The Debate: the age regulatory change

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Photo, from left to right: (Top) Henry Raschen of HSBC, Andrew Douglas of DTCC, Carsten Kunkel of SimCorp, (Bottom) Jonny Speers of Torstone Technology, Paolo Brignardello of FundSquare and Ralf Menegatti of AxiomSL.

HSBC, DTCC, SimCorp, Torstone Technology, FundSquare and AxiomSL give their take on accepting the age of regulatory change and how the buy and sell sides can learn from each other.

"Which side (buy or sell) has accepted the age of regulatory change the quickest, and why? And what can they learn from each other?"

Henry Raschen, head of regulatory and industry affairs, Europe, HSBC Securities Services: Buy- and sell-side participants rapidly recognised the need for change as they watched the collapse of seemingly robust financial institutions in late 2008. There may have been a tendency by some to think that the crisis had arisen from other parties' faults, but all players were dragged to the centre of the regulatory arena within a few months. Change or perish was the prognosis for everybody; acceptance didn't really enter into it.

The first inkling of what was coming was probably for the sell side when Jacques de Larosière (Feburary 2009) recommended the greater use of central counterparties. The vastly extended reporting and clearing regime from the European Market Infrastructure Regulation and the Dodd-Frank Act, coupled with the Markets in Financial Instruments Directive II, have affected both the buy and sell sides fundamentally. Custodians, too, have been swept up by the strict liability rules of the Alternative Investment Fund Managers Directive and UCITS V.

There may, in some cases, be opportunities for buy-side participants to offload their reporting and clearing tasks to custodians or general clearing members. Generally, there have been fewer routes for the sell side, notwithstanding the proliferation of data and technology firms offering data capture, normalisation and reporting for regulatory compliance purposes. Legislators have made it clear, however, that organisations are responsible for their own data and regulatory integrity, whoever is transmitting the information or acting as an interface to the market infrastructure. A side benefit of the new regulations has undoubtedly been a greater appreciation of each other's challenges, but both the buy and sell sides have had to recognise the full glare of regulatory integrity pointing towards them, and the complexity and cost of compliance.

Andrew Douglas, managing director and head of government relations for Europe and Asia, DTCC: The majority of regulatory requirements, which have come into effect in Europe following the financial crisis, have affected both sides. However, sell-side firms, the majority of whom have global operations, have tended to engage earlier in the process due to regulatory requirements affecting them in other jurisdictions around the world. This is particularly true of derivatives trade reporting where sell-side firms faced similar reporting requirements under the Dodd-Frank Act over a year before the European Market Infrastructure Regulation came into effect.

The process for buy-side firms, on the other hand, has involved an assessment of how much of the compliance with new regulatory requirements could be delegated to their brokers and how much of it had to be handled by the buy-side firms themselves. While these conversations understandably took some time, the majority of buy-side firms have been fully engaged in the process and compliance on the whole has been good. With the scope of regulation extending for the first time to non-financial counterparties, the latter have faced the greatest challenge in adapting to new regulatory requirements.

Market infrastructures have played an essential role in raising awareness of regulatory requirements and creating the conditions for regulatory compliance by both the buy side and the sell side. Many of the new regulatory requirements, such as derivatives trade reporting, have required the build-out of entirely new infrastructure capabilities. The commitment by market infrastructure providers, such as DTCC, to invest in these capabilities early on in the process, while at the same time engaging with the end users and their trade bodies to raise awareness of regulatory requirements, has been instrumental during this first phase of regulatory implementation.

Carsten Kunkel, head of regulatory center of excellence, SimCorp: With new regulations impacting the buy- and sell-sides in different ways, it is difficult to say definitively which one has responded best to regulatory change.

For example, failure to comply with regulations such as the Markets in Financial Instruments Directive (MiFID), resulting in hefty fines for some sell-side firms, has sharpened the sector's focus on adapting their businesses to accommodate an ever shifting and more onerous regulatory landscape. But these rules have imposed complex reporting requirements on buy-side firms that are also evolving the way they do business to accommodate them. With regulators emphasising the importance of data quality, data management has jumped to the forefront of organisational priorities. Buy-side firms, many of which still rely on legacy technology, have recognised that a failure to automate properly has left them incapable of effectively managing new data requirements. So they are turning to third-party vendors to help them meet tougher regulatory standards.

In response to rules focusing on the activities of buy-side firms, such as Solvency II, unsurprisingly this sector has led the way in developing effective responses, with the sell-side following. We have seen large insurance companies across Europe successfully adapting their investment management systems to respond to the new regime. As a consequence, sell-side firms are developing new investment products in order to stay competitive and in-line with new industry norms.

Jonny Speers, global head of sales, Torstone Technology: We are seeing that sell-side firms are becoming increasingly sophisticated in the way they manage their back-office operations in response to new regulatory requirements.

While many are doing away with legacy systems and investing in the complete automation of in-house back-office processes, large numbers of firms are instead leveraging the expertise of third-party technology providers to migrate them onto new platforms and manage these operations. For those that do decide to outsource, we have seen that approaches can vary. For example, some firms will choose to outsource every component of their post-trade operations across each asset class that they trade with in-house management supervision. Others may choose to opt for partial rather than full outsourcing of post-trade operations, using an approach we call 'hotsourcing' where they can test outsourcing of different business processes to find the most effective mix best suited to their risk profile.

The buy side has historically sought the sell side's assistance to share the regulatory burden, and this will undoubtedly continue. However, in an increasingly competitive environment some of the larger buy-side firms may choose to outsource its post-trade operations directly to a third-party provider as these firms focus on their core competencies of managing investor portfolios. Furthermore, not only does outsourcing allow fund managers to pass on the operating costs to their providers, they can also more efficiently allocate costs directly back to the funds they manage.

Paolo Brignardello, head product management and marketing, Fundsquare: The buy side has not yet seen the value of all regulatory changes happening in the fund industry in full. European pension reform is key element to the buy side appreciating the benefits of the various regulatory changes. One of the pillars for the new pensions world will be the fund industry as a vehicle for personal pensions and understanding this in a more sophisticated manner is an important stage to achieving the potential for investment funds. The sell side has clearly realised the opportunities in this respect.

As an example, the Markets in Financial Instruments Directive II greatly affects the relationship between the buy side and sell side and how they interact. The various investor protection requirements, such as for independent advice, enhanced information and reporting to investors, and stricter monitoring of sales remuneration, are not yet fully appreciated by investors. They will need to educate themselves about their investment choices or seek other types of advice.

Both sides can learn a lot from each other. Fund distribution is expensive, sometimes as much as half of the fund's fees, and although it is now beginning to change, investment fund distribution to retail investors is still dominated by banks in most of Europe. Fund platforms and others are beginning to gain market share and eventually investors will vote with their wallets. Now, therefore, is the time for the European fund industry to make some bold changes. According to a recent study we've conducted with Deloitte, by improving the efficiency of its distribution supply chain, Europe's cross-border fund industry could reduce these costs by up to 70 percent.

Ralf Menegatti, product owner asset management Europe, the Middle East and Africa, AxiomSL: Without a doubt, it is the sell side that has been quickest to adapt to regulatory change. Many sell-side firms have viewed the introduction of new regulations as an opportunity to help the buy side, and they have used mandatory changes as an opportunity to replace out-of-date, legacy systems. For some sell-side firms, it is also a 'do or die' situation: if they don't adapt today, they will be history tomorrow.

The buy-side, on the other hand, is always slower to react and more hesitant about spending a lot of money on regulatory change. Many firms plan their operational changes 18 months in advance. If a new regulatory deadline is announced in the interim, it completely disrupts their planning. As a result, many buy-side firms have chosen to outsource their regulatory compliance projects. This is what happened with the Alternative Investment Fund Managers Directive (AIFMD). In Luxembourg, where I am based, 90 percent of AIFMD services are outsourced. The same thing is happening with the Foreign Account Tax Compliance Act, Solvency II and Basel III.

Buy-side firms can definitely learn from the sell side, particularly by making regulatory compliance a strategic goal. There are some signs of this happening, including a number of asset managers that took a proactive approach to AIFMD compliance because they realised that being one of the first to have an AIFMD licence would attract investors. In turn, the sell side may benefit from considering the different service models that are now popular on the buy side, such as managed services and software-as-a-solution.