WELCOME TO THE OFFICE OF REGULATION AND COMPLIANCE:

THE IMPACT OF NEW TRANSPARENCY REQUIREMENTS IN GLOBAL CAPITAL MARKETS

KRISTINA DROBOCKY

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INTRODUCTION

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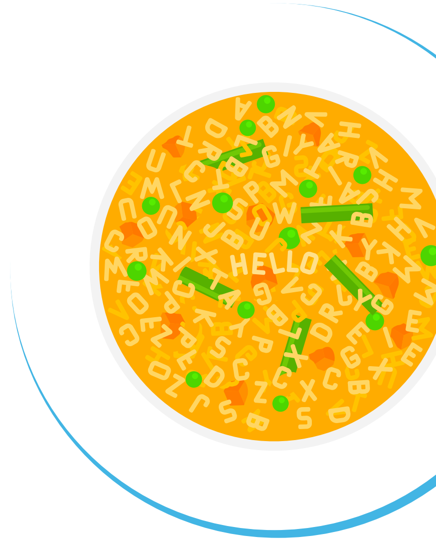
For much of the recent past, it seems that not a day has gone by without negative headlines about some aspect of the global capital markets industry. Whether in the throes of an escalating crisis, on the receiving end of yet another regulatory inquiry, or as the Petri dish for some get-phenomenally-rich scandal, financial companies have been earning a reputation for behaving badly.

Because some of the largest financial players—technically known as "systematically important financial intermediaries" (SIFIs)—are so inextricably intertwined with our modern capitalist culture, and are among the primary conduits for the distribution of government securities (i.e., our growing debt burden), their inherent complexity is difficult, resource-intensive, and risky to change by force of law. Sadly, maintaining the proper functioning of the economy is dependent on many of these large and complex players, regardless of whether the discussion is about the U.S. or another region.

This new era we find ourselves in calls for increased transparency, improved oversight, detailed compliance, and other checks and balances. This is a reaction based primarily on violations of the public trust by some of the largest and most visible SIFIs. As these episodes of misbehavior, which range from illegal to highly questionable activities, appear to have increased in frequency, so too have the cries for more oversight. The birth and expansion of the current "age of compliance" can be tied to these violations of the public trust. This is a global phenomenon that clearly has not yet been effectively controlled—and no one knows the full impact of the governance, or unintended consequences of the actions taken thus far.

The road to enhanced transparency and oversight is far from a superficial exercise. It requires fundamental changes to the DNA of these organizations, and to the regulatory apparatus that bears the new burden of reporting data and analytics. To be effective, new reporting methods must deliver the right data to the right person, at the right time, and in the right format. While it is clear that a new level of reporting functionality will be highly dependent upon improvements in technical solutions and data flows, the significant human capital resources it will take to accomplish these changes is often underappreciated.

With rising operational costs, increasingly complex investment opportunities, growth in merger and acquisition activity, and restructuring—and with a long-term trend toward more reliance on temporary or contingent personnel as the backdrop—workforce management needs to deliver effective transparency and oversight that will require specific expertise, vision, and guidance.



ALPHABET SOUP

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The Dodd-Frank Wall Street Reform and Consumer Protection Act—more affectionately known as DFA—is viewed as the primary source of change in global capital markets today, and often the first of the alphabet soup of regulations that comes to mind. Despite its U.S. focus, the broader financial world acknowledges the impact and reach of DFA. With a very broad mandate intended to address system-wide risks, numerous forms of market transparency and consumer protections, DFA's tentacles reach into most facets of financial markets in the U.S. to an unprecedented degree.

From communication standards between counterparties and their clients, to organizational structures, to compensation systems, to the evolution of market structures, DFA has something for everyone. In fact, the extraordinary magnitude of transformation it brings to the over-the-counter (OTC) derivative market—which includes products like swaps that we hear about in the news every day—is unprecedented in modern financial history.

The changes represented

Moving a traditionally peer-to-peer and largely unregulated market into an exchange-based framework, with centralized clearing and settlement of trades, is a massive undertaking that will take years to design and implement. This transformation will also have significant direct and indirect impacts on most market participants today, whether they realize it or not.

Despite the far-reaching goals of DFA, the alphabet soup of regulatory and legislative action does not stop there, and certainly is not confined to the U.S. For instance, the Markets in Financial Infrastructure Directive (MiFID) is essentially the "sister" legislation to DFA for the member-states of the European Union. Like DFA, and with some subtle differences that fall outside the scope of this discussion, the primary goals of MiFID relate to system-wide risk management and transparency in Europe.

Further complicating the situation is a series of additional new rulemaking directives. Known as Markets in Financial Instruments Regulation (MiFIR) and the proposed European Market Infrastructure Regulation (EMIR) which focusses more on OTC derivatives, centralized clearing, and trade repositories, the sheer length of the list symbolizes how desperately regulators want to calm the waters. Between Dodd-Frank and MiFID, the rest of the world is watching to see how these leading markets address the proposed improvements before they follow suit. Ultimately, all other major markets, including the Asia-Pacific, Middle Eastern, and South American regions, will adopt similar rules.

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The Volcker rule in the U.S. aims to limit risky, in-house behavior, known as proprietary trading, within SIFIs, like J.P. Morgan® or Bank of America®, that also accept customer deposits. A second part of Volcker will also limit how SIFIs own, invest in, and interact with certain asset management groups—a set of rules that has the potential to turn the asset management industry in the U.S. and beyond on its already-sore head. Though there is no specific equivalent in the Eurozone, there is no doubt that European banks will eventually become subject to similar restrictions. The Volker rule has implications for any SIFI that does business in the U.S., making it a potential global financial concern.

Basel III, the set of rules that essentially govern the amount of leverage in the banking system, will also indirectly influence transparency and governance efforts due to its influence on business mix, collateral management, and risk management systems. The Alternative Investment Fund Management Directive (AIFMD)—essentially a complement to the European Undertakings for Collective Investment in Transferable Securities directives (UCITS)—targets how both traditional and alternative investment funds (i.e., hedge funds and mutual funds) are registered with regulators, and provides specific direction on communications between asset managers and their investors.

Lastly, the Retail Distribution Review (RDR) in the U.K. is another example of consumer protection efforts that will significantly influence how investment funds are marketed to individual investors.

The bottom line in all this complexity

Brush all the alien acronyms aside and what's left is hopefully improved risk management and greater transparency in financial markets. With these—and others—as a guide, we should expect that the age of compliance is not only here to stay, but it's arguably still in its infancy. As this alphabet soup of regulation washes over the financial landscape in the months and years to come, the impacts on the core components of the firms that demand financial solutions and the firms that supply financial solutions will be dramatic. Furthermore, in an age where technology is believed to solve all that ails us, those who truly understand the enormity of the changes at hand will appreciate that this journey requires a full rethinking of the human capital management solution.

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PUBLIC TRUST

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For better or worse, financial firms have been imploding for a long time. In the modern era, the list of notables ranges from the likes of Drexel Burnham Lambert® to Barings® to Enron® (which was more like a hedge fund than an energy company) and the subsequent failure and rebranding of its auditor, Arthur Andersen®. Other examples include real hedge fund blow-ups, like Long-Term Capital Management® (LTCM) and Amaranth Advisors LLC®. With each failure, calls for more transparency and oversight rang louder and louder.

The failures of Enron and also WorldCom® were the catalysts that ushered in the birth of the chief compliance officer (CCO) position to manage the ever-lengthening list of rules most firms needed to adhere to. This evolutionary development in the capital markets arena, in particular, represented a relatively minor adjustment to personnel configurations in the new era of financial markets. In other words, the addition of output from one person or a small team of compliance-related staffers was eventually enhanced and optimized through technological automation.

But in the aftermath of the colossal failures of Bear Stearns® and Lehman Brothers®, and the subsequent bailouts of firms like AIG® and Bank of America®, and the nationalization of firms like Fannie Mae® and Freddie Mac® (and General Motors®, for that matter), it became clear that a compliance figurehead was not enough. Real, substantive change throughout the organization needed to be put in place. As a result, the nature and depth of transparency and oversight has been ratcheted up several notches not only for the financial services industry but for public corporations as well.

In fact, the sheer magnitude of data to be reported to government regulators and other stakeholders (think shareholders) today is so vast and complex that the recipients are not even equipped with the personnel or the technology to fully analyze what they are receiving. To make matters worse, in this period of increasing austerity, resources are not exactly plentiful to rectify the situation in terms of credit vehicles for capital improvement or budgetary access to human capital. In extreme cases, regulatory budgets are being purposely starved by opposing forces to make sure that regulatory response tools lack the necessary teeth to effect the intended changes. Regardless, all anyone knows now is that they must comply and report.

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The truly disruptive cost of enhanced transparency and oversight is what's known as the ad hoc request. The ad hoc request is that call from a regulator or significant stakeholder that requires, for example, the generation of a report based on data that has never been assimilated in that manner before. Ad hoc requests for data and new reporting require armies of personnel resources to be shifted around (or acquired) with little anticipation. Add the urgency of market turmoil to the mix—as we saw in the chapter surrounding the demise of Lehman Brothers—and the concept of "all hands on deck" gains new meaning.

In most cases, once the regulatory requirements are implemented, things will settle down—of course in the current environment implementation is going to take a while. "Normal and customary" work always gets done, but it is the uncertainty of implementation, ad hoc requests, and the threat of auditors on-site that can only be mitigated with a strong talent supply chain and workforce strategy.

HUMAN CAPITAL IMPLICATIONS

What is often overlooked are the associated workforce management challenges—the impact on people who will be required to design, develop, test, implement, and maintain the infrastructure needed to ensure compliance with a growing library of rules, regulations, and ad hoc requests.

Overall, the growing litany of transparency and compliance rules will have an impact on the building blocks of all financial firms: people, process, technology, and data. However, these days, we tend to hear the most about how technology can be used to address the impacts of greater transparency during this transformative period. Maybe this is because technology is thought to be sexy, and there are expectations that it can solve any problem.

The challenges that often get overlooked are those relating to workforce management—the impact on people who are required to design, develop, test, implement, and maintain the infrastructure needed to be compliant with a growing library of rules, regulations, and ad hoc requests. Moreover, this part of the story is not necessarily about IT personnel. Sure, they are critical to the overall response, but the business analysts and compliance specialists who understand the rules are also critical to the design and operation of effective compliance solutions.

Now, as if to add insult to injury, there are several overarching macro trends in the human capital realm that further complicate a strategy for the landscape ahead:

1. **Man vs. Machine:** Automation and efficiency through technical leverage is gradually eliminating the need for many administrative personnel layers. This is where we are seeing the greatest contraction in the traditional roles across the financial services industry.

2. **Permanent vs. Temporary:** "Permanent" workers are being strategically exchanged for contingent staff and free agent employment solutions in many businesses.

3. **Slowing Demand:** Dramatic transformation and/or lack of robust opportunities in many trading businesses (e.g., front offices) is on the verge of causing mass layoffs in and around Wall Street (which will become more evident once bonus season passes).

The successful financial services firms and corporate financial reporting teams will understand that they must consider the following in their workforce solution strategy:

- Access to a robust talent supply chain of traditional and innovative human capital. Are you connected to the right contingent, project, consulting, independent contractor, and outsourcing talent?
- The impact of the talent currently engaged. There is a cost associated with those in the chair today, but it is essential to leverage strategies that incorporate internal and external resources.
- The Free Agent Workforce. Things have changed, and without the ability to attract this flexible resource, it will be difficult to execute any strategy.
- How social media and corporate reputation is affecting access to talent.
- How to retain and engage "A-level" talent.

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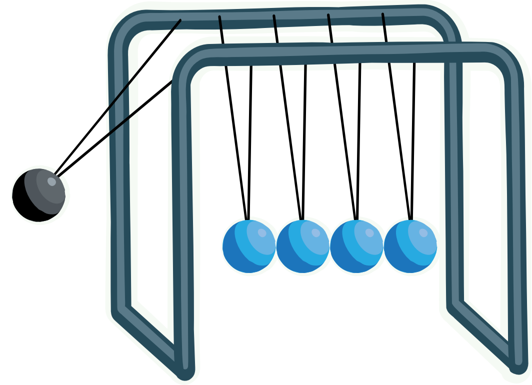

THE OFFICE OF COMPLIANCE

Compliance initiatives can't be successfully designed, developed, implemented, and managed over time without the right personnel.

When what is required has never been built before, subject matter experts must interpret the guidelines, design solutions and drive change throughout complex organizations, which are already navigating a very politically-charged era in capital markets.

Ultimately what amounts to dramatically enhanced monitoring, measurement, and reporting frameworks in all facets of financial enterprises will be largely dependent on improved data management and technical infrastructure capabilities. Without improved interconnectivity within and among various capital markets stakeholders and better data standards, which will enhance the ability of various parties to communicate more effectively, there is virtually no way that the goals encoded in the letter and spirit of all these regulatory initiatives can be successful over the longer term.

However, only under the guidance of one or more senior compliance officers and potentially teams of compliance and governance-focused analysts (depending on the size, nature and complexity of the organization) will effective long-term solutions come into being. Furthermore, given the fundamental impacts of this new reporting framework, compliance personnel will need to be sensitive to both horizontal (or enterprise-wide), and vertical (or business-specific) concerns and challenges. In short, the issues here are complex, and the shifting dynamics of the needs suggests that most firms will require specific guidance to manage the workforce implications of these changes.

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CONCLUSION

The "Office of Compliance" sounds like an Orwellian concept with some scary implications, but it is indicative of a general hunger for a more timely and detailed flow of information about the inner-workings of an arena that has consistently betrayed the public trust, despite concerted efforts. Though Enron may have earned the distinction as the firm that provided the spark for the role of CCO—and the demise of Lehman Brothers may have been a primary force for further measures to beef up the monitoring of market, credit, and operational risks—the truly disappointing problem here is that blow-ups like the recent bankruptcy filing of MF Global® have continued to occur with some regularity.

Unfortunately, we have not heard the last of the MF Global saga. It is arguable that the commingling of customer funds—a sacred cornerstone of the futures markets—is among the most egregious violations of the public trust of the modern financial age. And, as a result, participants from all corners of the global financial ecosystem should prepare themselves to be subjected to even higher levels of scrutiny (i.e., reporting requirements) than the current spectrum of regulatory proposals suggests.

Therefore, in order to effectively—if not profitably—navigate the treacherous road ahead, financial firms need to get their houses in order. This means the formation of a strong data management culture with sponsorship from visionary leadership and strong execution personnel. The more complex the organization, the more they will need a workforce management and talent supply chain partner with which to walk this road. Already, it is clear that the challenges are large, the uncertainties are high, and the sense that there are significant unknowns yet to be illuminated is great. When the age of technology meets the age of compliance, you are going to need the right people around to ensure that this journey is a successful one.

But at a time when the demands for greater transparency, insight, reporting, oversight and all manner of compliance has never been greater, there is hardly anyone left to answer the call. Recently, it was reported that only 7 percent of workers terminated in the post-Lehman era have been rehired at a level equal to or greater than their previous position. This level of degradation in how things operate in the firms—a loss of "enterprise memory"—only serves to further complicate what amounts to a much more sophisticated and pervasive reporting framework. How firms manage the human capital aspects of these challenges is becoming just as, if not more, important as how they manage the technical ones.

Organizations everywhere are urged to take heed and put systems and practices in place now to prepare for the continued but unique impact that compliance trends are sure to have in the coming years and decades. As today's financial workforce and economic environment grow increasingly complex, companies who adopt flexible, more project-based solutions will have a distinct competitive advantage in adapting to the transformation.

ABOUT THE AUTHOR

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