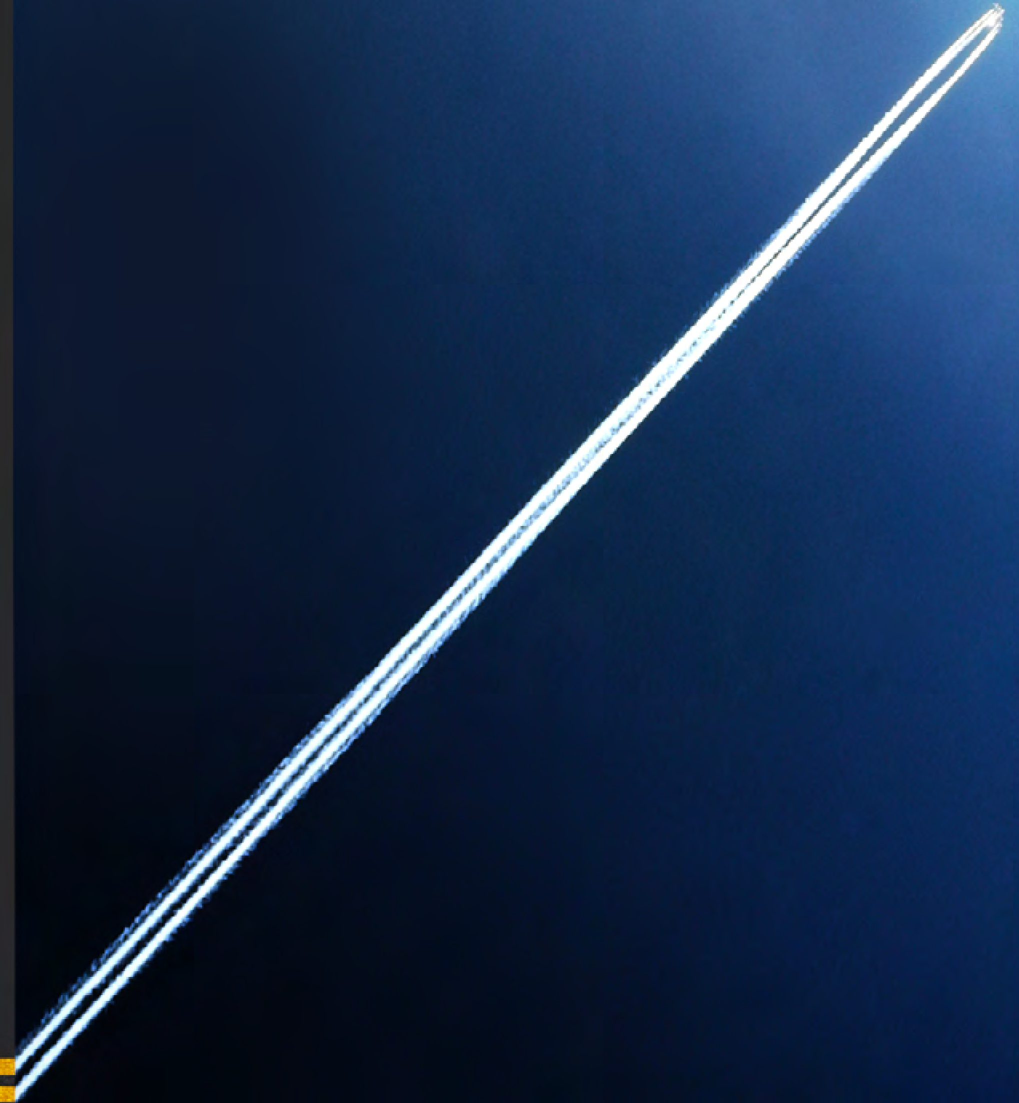
Compliance Solutions Strategies

Transforming Regulatory Compliance into a Strategic Advantage



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Compliance's Competitive Edge

More asset managers are realising that their response to increasing compliance requirements must be both tactical and strategic. To minimise impact on business as usual and internal resources, they want a cost-effective solution, matched precisely to regulatory requirements. But they also understand the value of a multi-faceted yet holistic approach which allows them to respond quickly to new and evolving requirements, as well as anticipating and preparing for future compliance challenges. As polling at our 2020 Regulatory Forum shows, regulatory change is still the compliance officer's biggest challenge. Some are even looking to use compliance-related data and processes to support and/or establish competitive advantage.

At CSS, we see this shift toward a more strategic approach on a daily basis. Requests for proposal (RFPs) from asset management firms increasingly ask us to propose solutions to a wide range of compliance needs, which has encouraged us to develop further our Compliance-as-a-Service (CaaS) offering. As clients' needs grow in volume and complexity, supplying tools to streamline and automate reporting and compliance processes is necessary, but insufficient. Increasingly, managed services are required, combining data, systems, and consultancy in an ongoing service partnership to meet current and future requirements cost-effectively.

It used to be said that compliance is not a competitive issue. After all, you don't win business for how well you fill in a form. That's true up to a point. But the efficiency and effectiveness with which you comply with and respond to regulatory requirements is a function of your organisation's overall corporate governance and management quality. A firm that is repeatedly penalised for non-compliance will suffer damage to its balance sheet, management focus and, eventually, its reputation. But the firm that continually invests in improving its compliance processes will reduce costs and risks over time, gaining the insights to position itself to handle future challenges. As such, compliance is becoming an indicator of competence, resilience and responsibility.

The due diligence requirements of asset owners and institutional investors are toughening up all the time. Returns will always be important, but they are not the only metric, especially in times of uncertainty. It is part of the fiduciary responsibility of plan sponsors to appoint intermediaries that meet high standards in terms of stewardship. Further, both retail and institutional investors increasingly expect asset managers not only to offer investment opportunities that meet ESG criteria, but to hold themselves to high standards against these criteria.

Good governance matters more than ever, a fact underlined by the inflows and performance of ESG funds. Just as asset owners expect portfolio managers to consider the governance capabilities of the firms in which they invest, they also expect asset management partners to demonstrate a strong governance record, including compliance. Whether implicitly or explicitly, for example through a third-party scoring mechanism like a credit rating, compliance effectiveness is becoming a key factor in investment and business decisions.

To make effective compliance a business differentiator, asset managers must not only share information efficiently with regulators, they must also utilise the strategic insights gained by the compliance function to deliver improvement, within compliance and beyond. Lessons learned in one realm or discipline can be leveraged across the wider enterprise.

> "We are drowning in information but starving of wisdom."
> **– E. O. Wilson, Biologist and Pulitzer Prize-Winning Author**

The esteemed biologist, naturalist and Pulitzer prize-winning author E.O. Wilson observed that we live in an age where, "We are drowning in information, but starving of wisdom. The world henceforth will be run by synthesizers, people able to put together the right information at the right time, think critically about it, and make important choices wisely." Wilson believed in the value of sharing ideas, facts and theories to achieve a common framework from which to understand the world.

At CSS, our approach to delivering compliance solutions and services is informed by this insight. By helping clients to automate and improve their compliance processes, we hope to contribute to the development of best practice and to the ability of compliance teams to support enterprise-wide business goals.

CHAPTER ONE

DATA'S NEW VALUE PROPOSITION

Data's New Value Proposition

The fragmentation of data sourcing, processes and technology is a profound barrier to efficient regulatory reporting frameworks. RBOR – the regulatory book of record – creates a highly centralised and inter-connected repository of verified data that overcomes complexity and optimises the sourcing and management of data for compliance and reporting.

Long before the heavy load imposed by the past decade's expanding regulatory burdens, data management was a challenge for many on the buy-side. Asset managers' operating models have typically been designed to be light and nimble in order to focus resources on core investment management and product development activities, both of which can be subject to rapid change in market realities.

In many ways prudent, this approach has led to high levels of dependence on third parties, notably broker-dealers and custodians, for key elements of asset managers' operating infrastructure, including technology platforms and data. When you're receiving post-trade transaction reports or NAV inputs in multiple formats and at varying times, data confirmation and consolidation can be extremely time consuming.

> "Through its centralised control of an RBOR-based approach, asset managers can build comprehensive links between data sets to provide stronger controls, share outputs with regulators, develop predictive analytics and reduce manual aggregation."

Buy-side data management and governance processes have been impaired by other factors, such as the proprietary formats of core technologies, e.g. order management systems (OMSs), and the often-balkanised internal structures across departments and desks. In this context, the timely access to accurate, comprehensive data demanded by today's regulatory environment is a steep challenge. Inevitably, when reporting requirements mount, from relatively standardised periodic filings to jurisdiction-specific processes reporting to a registered trade repository or around short-selling restrictions and investment threshold disclosures, compliance staff may need to call on many internal and external sources to conduct even the most routine tasks.

"Each new regulation brings more data requests to be obtained from your clients, then stored in a GDPR-compliant way, and scrubbed and used for transaction or trade reporting, and transmission to the regulator," observed Linda Gibson, head of regulatory change and compliance risk at Pershing BNY Mellon, at CSS's 2020 Regulatory Compliance Forum, held in London.

The pressure that multiplying regulatory requirements can put on a firm's data management and operational infrastructure can be intense. Gibson cited the example of needing to source information from beneficial owners to meet three separate regulatory obligations: the EU Shareholder Rights Directive; the Fifth Money Laundering Directive; and updated European transaction reporting guidelines. As Gibson noted, considerable coordination is required to avoid duplication when defining and implementing the processes, policies and systems needed to manage these overlapping data requirements.

"You need to look across everything coming through, not only in terms of how you are running your projects but how you're are going to store and report that data. It is getting more complex out there," she explained, emphasising the growing challenges around sourcing and holding data.

The centralisation challenge

Buy-side firms have long recognised the benefits of a more centralised approach, but many have still struggled to exert the control needed to achieve data quality and consistency. Often, this is due to the linear flow of transaction-driven processes across silos and counterparties (i.e. from front to back office, or from client to service provider), as well as a tendency to prioritise the information needs of the front office, rather than throughout the business.

Many larger firms have attempted to maintain a security master file, a comprehensive record of all data relating to an instrument or asset. The risk is that newer information received by the front office via an OMS is not necessarily reflected in the security master. Also, a risk management system

might generate instrument-specific data that is not shared beyond the middle office. And both systems may be constrained in the data they can hold and transmit by their original function or design, tied to a particular asset class, user group or jurisdiction. Even if these systems originally sourced data from a single master security file, coordination can lapse over time, if not explicitly built into rigorous data management processes.

From a compliance perspective, data requested by regulators can be drawn from any of these sources, with a potentially different output. And if the asset manager has selected a different compliance solution f or each new regulatory requirement (perhaps encountered when entering a new jurisdiction or asset class), it could end up with multiple applications tapping into incumbent systems, most frequently the OMS, leading to reporting inefficiency and inaccuracy. As well as the costs of implementation and duplication, this may well increase data governance and quality problems. Further, any changes to incumbent systems from which the data is sourced can require additional changes to all related compliance and reporting tools.

Recognising the value of data

Historically, many asset managers failed to make consistent investments in data, partly because its value is harder to quantify than its cost. This is changing in the digital age, as more firms recognise that 'data is the new oil'. More decisions are being driven directly by data, both in terms of alpha generation though new insights in the front office and alpha retention through operational efficiency in the middle and back office. Data is also leveraged to deliver a value-added and differentiated user experience, both in the institutional and retail markets. All this comes before we even consider the critical and growing importance of data in achieving and demonstrating compliance across a raft of processes and activities, with regulators already looking to leverage RegTech solutions and machine-readable regulation. As the value of data is recognised, forward-looking buy-side firms are investing in more efficient, structured approaches to managing it.

The fragmentation of data sourcing, processes and technology is a profound barrier to efficient regulatory reporting frameworks. But achieving a centralised approach to data management is as much a matter of organisational mindset as system architecture. According to a recent report from Deloitte, "Organisations should begin by taking stock of where they are and where they need to go, keeping the current landscape and regulations at the forefront of data strategy. Data governance is about not only maximising the value of data for operational effectiveness, decision-making, and regulatory requirements, but also minimising the risks associated with poor data management."

To this end, buy-side firms are beginning to explore the concept of the regulatory book of record (RBOR) to handle the challenges of efficiently sourcing and managing data for compliance and reporting purposes. Similar to the investment book of record (IBOR), the RBOR serves as a highly centralised and inter-connected repository from which verified data can be drawn, replacing the continuous wild goose chase of compliance tools and/or staff interrogating multiple systems and sources, often containing stale or incomplete records. Whereas the aim of the IBOR was to ensure portfolio managers had access to accurate, current information on which to base adjustments to investment strategies, the RBOR streamlines and automates the compilation and delivery of data for reporting and compliance purposes.

Armed with a single set of policies, processes and technologies, an RBOR is equipped to improve the quality and accuracy of regulatory data, and in so doing reduce prevailing levels of process complexity and duplication. If data is centrally maintained, a record that is amended once can be leveraged and reused safely across multiple tools and applications, both for compliance and business purposes. Once this principle is accepted, it is easier for a suitable architecture to be developed that meets company-specific realities and priorities. Frequently, APIs can play an enabling role in facilitating reliable, automated, end-to-end data flows, but customised to specific requirements.

RBOR lightens the load

Through its centralised control of an RBOR-based approach, asset managers can build comprehensive links between data sets to provide stronger controls, share outputs with regulators, develop predictive analytics and reduce manual aggregation. The resulting compliance framework not only efficiently automates existing regulatory requirements, but also provides valuable analysis to help staff identify and tackle new ones. With the flow of regulation unlikely to slow, more effective data management models are crucial to buy-side hopes of lightening the load.

CHAPTER TWO

REDUCING THE COST OF COMPLIANCE

Reducing the Cost of Compliance

The sheer breadth of regulation means that deployment of multiple solutions can soon rack up significant implicit and explicit costs. Given the scale and cost of compliance, asset managers are choosing to explore managed services or Compliance-as-a-Service (CaaS) offerings, based on a deeper, strategic relationship with fewer or even a single service provider, offering an evolving suite of tailored solutions.

Asset managers in general – and active managers in particular – have experienced a significant and sustained squeeze on profits in recent years. Established fee structures and margins have been eroded by competition from both passive and alternative investment providers. In parallel, costs have spiralled, with compliance and regulatory costs playing a major role. Operating margins for publicly traded US asset managers, for example, fell by 20% between 2015 and 2019.

> "Asset managers are issuing RFPs not to procure solutions but to select a compliance partner – a vendor that can provide support collaboratively across a range of needs, catering both for an evolving compliance environment and business model."

In response, asset managers have adjusted their business models in diverse ways, including product and market diversification and asset consolidation via M&A. But they all have looked to cut costs, pursuing savings and efficiencies wherever possible. With fee pressure and client demands requiring firms to be ever lighter on their feet, outsourcing and partnering are increasing in appeal. A recent Deloitte survey[1] reported 62% of asset managers implementing or planning major changes to their business configuration, with 59% focused on outsourcing/offshoring projects, and 49% working on streamlining initiatives.

1 2020 Investment Management Outlook – Deloitte Center for Financial Services

Traditionally viewed as a cost centre, compliance is expected to play a full part in firms' efforts to do more with less. Low hanging fruit, in this respect, can include automation to minimise the number of staff involved in repetitive, non-value add tasks, and consolidating the vendors and systems used to carry out similar processes. For many, this journey is only just beginning.

"A perfect storm"

From a resourcing perspective, compliance functions are facing "a perfect storm", according to Dr Rafael Gomes, managing director, finance and risk practice at Accenture. "On the one hand, the volume of risks they need to manage is increasing significantly: cloud; cyber; AI; epidemics; and quantum computing is around the corner. On the other, more than 70% of compliance professionals are facing quantifiable cost-reduction targets[2]," he said, speaking at CSS's 2020 Regulatory Compliance Forum in London. "They need to deal with more risks but have less funding. Compliance-as-a-sService (CaaS) is potentially a way to release that pressure, but it isn't a panacea."

For established and standardised regulatory requirements, the shift from manual to automated processing can reduce expenditure, whilst enabling compliance staff to handle their expanding sweep of re-sponsibilities. "The role of risk and compliance professionals today is to understand and standardise new and emerging risks," says Gomes. "For already well-known and well-understood risks, you can plug into service providers, increasingly those offering CaaS. The goal should be for everything that is well understood to be automated and / or outsourced."

Until recently, most firms have taken a tactical approach to automation, buying point solutions either as new requirements arise or existing tasks become sufficiently standardised. But the sheer breadth of regulation means that deployment of multiple solutions can soon rack up significant implicit and explicit costs.

Implicit and explicit costs

The costs of sourcing and running multiple solutions are manifold. Searching the market for the most cost-effective purpose-built solution to every new regulatory requirement can overlook existing capabilities – built in-house or developed by a third party – with implications for overall cost.

No matter how effective the chosen solution, onboarding new vendors on a regular basis can involve a lot of heavy lifting from multiple departments, requiring cross-functional input ranging from procurement, information security, system integration and project management. Once implemented, managing relationships with multiple vendors, even if highly professional and service-oriented, can be resource intensive in terms of ongoing monitoring, negotiation and maintenance.

Maintenance cost implications can grow incrementally and invisibly as upgrades and smaller changes to an underlying system are likely to have implications for the many other connecting applications. A multi-vendor framework will require internal teams to integrate and manage multiple interfaces into the same platform and/or data. As well as being labour intensive, choosing multiple best-of-breed solutions may add duplication and complexity to infrastructure and process, with negative implications for data governance and quality.

Increasingly however, it is becoming clear that many regulations, even within the same jurisdiction, are making slightly different calls on essentially the same core internal data. Firms that adopted a best-of-breed approach often find they are interrogating the same data set, within an order management system or similar core platform, multiple times via multiple solutions. The pain of this experience and the prospect of upcoming compliance challenges, such as Securities Financing Transactions Regulation (SFTR), is leading firms to take a more strategic approach to their compliance resources. Increasingly, asset managers are issuing RFPs not to procure solutions but to select a compliance partner, i.e. a vendor that can provide support collaboratively across a range of needs, catering both for an evolving compliance environment and business model.

Increasingly, firms with complex needs are choosing to explore managed services or CaaS offerings, based on a deeper, broader relationship with fewer or even a single service provider, offering an evolving suite of tailored solutions. When looking to handle frequent and far-reaching regulatory change with implications across departments, partnership with fewer

2 From pressure comes clarity - 2019 Global Compliance Risk Study (Accenture)

experienced, scalable vendors can be more cost effective than multiple relationships. Making adjustments or extensions to a service provided by a strategic partner inevitably involves significantly lower delta than multilateral approaches.

Evolving skillsets

The value of cost-effective vendor partnerships is thrown into even sharper relief by evolving compliance skills requirements and its impact on budgets. A total of 63% of senior compliance practitioners told Thomson Reuters they expected to have more budget available in 2019, with 59% predicting a higher headcount. According to Thomson Reuters Regulatory Intelligence's Cost of Compliance 2019 report, "Over half of respondents continue to foresee an increase in the cost of senior compliance staff driven by the increasing need for expert skills and knowledge needed to handle the challenges and complexity of the compliance issues facing financial services firms."

Even when concentrating on newer, not-yet-automatable risks, staff are relying more heavily on technology, increasingly including machine-learning applications trained on vast data sets. In terms of skillsets, technology and data science smarts are only getting more important in the compliance realm. This is partly due to the centrality of effective data management to efficient compliance, but also because of the increasing regulation around data privacy and usage. "To correctly assess regulatory risk, we need to become more conversant with data and technology. Data provenance, governance and traceability are going to be really core compliance skills," Gomes told our 2020 Regulatory Forum.

Previously, compliance teams drew heavily on staff with legal and accounting expertise, but there is now greater emphasis on recruiting data scientists. Accenture's 2019 Global Compliance Risk Study reported that 84% of respondents employ a technology compliance officer. As new risks to the financial sector emerge, regulators will respond and the compliance remit will expand further. "There are a whole set of new skills that we need to evolve," said Mike Zehetmayr, partner, risk compliance and regulatory technology at EY, speaking at CSS's 2020 Regulatory Compliance Forum.

At the same time, domain expertise will remain a pre-requisite. Just as non-compliance staff have a key role in meeting regulatory requirements, compliance teams should serve as a business enabler too, observed Vikramaaditya, chief transformation and administration officer, HSBC Asset Management, at the 2020 Regulatory Compliance Forum. "How are we thinking about new products? How are we thinking about new markets and services? What risk does that present to the business? How do we address those? What are the emerging risks? That is the role which adds material value to the business," he noted.

Challenging outlook

The regulatory outlook gives little indication that compliance costs will decline in the foreseeable future. Even before the impact of Covid-19 on global markets, the Deloitte Center for Regulatory Strategy's 2020 Investment Management Regulatory Outlook predicted a 'fraying international consensus' at the geopolitical level could have diverse and unpredictable consequences. "While deregulation might reduce some compliance costs, global firms will face more complexities and expenditure as regulatory standards across jurisdictions diverge in timing and substance," commented Deloitte.

In this challenging context, asset managers may need to accelerate their journey toward a more cost-sensitive approach to compliance.

CHAPTER THREE

STRATEGIC MODELS FOR MANAGING REGULATORY RISK

Strategic Models for Managing Regulatory Risk

Compliance is a process not an event. The legacy of a decade of reforms is heavy with unfinished business, undermining efforts to handle new regulations and meet new deadlines. Forced to react to successive waves of regulation, financial firms have ended up with a plethora of point solutions. Though a common tactical response to short-term regulatory risk, it is one that is ultimately unsustainable, failing to future-proof against the pace of regulatory change and adequately address vendor risk.

In many respects, compliance is about reducing risks, both to underset owners and to a firms' own operations. Most mandatory rules followed by financial services firms are designed to maintain customer choice and trust and preserve systemic stability, including adherence to market best practice and protecting against market abuse. Following the rules minimises these risks, as well as damage to reputation and balance sheet. But there are also risks inherent in how firms carry out their compliance obligations. Over-reliance on – or under-resourcing of – in-house compliance teams, for example, can increase staff turnover risks and costs, as well as the risks of high error rates due to manual handling and processing. The selection and management of compliance solution vendors is replete with risks too, even beyond the efficacy and reliability of individual solutions and services.

> "Small, specialist vendors often lack the balance sheet or resources to extend product range, to upgrade regularly in response to ongoing adjustments to regulatory requirements, or to invest in business continuity capabilities needed to maintain service levels in all conditions."

For the chief compliance officer, the ongoing risk-reduction challenge is to standardise and automate where possible, proactively managing and reviewing supplier relationships, whilst ensuring in-house staff have the skills and resources to identify and address emerging risks.

> "If we can start to standardise some of the reporting parameters, we should be able to make more use of Regtech." **– Kay Swinburne, Vice Chair, Financial Services at KPMG**

The incomplete post-tsunami clean-up

Automation of repetitive compliance processes, such as checking or completing standardised forms, reduces error rates, increases volume, and cuts cost. This need to automate compliance has become more urgent over the past decade, with many firms incrementally increasing headcount at junior and senior levels to handle successive waves of regulation. But once staff are hired, trained and deployed, the forces of inertia can make it hard to follow through, i.e. task refinement, process automation and employee reassignment.

Ideally, compliance processes should become more standardised – and subject to fewer operational risks – as best practice is established. Staff engaged to carry out new regulatory requirements should subsequently move to more value-added roles as tasks become routine, freed up to trouble-shoot, handle complex and/or anomalous challenges, or take on more strategic roles. These might include liaising with vendors about evolving requirements, collaborating with client-facing colleagues to minimise the impact of compliance on end-users, and working with third parties, including regulators, to understand and anticipate forthcoming regulations.

But the legacy of a decade of reforms is heavy with unfinished business, undermining efforts to handle new rules and meet new deadlines. Compliance is a process not an event. And, for many, that process is far from complete. The tsunami of post-crisis reforms obliged many firms to take a tactical, pragmatic approach to regulators' deadlines, achieving only minimum levels of compliance, whilst trying to conduct business as usual at a time of stiff competition and increasingly squeezed margins. This has left many processes unoptimized, remaining either highly manual or reliant on too many point solutions requiring constant attention and upkeep.

Vendor risks large and small

Like compliance processes, asset managers' use of technology-based compliance solutions should also involve continuous improvement. Regulation-specific vendor-developed tools have often been the first port of call as new regulatory requirements are identified. Due to its wide-ranging nature, MiFID II gave rise to a multitude of new compliance-related needs, from unbundling to best execution through to transaction reporting and product governance. Many firms ended up with a plethora of new tools as they tried to source the most suitable solutions. This is understandable in the short term, but ultimately unsustainable.

Many quick fixes are already proving incomplete solutions, giving rise to operational risk in a number of ways. First, the sheer number of point solutions can lead to high and undesirable levels of complexity for the user, making compliance less efficient and transparent. Second, small, specialist vendors often lack the balance sheet or resources to extend product range, to upgrade regularly in response to ongoing adjustments to regulatory requirements, or to invest in business continuity capabilities needed to maintain service levels in all conditions. Third, small vendors rarely have the bandwidth and expertise to refine processes, optimise practices and streamline compliance activities via consulting and change management services.

At the other end of the spectrum lies the risk of over-exposure to a single or main service provider, potentially giving rise to concentration risk. Indeed, regulators are increasingly concerned about operational risks inherent in outsourced back-office processing deals, and the sourcing and hosting of third-party services, including compliance-related managed services, via public cloud infrastructure providers.

"If you're thinking of putting regulatorily critical processes with an outside provider, you need to consider the risks and controls with respect to cloud hosting," Vikramaaditya, chief transformation and administration officer, HSBC Asset Management, observed at CSS's 2020 Regulatory Forum in London.

The UK's Financial Conduct Authority has warned regulated firms, including asset managers, that they regard current resilience levels as insufficient. As well as extending the Senior Managers and Certification Regime, which underlines the personal responsibility of senior executives for operational risks, the regulator has made resilience a key theme

of its 2020/21 business plan. Indeed, regulators across the globe are increasing scrutiny, meaning all regulated firms need to re-assess the operational risk implications of all their activities, including those facilitating regulatory compliance.

Regulators are right to flag these issues, but they largely underline the known operational risks of commercial relationships with scale providers. The robustness and responsiveness of third-party arrangements are legitimate concerns, but they can be mitigated.

Users and providers of mission-critical services – whether offered on an outsourced basis or otherwise – must work closely to ensure an appropriate level of oversight. Technologies such as APIs that offer streamlined data exchange increasingly provide continuous interaction and monitoring, including real-time alerts, of both on-premise and remotely located services. Feedback frameworks help to ensure long-term partnerships deliver value over an extended period, rather than fail through neglect and reduced investment after the first few years. Service level agreements, key performance indicators and regular review processes can help to ensure clients' objectives are being met, refining and improving existing capabilities, with reference to new needs.

New technology, new models

Digital technology innovation is overwhelmingly positive for buy-side compliance teams, as machine learning and other technologies are deployed to find new ways of automating and enhancing compliance duties and processes. According to Thomson Reuters Regulatory Intelligence's Cost of Compliance 2019 report, 43% of all senior compliance officers expected to spend more time assessing FinTech/RegTech solutions, rising to 59% among bigger firms.

Regtech is making contributions in many areas, including combatting market abuse, where it is used to monitor staff activities and behaviours. "Finance generates a lot of data, so it's sensible to automate the sifting of that data," says Kay Swinburn, vice chair, financial services at KPMG. "If we can start to standardise some of the reporting parameters, we should be able to make more use of RegTech."

Niche vendors are taking innovative approaches to solving compliance challenges. As a fast-evolving, highly competitive space characterised by emerging technologies and expanding regulatory requirements, RegTech is an inherently disruptive and unstable supplier ecosystem. Some will fly at speeds that allow them to scale up; more will crash and burn. If regularly seeking funding, management can be distracted from critical service and product development activities, leading to a drop in quality or a change of strategy that leaves customers high and dry. Mitigation is possible, through an escrow arrangement that enables transfer to a new provider, but innovation need not mean instability.

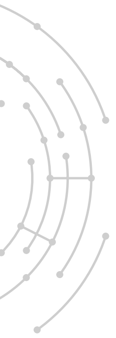
Many of the aforementioned risks can be avoided through partnership with a vendor that has a strong balance sheet, deep levels of experience, a wide range of solutions and flexible service model. And deep relationships may be the way ahead in compliance now that digital technologies, especially cloud, allow vendors to deliver, upgrade and augment comprehensive solutions that combine data, analytics and applications according to evolving client requirements, both in terms of service levels and product range. As noted in the previous chapter, the concept of compliance as a service (CaaS) is gaining ground. For large firms, with a wide range of compliance needs across jurisdictions and asset classes, service consolidation with fewer or a single strategic partner can reduce risk without reducing expertise or effectiveness.

As Steen Blaafalk, chief financial and risk officer at Saxo Bank, has noted, "RegTech will be an integral part of the value chain from the onboarding process to surveillance of financial crime to regulatory reporting." But engaging with RegTech should always reduce risks, not increase them. Choosing partners to support compliance automation is becoming a critical success factor for the buy-side.

CHAPTER FOUR

STAYING AHEAD OF RULES CHANGE

Staying Ahead of Rules Change



Compliance is a moving target. Existing rules and priorities are frequently adapted and evolved by regulators, to the extent that EU legislation explicitly includes consultation processes to refine and improve rules. Top of agenda items are re-ordered to align with new market realities, ranging from BCP to ESG-related regulation. Change can be all-encompassing, requiring an enterprise-wide effort to develop new operating models for compliance and new frameworks for benchmarking future performance.

It is hard to believe that compliance was once considered a staid and slow-moving department. The expanding scope of regulatory requirements over the past decade have changed all that. Today, efficient compliance for asset managers implicitly demands effective change management capabilities. Improving established processes is worthwhile in its own right, but it is essential to any firm's ability to handle upcoming compliance obligations, including revisions to existing rules.

This is partly a function of volume. But it also reflects a regulatory environment in which change, review and uncertainty are permanent factors. This new reality adds business-critical urgency to the accepted view that the bulk of internal compliance resources should be focused on anticipating change. If too high a proportion of management time and effort are spent on non-value-added tasks, compliance-related or otherwise, the whole business suffers. As ice hockey legend Wayne Gretzky says, "Skate to where the puck's going, not where it's been."

Multiple sources of uncertainty

Brexit, for example, has been a high priority for asset managers serving clients in the UK and continental Europe since the 2016 referendum mandated the former's EU departure. Although the UK officially left the EU in January 2020, there is little certainty on the future relationship between the two. Existing concepts of third-party equivalence may not be appropriate, and much work is required if a new 'second country' status can be negotiated. Both the timing and the scope of any deal are highly subject to change.

"We're still waiting for political certainty on the future relationship," former MEP Kay Swinburne, now vice chair, financial services at KPMG, told CSS's 2020 Regulatory Forum in London. "This means firms have to prepare for all eventualities from close alignment to a complete split, which includes talking to their regulators about different outcomes."

Political and regulatory uncertainty is not just a feature of Brexit. Geo-political tensions over a range of issues – from trading relationships to pandemic responses – are heightening sources of regulatory unpredictability, especially for firms operating in multiple jurisdictions. In parallel, compliance is now a moving target, with regulators reassessing rules and priorities more frequently. EU legislation explicitly includes consultation processes to refine and improve rules, but Europe is far from alone in tweaking its requirements of regulated firms.

Implemented in 2018, MiFID II is already subject to review processes by the European Commission and the European Securities and Markets Authority. It is a reflection of today's unpredictable environment that the UK may adhere more closely to certain elements of MiFID II's current requirements, such as research unbundling, than the EU-27, despite having left the bloc.

"I don't think firms are going to be able to reduce their compliance costs any time soon," warns Swinburne. "They must be aware that the regulatory environment in Europe in particular is a constantly evolving landscape."

"We can't underestimate the impact of ESG on the asset management industry." **– Sarah Crabb, Managing Associate, Simmons & Simmons**

Constant change

The expanding scope of regulation also demands constant change and improvement. Alongside post-crisis reforms around systemic stability and investor protection, the finance sector has had to contend with many other fast expanding areas, such as conduct risk, data privacy and financial crime. Indeed, the sector has been co-opted by governments to support multiple measures to stop illegal use of the finance system, from trade sanctions, to anti-money laundering to counter-terrorist financing initiatives.

Financial services firms are currently spending USD 180.9 billion on financial crime compliance alone, according to a survey by Lexis Nexis Risk Solutions[3]. "On a global level, the average increase in financial crime compliance costs over the last 24 months was 7% and by the end of 2019 most global respondents expected an average increase in compliance costs of 12%," the report read. Although the costs have been borne largely by banks – in terms of adjustments to operations, increased headcount, deployment of new technologies and fines for non-compliance – the impact on the buy-side has been non-trivial.

These efforts will continue, as public and private sector collaborations deepen, as will attempts to automate checks, reports and other processes, via machine learning and robot process automation. Meanwhile, the finance sector is also being asked to support governmental efforts to direct capital into sustainable investment opportunities, often defined with reference to the United Nations' Sustainable Development Goals.

Through initiatives such as Europe's Green New Deal, unveiled in Q1 2020, policy makers are encouraging asset owners to prioritise investments that tackle shared global challenges, such as climate change, resource scarcity, poverty and inequality. Active managers in particular are embracing this challenge, partly due to growing investor demand for investments that integrate environmental, social and governance (ESG) factors. Political and investor interest in ESG investing are driving the development of industry standards, but also new regulation.

3 True Cost of Financial Crime Compliance Global Report - Lexis Nexis Risk Solutions (April 2020)

To be effective at scale, ESG investing requires an overhaul of disclosure requirements, both by corporates and investment intermediaries, to inform, evaluate and report on sustainable investment decisions. The EU, for example, has introduced disclosure and taxonomy regulations to help asset managers and their customers to speak the same language on ESG investments, and thus make informed decisions when incorporating ESG into their investment strategies.

Under the Disclosure Regulation, asset managers, insurance firms and pension product providers must publish information on whether and how they have considered sustainability risks, on their websites, pre-contractual disclosures and periodic reports to help clients understand the attributes of funds marketed as ESG or sustainable. This covers information on ESG integration in investment processes and policies, due diligence and engagement policies, as well as business conduct rules and remuneration policies. The Disclosure Regulation is augmented by the Taxonomy Regulation, which establishes a unified classification system and defines the criteria under which investments can be considered sustainable. This will have potentially far-reaching implications for asset managers, requiring them to assess the potential impacts of their investment portfolios.

"We can't underestimate the impact of ESG on the asset management industry," said Sarah Crabb, a managing associate at law firm Simmons & Simmons, specialising in investment funds. "Coming into force in March 2021, the Disclosure Regulation focuses on how investment firms integrate sustainability and risk factors into their investment processes and requires managers to make disclosures on that basis."

KPMG's Swinburne warned that the impact of ESG-related regulation could prove "all-encompassing". An enterprise-wide effort may be required to re-evaluate existing loan books and portfolios, whilst developing new frameworks for benchmarking future performance against ESG criteria. "There are big strategic issues to deal with as well as the existing regulatory framework and the overlay of political uncertainty. Regulators are making firms work really hard right now," Swinburne added.

Robust, but flexible

Compliance processes must be accurate and robust to provide the required information to regulators and stakeholders under any circumstances. In today's fast-changing regulatory environment they must also be low-touch and highly adaptable. Compliance processes and the platforms on which they run must support staff efforts to focus on upcoming challenges, both by providing insight and by handling existing tasks, at scale.

One critical element of an agile compliance infrastructure is data quality. Strong data governance practices allow processes to be more automated and streamlined, and mitigates against data fragmentation across multiple point solutions. Data quality and efficient automation should enable staff to manage existing processes by exception, whilst providing support as and when new requirements arise.

Further, as technology innovations allow for higher levels of automation, vendor management becomes a more crucial building block of the proactive compliance function. Vendors can support client agility and responsiveness by providing the analytics that flag operational failures or alert staff to non-compliant activity. They can also add value by managing and refining existing processes by seamlessly implementing upgrades to remotely-hosted solutions, as well as augmenting clients' surveillance and understanding of the regulatory landscape.

Compliance priorities can change rapidly. Thomson Reuters Regulatory Intelligence's Cost of Compliance 2019 report found that compliance officers' priorities included increasing regulatory burdens, culture and conduct risk, and financial crime, AML and sanctions compliance, whereas the previous year data privacy and GDPR featured more strongly. The global pandemic has undoubtedly changed compliance priorities once again, with regulatory scrutiny shifting focus to business continuity planning and the systemic risks inherent in firms' response and adaptability to the crisis.

But whilst change is a given, improvement is down to individual firms. According to Lexis Nexis, 53% of global respondents feel financial crime compliance processes "have a negative impact on productivity", whilst 55% said their processes have a negative impact on customer acquisition. Only by building process improvement into the compliance function can these issues be addressed efficiently, enabling compliance officers to look ahead to new challenges.

CHAPTER FIVE

TOWARDS AN OPTIMAL MODEL FOR COMPLIANCE

Towards an Optimal Model for Compliance

Many asset managers acknowledge that their compliance and reporting processes are sub-optimal due to a reliance on legacy processes and a lack of automation. Refining, standardising and automating processes not only increases the efficiency of compliance with specific rules, but lends firms the bandwidth to handle more business, more volume, more regulation. To share the compliance burden, asset managers are turning to a variety of semi-outsourced models. These include utility models as well as managed services, increasingly offered as Compliance as-a-Service (CaaS).

Whilst all regulations are local, issued and enforced by an authority within a defined jurisdiction, the response of the regulated entity does not need to be. By some reckonings[4], there are close to 400 separate regulatory implementations currently 'in flight' across the global financial services industry. This sounds daunting, but the overlap between national and regional regulatory frameworks is large and growing. Increasingly, regulators share common concerns and follow similar priorities and principles, even if their rules and requirements are governed by local circumstances. This means there is significant scope for asset managers to use centralisation and scalability to improve the cost-effectiveness of their compliance operations.

> Managers must not only achieve compliance… but do so in a manner which "doesn't compromise either delivery to the client or the cost structure within which we need to operate." **– Vikramaaditya, Chief Transformation and Administration Officer, HSBC Asset Management**

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And let's be under no illusions: scale is needed. Regardless of overlapping requirements, the regulatory challenges facing asset management firms have grown exponentially. The sheer pace of new regulation may slow, but it will not stop. Regulators are continually seeking more choice, protection and transparency for end-investors, whilst also bolstering systemic stability and resilience. Intense scrutiny is now a permanent reality, so all opportunities for improvement and efficiency should be explored.

Effective compliance as a differentiator

An asset manager's ability to meet multiple regulatory obligations in its stride is increasingly seen as a function of management quality and good corporate governance by clients and other stakeholders. Successful firms can respond to new requirements without having to divert scarce financial resources and management focus away from strategic business priorities. Consistent investment ensures day-to-day compliance tasks are handled in an efficient, standardised and, ideally, automated fashion, leaving in-house compliance teams free to prepare the firm for future challenges.

Heightened competition for assets in a low margin and low return environment means effective compliance is becoming a competitive differentiator. Vikramaaditya, Chief Transformation and Administration Officer, HSBC Asset Management, sets the sector's compliance challenges in context of the regulatory changes reshaping the wider financial services industry, including insurance firms and other asset owners. Managers must not only achieve compliance, thus minimising fines and penalties, but do so in a manner which "doesn't compromise either delivery to the client or the cost structure within which we need to operate", Vikramaaditya told CSS's 2020 Regulatory Forum in London. Efficient compliance is becoming integral to the business model.

In search of scale

In the first instance, scalability requires process standardisation and automation. Many asset managers acknowledge that their compliance and reporting processes are sub-optimal because they have not been revisited and streamlined since implementation. Refining, standardising and automating processes not only increases the efficiency of compliance with specific rules, but lends firms the bandwidth to handle more business, more volume, more regulation. A second element of scalability is awareness of synergies. Due to the overlap between regulations from different jurisdictions (or sometimes even within), firms can draw on the same centrally managed dataset, rather than having multiple reporting tools sourcing from diverse systems and databases in different jurisdictions. Hiring staff to conduct similar in-country onboarding checks across markets may lead to high costs and error rates.

As such, scale has organisational, as well as technological, implications. More firms are managing regulation on a more globalised basis, i.e. coordinating compliance via a centre of excellence, to reduce duplication of effort across multiple locations. As well as scale efficiencies, greater coordination allows for improved oversight and the deployment of more centralised solutions.

To share the compliance burden, particularly for repetitive and high-volume processes, asset managers are turning to a variety of semi-out-sourced models. These include utility models as well as managed services, increasingly offered as Compliance as-a-Service (CaaS) solutions. Both shift operational responsibility for compliance processes to third parties, but the latter bear closer comparison with business process outsourcing services.

> "The industry as a whole has struggled to build a more optimal and scalable operating model for compliance. At its core this model must be able to repurpose a common set of data, controlled from a central repository, and shared with regulators. It's neither purely a tactical nor a strategic approach; it's a journey from tactical engagement to building out a regulatory roadmap with a trusted partner."
> **– John Lee, President, CSS**

As such, CaaS solutions must meet regulators' expectations on operational resilience, as laid out in the UK Financial Conduct Authority's Senior Managers and Certification Regime and elsewhere. As noted at CSS's 2020 Regulatory Forum by Pauline Hawkes-Bunyan, director of business risk, culture and resilience at the Investment Association, "You can outsource the service, but you absolutely don't outsource the accountability for delivery."

Utility models vs managed services

Utility models have many strengths in theory, but face many challenges in practice, including the difficulties of achieving ongoing collaboration between erstwhile competitors. If all firms in a given sector are required to conduct similar checks on customers, or provide the same types of report to a regulator, they should achieve significant economies of scale by pooling resources and adopting common standards and practices, coordinated by a central utility. But differences between participants around risk appetite and difficulties around standardisation have often thwarted attempts to facilitate efficient information flows. In turn, this can cause regulators to doubt whether the model can mitigate the risks as intended.

According to Mike Zehetmayr, Partner, Risk Compliance and Regulatory Technology at EY, “If you can’t reconcile differences in risk appetite, it becomes very difficult to deliver a standardised service and you don’t get the benefit of lower unit costs.” A further challenge for utilities, notably in the KYC space, is the need to offer incentives to end-clients to also follow its processes and guidelines. In addition, the service provider must be incentivised to deliver ongoing improvement of process efficiency and effectiveness, rather than reaping reward by increasing volume.

As utilities wrestle with these issues, more firms are gravitating toward off-the-shelf systems and solutions that require minimal initial customisation, in part because these are easier to subsequently update and maintain remotely. “Clients are now thinking about plugging in the CaaS offerings of RegTech firms and other providers, providing they align with their technology strategy,” said Rafael Gomes, Managing Director of the Finance and Risk Practice at Accenture. As with any transfer of operational responsibility, asset managers must be alert to potential changes in service levels and the impact on clients. A further consideration is the nature of the process being outsourced. More complex, value-added, highly integrated workflows will require different approaches, compared with more vanilla, repetitive tasks.

For Gomes, the potential application of CaaS reaches well beyond established use cases such as automating the management of regulatory change. “There are also some exciting propositions out there, in relation to data privacy for example, including solutions for how you unlock data speedily for different user profiles. We also think there is a lot of value in outsourcing regulatory reporting, particularly as regulators are increasingly interested in querying the data, rather than just receiving reports,” he said. “As firms move services to the cloud, we’re seeing the development of open source analytics tools for reporting. KYC has long been a feature of CaaS propositions, but this is now being augmented to include third parties.”

Ongoing engagement and improvement

As regulatory guidelines suggest, the relationship between outsource service provider and client should be one of ongoing engagement and improvement to support efficient compliance at scale over the long term. To align interests, firms are increasingly adopting models that emphasise joint accountability and risk-sharing.

This approach helps managers to anticipate future needs, as both business and regulatory models evolve. Many regulators are launching initiatives to digitise regulation, for example, using semantic technologies to improve the precision of compliance obligations and definitions, potentially eliminating barriers between transaction and regulatory data. As machine-readable regulation matures, firms will want to work with suppliers that are well advanced in their understanding and application of AI and machine learning to leverage its potential to streamline compliance processes.

Robust, effective compliance is essential to providers of financial services. It keeps clients safe and regulators informed. A firm that demonstrates a strong commitment to compliance, through investment in the necessary skillsets and resources, will earn the trust of its clients, regulators and other stakeholders over the long term.

“Compliance solution providers have succeeded in the supply of tactical deliverables,” said CSS President John Lee, at our 2020 Regulatory Forum. “But the industry as a whole has struggled to build a more optimal and scalable operating model for compliance. Some specifics will vary, but at its core this model must be able to repurpose a common set of data, controlled from a central repository, and shared with regulators. It’s neither purely a tactical nor a strategic approach; it’s a journey from tactical engagement to building out a regulatory roadmap with a trusted partner.”

About CSS

CSS is a trusted global RegTech partner that uniquely brings together innovative technology-driven solutions to support financial services firms in navigating a clear and strategic path through the complex and fragmented global regulatory space. Our solutions and services help firms meet regulatory deadlines while optimizing compliance data, operations and technology. CSS covers a full range of global compliance disciplines spanning fund reporting, transaction reporting, investment monitoring, compliance management, regulatory expertise and managed services with a complementary, centralized approach to strategic management of regulatory data called RBOR (Regulatory Book of Record). For more information on CSS, please visit: www.compliancesolutionsstrategies.com