aspects of their work.

- **Power and responsibility:** Complexity in management structures may run the risk of separating power from responsibility: in other words, individuals who have nominal responsibility for discharging a certain function do not have the power to do so because they are constrained by internal rules or the need to seek internal approvals before they can exercise their duties. This has long been objectionable to many regulators.

ACTION POINTS

- **Group structure chart:** If it does not already exist, a full structure chart, showing all legal entities, should be compiled and kept up to date. This chart should indicate where each entity is incorporated, in which jurisdictions it has branches (where relevant) and the identity of any regulator(s). One or more named individuals should be given responsibility for maintaining this chart and systems should be established to ensure that person is informed whenever there is a change.

- **Understand the reasons for and benefits of the structure:** Take steps to understand why the structure of the group developed in the way it has and whether the original justifications for the structure still hold true. If these are not readily apparent (e.g. because none of the individuals who were involved in the establishment of the structure remain in the group) then consider what the benefits of retaining the structure might be.

- **Are there any simplification benefits?** Are there benefits that might be obtained by simplifying the group structure? What would be the implications of changing the structure from a corporate, tax, regulatory, regulatory capital and, where relevant, consolidated supervisory perspective?

- **Regulatory powers:** Understand what powers regulators may have to require that the structure of the group be simplified. Note that where these powers exist regulators may, if they identify wider benefits of doing so, exercise them without regard to any detrimental commercial impact this might have on the group concerned.

- **Have a contingency plan for regulatory objections to the structure:** Where changes to the group structure would not deliver benefits to the group, assess whether there are nevertheless complexities in the structure to which regulators might object and give serious consideration to developing a simplification plan that could be proposed to an objecting regulator at short notice.

- **Management structure:** In addition to the corporate structure, apply the points above to the management structure of the group.

2. TRANSPARENCY

THE ISSUES

Regulators are pushing for ever more openness, transparency and co-operation from the firms which they regulate. At the same time, regulators are increasingly sharing large amounts of confidential information

between themselves across borders, often as part of supervisory college arrangements. How can firms protect their legitimate interests regarding commercially sensitive, privileged or otherwise confidential information that regulators ask them to disclose?

- **Indiscriminate and increasingly detailed requests for information:** Regulators in many jurisdictions are requesting ever more detailed data and other information from firms, without, in many cases, articulating clearly why they want or need that information. For some years this has been placing an increasing burden on major banking and insurance groups in particular.

- **Commercially sensitive information:** Many regulators routinely request that firms disclose information of a highly commercially sensitive nature, without providing assurances as to what will be done with that information, where and how it will be secured and to whom (if anyone) it will be transmitted.

- **Legally privileged documents:** The approach of regulators to requesting disclosure of legally privileged documents varies widely. In jurisdictions where disclosure of such documents to a regulator will or may result in a waiver of privilege regulators can pay scant regard to the damage that this could cause the firm concerned.

- **Exchange of information between regulators:** The legal basis on which regulators may exchange confidential information is not always clear, and there are particular challenges in this regard in the context of supervisory colleges. Even where the legal basis is clear, disclosure of information between regulators may result in the transmission of that information from a regulator with relatively robust security arrangements to one without such arrangements.

- **Duties of openness and co-operation**: legal and regulatory duties on firms to be open and co-operative with their financial regulators arise in many jurisdictions. While this can and does bring benefits both to firms and regulators, it can cause difficulties where there is an actual or potential disagreement with a regulator as to whether particular information should be disclosed.

ACTION POINTS

- **Assess each request for information from a regulator critically:** It is important to ensure that there is a reasonable understanding of the purpose of the request, the powers that the regulator has to make the request and the nature of any obligation on the firm to comply.

- **Privileged documents:** Privileged or potentially privileged documents should be handled with particular care. If their disclosure to a regulator would or might result in a waiver of privilege then this should be brought to the relevant regulator's attention as soon as possible. On occasion, disclosure of the document in question is essential to enable the regulator to understand important points and to carry out its role. It may then be necessary to explore whether there are mechanisms available in the relevant jurisdiction to disclose salient points to the regulator in a manner that minimises the risk of a waiver of privilege, but even where they exist these mechanisms should only generally be considered as a last resort.

- **International exchange of information between regulators:** International groups are generally well aware of the likely conduits of information exchange between their regulators. It is important that they gain a good understanding of the security and confidentiality arrangements of each of their regulators and, where possible, of the procedures that their regulators will employ when exchanging confidential information. Firms should also understand the legal basis on which transfers of information may take place and, where this is uncertain,

they should seek clear explanations from their regulators. This is particularly important at present in the context of supervisory colleges.

- **Records:** It is essential that firms maintain clear records of information that has been submitted to their regulators. One of the more challenging aspects of this is ensuring that these records capture information submitted on a worldwide basis: many groups do not yet maintain a central register of all such submissions. The risks associated with a lack of record keeping in this area are obvious. They include inadvertent submission of inconsistent data to different regulators and lack of knowledge in a group of what the group's regulators know and understand at a time when the group may require rapid regulatory approvals or other assistance in connection with a strategic business development, reorganisation or M&A transaction.

- **Duties of openness and co-operation**: While it is clearly important to comply with rules requiring open and co-operative behaviour towards regulators, it is critical that firms understand what those rules mean in practice and take advice where necessary. In cases of uncertainty it is important to adopt a consistent approach to compliance.

3. UNCERTAINTY 1: ANTICIPATING CHANGE

THE ISSUES

Rules are changing rapidly. How can financial institutions best anticipate what changes are around the corner?

- **The wall of regulation:** It is self evident that financial institutions are facing an immense amount of regulatory change. Even for the better resourced groups it is proving to be very difficult to know what to prioritise and how to see the wood for the trees. Trade associations have often not been best placed to identify key issues, particularly as these often differ radically between groups.

- **Last minute changes despite long notice:** While many regulatory changes are announced well in advance of implementation and often go through a tortuous process of negotiation and development, this does not prevent last minute changes.

- **The trap:** Groups that do not anticipate regulatory change risk playing a constantly reactive role. Groups that have taken this approach find themselves regularly "fighting fires" and reacting in a piecemeal way to a bewildering array of new regulatory initiatives that impinge on their strategies. The hostility to regulatory change that this can generate within groups then only adds to the difficulty of engaging constructively with regulators.

ACTION POINTS

- **Assess the effects of impending change:** Anticipating change does not end (or even begin) with assimilating the proposals of governments and regulators. It involves assessing the potential impacts of those proposals on the group's operations and development plans. Groups that invest significant sums in in-house legal, compliance and other resources devoted to this assessment without (a) involving input from all key business areas and (b) requiring business involvement in this assessment as a priority, risk obtaining poor value for their investment.

- **Address the impact:** The next stage, following an adequate assessment of the potential impact of an impending change, is to assess the options to address and, where appropriate, to mitigate that impact. Where there is more than one option, the relative merits of each option should also be assessed.

- **Understand what proposals mean:** It is often not enough simply to read consultation papers and other documentary proposals for change. Conversations with contacts at regulators and with other market participants can often provide useful insights into what changes could really mean in practice. Opinion is divided on the utility of conferences for this purpose. Trade associations, professional conference organisers, legal publishers, media organisations, law firms and regulators themselves are holding an increasing number of conferences and seminars to discuss and debate regulatory change. Inevitably, some of these events offer much more helpful insights than others. Those with the time (and the budget) to attend conferences should focus on those featuring heavyweight contributors from regulators with maximum opportunity to engage in real discussion.

4. UNCERTAINTY 2: THE FOCUS ON OUTCOMES

THE ISSUES

The gulf between what the rules say and what they can be said or made to mean in practice has never been wider. Regulators will increasingly focus on outcomes, reverse engineering the desired outcomes to frame the manner in which financial institutions should behave. How can financial institutions address the lack of certainty that is inherent in this approach to regulation?

- **Risks and opportunities:** The focus of many regulators on outcomes carries both risks and opportunities for financial services businesses. The risks include that regulators require outcomes that firms are not currently achieving and/or that regulators judge the quality of outcomes by reference to criteria that are not widely taken into account in the market. Conversely, there may be more effective ways of achieving a required outcome.

- **Uncertainties:** The outcomes that regulators desire may, however, be uncertain. Regulators may express these outcomes in terms of “fair” and “reasonable” treatment of customers without specifying specific results or states of affairs. In this way regulators can also readily “move the goalposts”.

ACTION POINTS

- **Understand the outcomes required:** Where a regulator specifies an outcomes-based regime for particular regulated products or activities, take steps to understand what that outcome is and what it means in practice. Could it mean different things to different customers? Are there any customers for whom exceptions should be made because their position and needs are manifestly different from those of other customers?

- **Address uncertainties:** Where the required outcome is uncertain, it will be necessary to consult the regulator or to come to your own view of acceptable outcomes, having regard to the regulator’s priorities and stated objectives. View this process as one of regulatory risk management in which you arrive at an outcome for your customers which is, in your considered view, the one least likely to give rise to regulatory criticism. Knowledge of the developing policy of the relevant regulator(s) is essential in this risk management exercise.

5. UNCERTAINTY 3: PRODUCT REGULATION

THE ISSUES

Many financial regulators have, at least in the past 20 years, actively avoided prescriptive regulation of individual financial products. That is now changing quickly in many jurisdictions. How can financial institutions launch new products while the future development of the regulatory regime remains uncertain? How can they standardise products across borders when different regulators are applying different prescriptive rules?

- **Why product regulation?** Product regulation is often said to be a futile exercise for regulators: as soon as one product is regulated another product is devised and regulators find themselves in a game of cat and mouse with firms. So why are some regulators now starting to regulate (or prohibit) specific products? There are a few things to say about this:

  – Product regulation need not be particularly prescriptive. It can, for example, simply be a manifestation of outcomes-based regulation (see above) with reference to specific products.

  – There is some cross-border impetus to product regulation in the EU. The growing importance of the EU's UCITS regime means that an increasing number of retail funds (and their managers) are subject to rules set at EU level as to how such funds are marketed and managed. The product-specific aspects of EU financial services regulation will expand with the implementation of the Alternative Investment Fund Managers Directive and may be widened very much further if, as has long been proposed, a new regime for "PRIPS" (packaged retail investment products) is introduced.

- **Subsequent changes:** Once a set of product-specific rules is introduced it can generally be expected that regulators will find it easier to amend those rules than they found it to introduce those rules in the first place.

- **Implications for product development:** Financial institutions are now well used to developing new products against a backdrop of regulatory change. But what new factors are brought into play where regulatory change could be directed specifically at products under development today?

ACTION POINT

- **Look again at product development processes:** Many financial institutions have spent considerable time and resources in the last 10 years introducing internal regulatory review into their product development processes. The advent of more product-specific regulation will only increase the need for this. Firms would be well advised to assign responsibilities to specific individuals to keep under review the development of regulation relating to specific product areas: this may well be too much for one person to do over the full range of a consumer financial services group's businesses, even within one jurisdiction.

6. MANAGING RELATIONSHIPS WITH REGULATORS

THE ISSUES

None of compliance staff, legal staff and risk staff are, on their own, the optimal guardians of a group's relationships with its regulators. Whom should financial institutions appoint to lead the management of their relationships with regulators, how should that person (or those persons) fit in to the wider organisation of the institution and what does the role now involve? Why, by the way, do relationships with regulators need "managing"?

- **What about compliance staff?** Compliance staff are dedicated to ensuring that a firm complies with the rules applicable to it, so why should they not be at the forefront of a relationship with a regulator? The answer is, of course, that they should be. But in larger and more complex groups we do not think they can be the sole guardians and co-ordinators of that relationship. In particular, where there is a serious compliance problem, those professionals may be implicated in that failure. This is likely to curtail their ability (and/or credibility) to play a leading role in solving the resulting problems. To whom in the firm should the regulator turn in such an unfortunate situation?

- **What about legal staff?** Lawyers should, amongst other things, be problem solvers. That implies that, at least where there is a potential for legal liability to arise, they should be involved in finding solutions to compliance problems. That does not, however, mean that the in-house legal function of a firm should have day to day oversight of the firm's compliance function. That would risk implicating the lawyers in the very problem that we highlight above in relation to compliance professionals.

- **What about risk staff?** Defined narrowly, risk management functions are not best placed to lead-manage a relationship with a regulator because their role is essentially one of monitoring the risks to which the relevant firm is exposed rather than one of exercising oversight over the firm's regulatory affairs more generally. In addition, by their very nature, aspects of risk management require a degree of detachment from the business concerned so as to ensure that those measuring and monitoring risk are not "captured" by the earnings objectives of the business or personal ambitions of those individuals who are authorised to put the firm on risk. This detachment from the "executive direction" of the firm means that risk staff are typically not best placed to manage a firm's overall relationship with a regulator even where they may frequently interact with the regulator.

- **The international dimension:** As discussed further below, multiple operations in numerous jurisdictions add additional complexities to this challenge.

- **What is it that needs managing?** Based on the frequency with which it happens, it is surprisingly easy for firms to forget that regulators are run and staffed by individuals who are made fallible by their own limitations, including pressures of work. The success or failure of a firm's engagement with the regulator will depend to a significant extent on how effectively it engages with its individual supervisors at the regulator. The quality of this engagement can depend on many months or years of effort: it is a relationship-building exercise and that is what we mean by "management" of the relationship with the regulator.

- **Who can play this role?** There is no answer to this question that is appropriate to all financial institutions. Some groups that recognise and have experienced all of the issues noted above have taken the more radical step of appointing an individual with business-wide authority and responsibility to front their dealings with all of their regulators and to head a department which manages and monitors all regulatory issues to which the group is subject. This role differs from that of most compliance professionals because it is not principally concerned with day to day compliance; it is more concerned with longer term strategic aspects of regulation and its effects on the group's businesses.

ACTION POINTS

- **The relationship needs to be managed:** Do not dismiss the idea that the relationship with a regulator needs to be managed. The better the relationship is, the more likely matters are to proceed smoothly when the group really needs the regulator's assistance, such as on a difficult or contentious acquisition, disposal or reorganisation.

- **Responsibility:** Do not leave responsibility for the management of that relationship fragmented between different individuals and groups of individuals without adequate co-ordination. Consider appointing an individual with real power and authority within the group to carry out the co-ordinating role. The emphasis here is on power and authority: we have seen some examples of groups who appointed global co-ordinators with the best of intentions but did not invest those individuals with sufficient power and authority to do the job effectively.

7. INTERNATIONAL DUPLICATION

THE ISSUES

How should financial groups address these issues in multiple jurisdictions? Is this simply a question of duplication of effort or is a more sophisticated approach called for, particularly with the increasing relevance of colleges of regulators and international co-operation between regulators increasing?

- Addressing the issues described in this paper across multiple jurisdictions is not simply a matter of duplicating resources and regulatory work across those jurisdictions. Financial institutions need to take account of the inter-connections between their operations in different jurisdictions as well as the need for centralised control, consistency of messages to regulators and an overview of the group's operations.

- This is easy to say but can be difficult to put into practice. Challenges include the following:

  – **Volume of material:** The volume of rules and guidance produced by regulators worldwide can make it an impossible task for any central compliance or regulatory function to assimilate, understand and act on all developments. Some local delegation will typically be required and some regulators may well insist on a local representative to take charge of regulatory matters in any event.

  – **The potentially conflicted position of local management:** Most financial regulatory systems place personal responsibilities and/or liabilities on local management of regulated businesses. Local management therefore face a potential conflict between the need to acknowledge and, where possible, put into practice the strategies of their parent and the need to comply with local rules and requirements imposed by regulators. This can cause particular difficulties where a regulator is seeking to impose requirements on a local business against the wishes of the parent in another jurisdiction. Local management may, as a result of their personal obligations under local rules or otherwise, not be inclined to resist the regulator's demands. In some circumstances the parent may only find out about the demand after local management has tacitly accepted it. At its worst, this can result in a parent effectively losing control of significant aspects of the way in which an overseas subsidiary conducts its business.

  – **Requirement for oversight:** Many regulators require that a parent company over which they have jurisdiction keep itself informed of developments in its subsidiaries so that, so far as possible, it can influence the outcomes of local regulatory requirements.

  – **Consistent messages:** It is critically important that a group delivers consistent messages to its various regulators, not least because those regulators increasingly communicate with each other and the credibility of the group may well suffer if one regulator finds that it has received information that is not consistent with that received by another.

  – **Non-core jurisdictions can cause significant problems:** Economising on regulatory monitoring and coverage in jurisdictions that are not central to a group's plans may be a false economy. Regulatory problems that arise in one jurisdiction can cast the group as a whole in a bad light and the resulting reputational damage can have a corrosive effect on the group's relationship with its lead regulator.

ACTION POINTS

- **Central co-ordinator:** Many of the challenges described above are best handled by a single, authoritative regulatory co-ordinator of the type described in section 6 above.

- **Central knowledge:** The challenges described above point towards a need to maintain a certain minimum knowledge of local regulatory requirements at the centre. This could be in the form of a description of the relevant local regulatory system, responses to questionnaires that are updated on a regular basis, links to clear explanations of the regulatory system on subscription websites or a combination of these. It is also sensible to maintain links with advisers who are independent of local management in overseas jurisdictions and who can be called upon to advise in circumstances where local management face the potential conflict referred to above.

- **Local representatives:** Ensure, as far as practicable, that in all jurisdictions where the group carries on business there is a representative of the group tasked with providing early warning of impending regulatory challenges and related supervisory issues. This person would, in each case, ideally not be subject to personal obligations under the local regulatory system and therefore not subject to the potential personal conflict referred to above.

8. INFLUENCING THE NEW RULES

THE ISSUES

What can financial institutions realistically do to influence new rules at UK and EU levels?

- **General failure to consider implications of reforms:** Despite numerous consultation procedures, open hearings, conferences and other opportunities for industry participants to express views on proposed new legislation and rules at national and international levels, one of the most striking aspects of regulatory reform in the past three years has been the failure by governments, regulators and, above all, industry participants themselves to consider the likely impact of reforms in a systematic and logical way. This is shown by the number of occasions on which previously unanticipated consequences of new regulation have come to light when it is too late adequately to change the course of reform.

- **Inadequate consideration of industry comment:** Many government departments and regulators find it difficult to distinguish between concerns well expressed and clever lobbying tactics. Who could blame them? But their response has often been to push on with reforms without adequately considering the consequences.

- **Industry bodies:** Industry bodies can provide useful means for industry participants to express and exchange views on regulatory reforms. Many of these bodies were, however, established in a pre-crisis age when regulatory change was slow and far from the political spotlight. They have often struggled to keep pace with reforms and some of them find it difficult to pursue important points effectively on behalf of the sectors which they represent because they do not have the resources to do so. We have seen two responses to this issue:

  - More bodies claiming to represent particular financial sectors have been established. The proliferation of committees and other trade bodies has not, on the whole, helped regulators to recognise what is important when considering the effects of their reform plans.

  - Many more sophisticated financial institutions have taken to responding to consultations and making representations to governments and regulators themselves.

ACTION POINTS

- **Engagement:** Despite the concerns expressed above, we emphatically recommend that financial institutions with the resources to do so engage with their regulators on reform proposals. Such engagement could include discussing the proposals with supervisory and other contacts within regulators, responding to consultations (either directly or through a properly resourced industry body) or attending and participating in open hearings that regulators may organise to discuss proposals.

- **The point of greatest influence:** It is particularly the case in the context of EU reform proposals that the point of potentially greatest influence for firms is most likely to fall before the European Commission starts to draft proposed legislation. It is important to make contacts in the Commission with officials involved in the process by which legislative proposals in financial services are drawn up and to convey views to those officials. When commenting on draft EU legislation, it is helpful to have knowledge, or to have access to external advisers with knowledge, of how particular issues have been addressed in other EU legislation in the past. It can often be far more persuasive to suggest a drafting solution that has been employed before than to mark up a draft with comments that may seem unfamiliar or new to officials who will often be concerned about unintended consequences of new drafting.

- **The real economy:** In an era, at least in Western economies, of a general political hostility towards some types of financial institution, it remains very important, when commenting on reform proposals, to provide real economy examples of the potential negative consequences of deficiencies in the proposals. It is easy to forget that legislators and many regulators may not have the background knowledge and understanding to be able to appreciate quickly the practical consequences of a proposal which may, for example, be directed ostensibly only at the banking sector.

9. THE BOARD

THE ISSUE

What part should the board be playing in addressing these issues and what continuing engagement with regulatory issues is it appropriate for the board to have?

ACTION POINTS

- **Corporate governance:** It is a mark of the importance that is now attached to ensuring that the board understands the regulatory issues facing a firm that most regulators now regard this as an essential part of a firm's corporate governance arrangements. A survey of corporate governance developments is beyond the scope of this paper. However, the key points regarding the board's engagement with regulatory issues are as follows:

  - *Understanding the issues:* At the most critical and basic level, the board needs to understand the regulatory background against which it is taking decisions. It needs to understand expected future developments as well as regulatory reform that is already in place. Without this understanding the board risks taking decisions which do not achieve their intended outcome or, worse, which have unintended negative effects. Boards also risk failing to identify important issues before it is too late to do anything about them.

  - *Explaining the issues to the board:* The question therefore arises as to what arrangements the board should have to ensure that regulatory issues that could affect its decision-making are identified, articulated clearly and adequately taken into account in the range of options that the board considers when it discusses matters of critical importance to the firm. The answer to this question will vary between boards, and

between the subject matter of the decisions concerned. Legal, compliance and risk personnel often, to varying degrees, play this role. It is important that whoever does so has thought carefully about the issues at hand themselves; is able to engage with the board (in person or in writing) in a way that gives the board confidence that adequate thought has been given to those issues; and has a sufficiently broad and deep understanding of the firm's businesses that they can frame their explanations in a practical context.

- *Pre-empting issues:* One of the most difficult questions for the board and for those executives suggesting issues for the board to consider is when to discuss an impending regulatory development that could have a significant effect on the firm's business. It is clearly possible that to delay discussion until the new development has been finalised and will shortly come into effect will often be to leave it far too late to consider the implications. It is therefore critical that there are systems in place to ensure that such issues are brought to the board's attention early enough. By bringing an issue to the board's attention we mean: (i) explaining the impending development clearly and concisely, (ii) explaining its potential implications for the firm's business; (ii) identifying the uncertainties (if any) in the likely scope and timing of the development and (iii) where appropriate, suggesting options for the board to consider to address the development.

- *Agenda item:* Some firms, particularly in those sectors that are having to cope with particularly high volumes of proposed and actual regulatory reform, have adopted the practice of having a standing agenda item at board meetings at which an update is given to the board on regulatory developments and what the firm is doing about them. Other firms consider this approach to be overly rigid. The important point is that critical regulatory issues should be brought to the attention of the board in the most effective way. This is particularly so in the case of an issue that could give rise to regulatory or civil liability for the firm, where there is evidence that directors received information about the issue but, for whatever reason, failed to do anything about it.

• **Non-executive directors (NEDs):** Regulators in many jurisdictions have, on numerous occasions since the financial crisis, emphasised the importance of NEDs holding executive directors to account. In our experience, in some firms it is currently the NEDs, just as much as the executive directors, who are demanding better analysis of the implications of regulatory developments for firms. We would recommend that:

  - NEDs are integrated fully into discussions at board level on these matters.

  - NEDs are provided with opportunities to consult internal or external advisers on regulatory matters and to participate in internal training on important regulatory matters where they would find that helpful.

  - Where a NED has experience of dealing with large scale and complex regulatory developments elsewhere, the firm should draw on that experience so as better to understand good and bad practice when developing an adequate response to regulatory developments.

  - When selecting new NEDs, firms should consider their experience of dealing with regulatory developments.

• **Interactions with the regulators (1):** Many regulators are demanding more access to individual directors (both executive and non-executive). For example, the FSA in the UK is routinely interviewing candidates for directorships of systemically important financial institutions and is finding other opportunities to interview directors when carrying out its supervisory role. Firms should have in place adequate systems to ensure that directors are properly briefed before they attend such interviews and that a proper record is kept of what is

said at those interviews. A briefing paper for directors explaining the process for interviews with the regulator (including key "dos and don'ts") can help.

- **Interactions with the regulators (2):** Some regulators seek to attend board meetings from time to time. Where this has happened there is a temptation amongst members of the board not to have as open a discussion as would otherwise be the case. Great care should, of course, be taken to ensure that the firm does not prejudice its position in future legal or regulatory enforcement proceedings by what is said, or how it is said, at a board meeting at which the regulator is represented. On a more positive front, some firms have turned such meetings to their advantage by using them to demonstrate to the regulator the sophistication of their planning for regulatory developments and to highlight at first hand some of the practical difficulties that regulatory reforms might be presenting for the firm's businesses.

10. THE GENERAL COUNSEL

THE ISSUE

The approach of general counsel to these issues varies widely, but the key question for all general counsel remains the same: when and how might regulatory issues and developments create legal risk? How does the answer to this question differ now from a few years ago?

- **Are the legal and compliance functions insufficiently co-ordinated?** Inadequate legal analysis of issues that begin as regulatory problems, and inadequate regulatory analysis of issues that begin as legal problems, would appear to suggest that this is often the case:

  – **Inadequate legal analysis of regulatory problems:** The list of problems that have emerged in financial institutions in the last 10 years as essentially regulatory problems, but have then taken a nasty turn from a legal perspective, is very long. Examples include:

    – various forms of product mis-selling (historically often treated as breaches of a regulator's rules without adequate analysis of the accompanying civil liability, with all the usual consideration of types of claim (contractual or tortious?), causation, quantum of loss and remedies that such an analysis involves);

    – mistakes in customer documentation and marketing materials (again, historically often treated as breaches of regulation without a proper analysis of potential unenforceability and/or legal liability for misrepresentation, negligence or breach of contract);

    – failure to consider or understand legal and equitable concepts such as fiduciary duties (for example, in the context of profits or other benefits to the firm that are not disclosed to customers, and conflicts of interest) and the duties of trustees and agents;

    – inadequate consideration of whether the risk of regulatory enforcement, and the manner in which a firm responds to regulatory enforcement action, may increase the risk that civil litigation could also arise;

    – inadequate consideration of the contractual or other liability of third parties to a firm where they are the cause of a mistake that has resulted in the firm breaching applicable rules;

    – failure to appreciate what system of law governs a particular contractual relationship and to obtain appropriate legal advice from lawyers qualified to advise on that law; and

  - analyses of whether documents or information should be disclosed to the regulator that lack adequate consideration of the implications of doing so from a civil liability perspective (e.g. are documents privileged? Who else might be able to gain access to the documents if they are disclosed to the regulator?).

- **Inadequate regulatory analysis of legal problems:** There are also numerous examples of legal problems not being subjected to sufficiently rigorous regulatory analysis, including the following:

  - firms negotiating and entering into contracts without considering key regulatory points which might affect what those contracts should provide for (such as limitations on the firm's ability to take or refrain from taking certain steps);

  - inadequate consideration of the implications of giving contractual undertakings to comply with applicable law and regulation;

  - firms neglecting to consider a regulator's policy towards unfair contractual terms in consumer contracts when designing customer documentation;

  - firms neglecting to raise critical points against regulators that overstep their powers, for example, in relation to regulators demanding disclosure of information without the legal power to do so; and

  - inadequate consideration of when and how to disclose the existence of pending litigation to regulators.

- **But legal and compliance disciplines are fundamentally different:** The examples listed above imply that legal and compliance functions ought to be working together more closely. We do not, however, think that these examples will always make a strong case for integrating the two functions. In particular:

  - *Resourcing and allocation of work:* In many firms it makes sense, in terms of adequate resourcing and assigning tasks to staff with appropriate skills, to have a separate member of staff or group of staff who are responsible for looking at the minutiae of the regulators' rules.

  - *Conflicts (1):* If the legal department of a firm also carries out compliance duties then the lawyers within that department may find themselves personally conflicted if, in circumstances where there has been a breach of a regulator's rules, they are charged with finding a solution. It is rarely a comfortable position (or, in some cases, a tenable position) for a lawyer who has failed to prevent a problem also to be responsible for solving that problem. So there is a case for ensuring that at least some in-house lawyers at a firm are sufficiently far removed from regulatory compliance work at the firm to be able to address the legal implications of compliance problems dispassionately and are free of personal conflict.

  - *Conflicts (2):* Some regulatory systems, including that in the UK, impose personal duties and responsibilities on holders of certain compliance functions within firms. If the individuals concerned are practising lawyers then these duties and responsibilities under the regulatory system may conflict with their professional duties as legal advisers. For example, lawyers who are also holders of such compliance functions have found themselves in the uncomfortable position of having personal duties to disclose information to the regulator under rules applicable to the holders of those functions while also operating as legal advisers with attendant duties of confidentiality. Many in-house lawyers will wish to avoid such potential conflicts and fetters on their ability to advise their firm by steering clear of the compliance roles that attract personal duties of the kind mentioned above.

ACTION POINTS

- **Better co-ordination:** In our experience, in some groups with separate in-house legal and compliance functions, co-ordination between the two functions could be improved, and in some cases to a very great extent. The in-house lawyers need to appreciate the regulatory implications of issues on which they are advising, and compliance professionals must understand the legal implications of their work. This is difficult to put into practice: many lawyers have little interest in compliance matters and compliance professionals who are not lawyers cannot be expected to grasp all of the legal implications of a regulatory issue. Some ideas that we have found can help include the following:

  – Regular joint training and/or seminars for the legal and compliance functions on topical issues can help individuals in those functions understand when they should contact the other function for assistance.

  – When a problem involving legal and compliance elements has been addressed it can be helpful to arrange a joint debriefing session at which views can be exchanged on how the two functions worked together and implications for the future.

  – Surprising to some, there are some lawyers who take great interest in regulatory matters. General counsel should consider making better use of these individuals to act as a liaison between the legal and compliance functions of the firm.

- **Blurred boundaries:** The boundaries between legal and regulatory disciplines are increasingly blurred. When recruiting new legal staff, firms should consider the regulatory experience of individual candidates. If a candidate has little or no regulatory experience then it could be very difficult (or simply impossible) for him or her to learn "on the job" in a fast moving business.

11. BUSINESS OPPORTUNITIES

THE ISSUE

What, in broad terms, are the business opportunities that the new regulatory world may bring for well organised and far-sighted financial institutions?

- **The role of lawyers and compliance professionals:** It is certainly in the interests of lawyers and compliance professionals to find and highlight business opportunities that regulatory developments may present. But how many lawyers and compliance staff actually have a clear mandate and opportunity to do this?

- **Examples of opportunities:** Business opportunities arising from regulatory developments may, based on past experience, be categorised as follows:

  – *First mover opportunities:* Where a regulatory change requires significant thought, expenditure and/ or organisational change in a firm then firms that realise this early and act on it are likely to have an advantage over their competitors who face the same challenges.

  – *New products:* Regulatory changes may give rise to opportunities to develop new products. Recent retail examples include the development of e-money and new cross-border payment systems, changes to the UCITS funds regime in the EU and the changes in some jurisdictions to accommodate the development and marketing of Islamic investment products. Recent examples in wholesale business include the development of more attractive derivative products for funds in the post-Lehman world (e.g. more effective

segregation of client assets), new risk mitigation instruments for banks and insurers and new clearing arrangements for OTC derivatives.

- *Access to new markets:* Regulatory change in markets where a firm does not currently operate may present opportunities for the firm, particularly where it possesses the skills required to prosper under the new regulatory regime (e.g. because a similar regime already operates in the firm's home market). Market liberalising changes also present opportunities. Surprising though it may be, there are some impending examples of this in Europe, including (subject in all cases to certain conditions) potentially greater access to the EU markets for non-EU reinsurers under the EU Solvency II Directive and a potential future "passporting" regime within the EU for the managers of non-UCITs funds under the Alternative Investment Fund Managers Directive.

- *Regulatory capital:* Reforms requiring firms to hold greater regulatory capital, and changes to the required characteristics of capital instruments, are presenting opportunities for some firms to raise additional capital that may be required ahead of their competitors or, for the more sophisticated firms, to develop new capital instruments. In the realms of reducing risk-weighted capital requirements, banks and insurers are now thinking more than ever before about instruments and transactions that might achieve this effect.

- *Structural opportunities:* Some regulatory changes threaten to render certain group corporate or organisational structures inefficient. For example, many insurers with significant operations in the EU are considering their group structures in the context of the introduction of the Solvency II Directive.

- *Transaction opportunities:* Some regulatory changes are so radical that they encourage sector consolidation. Changes in this category include changes that force firms to find additional capital or liquidity that they cannot easily raise themselves, and changes that render certain business models inefficient (with the result that some groups may be broken up or businesses closed).

- *New relationships with regulators and legislators:* Major regulatory change presents firms that have the resources to do so with opportunities, in the course of lobbying or responding to regulatory consultations, to make new contacts at regulators. These activities can provide one of the few opportunities that many firms have to work to achieve positive outcomes with a regulator on projects where the regulator does not have in mind a set of objectives specific to the firm.

ACTION POINTS

- **Consider opportunities:** As a matter of routine, staff within firms who are responsible for business or strategic development should consider whether any of the opportunities listed above arise whenever a significant new regulatory reform is proposed.

- **"Idea originators":** One or more members of in-house legal and compliance functions should be assigned the task of thinking about opportunities of the types listed above. In practice, if such opportunities arise then exploiting them will require the involvement of many more staff with different roles to play, but "idea originators" are required. Ideas need not, of course, always be originated within a firm. Subject to confidentiality and third party proprietary rights, firms can look further afield for ideas, to their external advisers, consultants and conferences.

- **Protect proprietary knowledge:** Where opportunities are developed, firms should think carefully about where knowledge of those opportunities lies and the risk that staff who are critical to the exploitation of an opportunity may leave the firm for a competitor.

OUTLOOK

Many of the issues and ideas discussed in this paper were not very far up the agenda of financial institutions before the financial crisis. The issues we have identified here demonstrate how important it has become for the senior management of firms to engage with regulatory matters and the pitfalls, particularly in strategic terms, if they fail to do so.

At the same time, addressing these issues is challenging and is likely to become increasingly so. The key to success is to try to get ahead of the game by developing systems to assimilate, assess and analyse the effects of regulatory developments before competitors do so and before reform proposals become so embedded that their most problematic features cannot be challenged and modified. Groups that manage to achieve this better than others stand to gain a real advantage over their competitors in the years to come.

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