Building trust with regulators

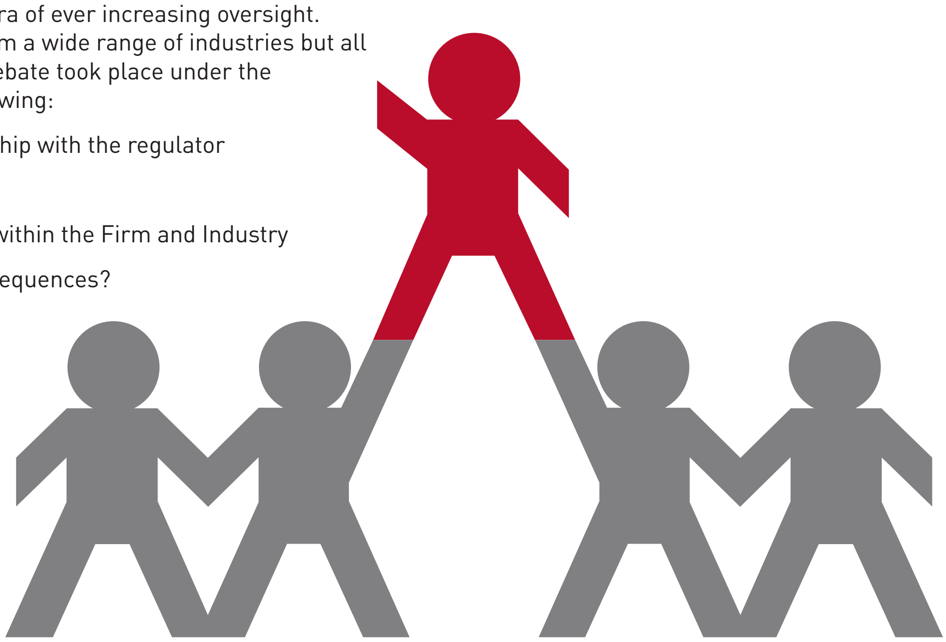
Why does trust matter?

Businesses live in an age of unprecedented scrutiny. Clients, customers and other stakeholder groups are increasingly demanding greater transparency and ethical behaviour from the businesses with which they interact. Reputation, the sum of past interactions with stakeholders, used to be seen as integral to the ongoing success of a business with its stakeholders. But reputations are frequently failing as a bulwark against sustained scrutiny. Many businesses are now realising that reputation alone is not enough and that something more is needed. That something is Trust.

Financial institutions are now operating under a level of regulation and oversight that exceeds anything experienced before, much of it enacted and enforced in response to the financial crisis of 2008. In the US, the Dodd-Frank Act has ushered in the biggest set of regulatory changes since the Great Depression of the 1930s, while the European Commission, for instance, has proposed almost 30 new sets of rules since 2010, all aimed at enhancing regulatory oversight. Authorities are more robust than ever in enforcing these new laws and, needless to say, penalties for transgressions are rising. Furthermore, especially in the wake of the financial crisis, reputational damage from failure to comply with regulations has the potential to be greater than ever in both the eyes of peers and the public.

In October 2014, Baker & McKenzie hosted the Trust Matters forum, bringing together senior executives from across the world to explore how organisations can build trust in order to meet the expectations of the law, their stakeholders and the communities in which they operate. At the forum, senior executives attended a roundtable to discuss how trust can be built with Regulators in an era of ever increasing oversight. The individuals discussing this topic came from a wide range of industries but all were leaders in their respective fields. The debate took place under the 'Chatham House rule' and discussed the following:

- The advantages of building a good relationship with the regulator
- To report or not to report?
- Building an internal culture of compliance within the Firm and Industry
- Is regulation effective and what are its consequences?



The advantages of building a good relationship with the regulator

To meet these new and emerging challenges, banks must adapt and tailor their strategies. It isn't enough simply to react to investigations or loosely adhere to regulatory guidelines. Now, to be successful, banks need to develop and implement compliance strategies that are both comprehensive and pre-emptive in nature. Establishing a good relationship with regulators, indeed earning their trust, should be a key priority, particularly in the event of an investigation. Other key issues for banks in this evolving regulatory environment include, deciding on a best practice policy when it comes to making self disclosures prior to an investigation and how to handle multiple regulatory disclosures across different markets.

It is now often the case that regulators will interview a director of a company at the appointment stage. This is a reflection of the more robust style and interventionist role which regulators are playing in the current business landscape. It also has the consequence of raising the bar for financial institutions as it means the regulator has personally outlined its primary concerns, requiring the director to be up to speed from the earliest stage. While the relationship with the regulator may seem inherently contentious, due to the fundamental nature of the regulator's role and the perception that industry views are not being taken into account, the discussion was unanimous in agreeing that a good relationship between company and regulator is extremely helpful and is especially useful in the case of an investigation.

"Many financial institutions don't build relationships with the regulator," commented one participant. "This is not good as the relationship can then be antagonistic. You will be better off if you build a relationship before anything goes wrong."

The best way to build a productive and positive relationship with the regulator isn't always clear, especially during an investigation when too easy a relationship and too much disclosure can be detrimental to the business in the long-term. Deciding on a strategy in the event of an investigation is key. The panellists at October's conference were in agreement that in the event of an investigation establishing trust with the regulator at the opening stage is crucial.

"How you respond at this stage is important," said one panellist. "If the regulator realises that you are taking issues seriously this will send the right message. If you are aggressive or confrontational or delegate the whole issue to lawyers this will send the wrong message." While this approach was endorsed by the panel, it did also come with a caveat. One member said financial institutions must be careful in their dealings with regulators during a probe as they can "seem to be friendly and lull you into a false sense of security."

One final thought was whether sufficient channels exist to develop a positive relationship with the regulator. Even if an organisation was willing and able to engage proactively, do regulators do enough to encourage an open conversation?

To report or not to report?

In an age of increasing globalisation, with financial institutions often making deals and engaging in joint ventures in multiple jurisdictions, the risk of running foul of compliance and regulatory issues rises exponentially. At the same time authorities across the globe are realising the need for joined-up regulatory enforcement and agencies. This is even in emerging markets, where regulators are enforcing laws more stringently than before. In this environment, the questions of what advantages are gained by self-reporting and how best to do it are a key consideration for all financial institutions.

While one panellist questioned whether agencies really gave credit for financial institutions flagging up potential breaches, the majority were in agreement that self-reporting had definite advantages. One panel member pointed out that under current legislation relating to cartel violations, those who are first to report get full immunity while those who report second get only a reduction in the ultimate fine, concluding by saying "those not self-reporting or who are not first to do so face a huge disadvantage."

> "Businesses need to implement compliance strategies that are comprehensive and pre-emptive."

> "You will be better off if you build a relationship before anything goes wrong."

Among the concerns for banks when it comes to self-reporting is how the regulator will view the breach; will it be seen as being down to 'rogue' employees or a systemic failure of the company's compliance culture or processes. One of the panellists said that internal sanctions by the company will not be the focus of the regulator, instead the authorities will concentrate on issues such as whether internal training is available to prevent it happening again, adding that in jurisdictions such as the US, UK and Germany, which have criminal powers, individuals will be held to account.

Building an internal culture of compliance within the organisation and Industry

In order for a company to build an internal culture of compliance one element is essential: trust. The company must inculcate a culture whereby employees aren't afraid of going to senior management and directors with concerns. In recent years a number of high-profile compliance and anti-trust cases have shown that large, global institutions could question an employee's 'team ethic' if too many concerns were raised. Of course financial institutions must balance these concerns with the need to be internally cohesive.

One participant, while acknowledging that the internal politics of any organisation will impact on trust levels with specific people, said "you must be able to fundamentally believe in your colleagues. You must be able to question your colleagues". For the CEO it is also important to have the right systems in place to avoid the risk of over-reliance on the advice of the compliance officer. The participants were also told that key to having an effective internal compliance program is the ability to challenge the orthodoxy of any organisation and that the failure to do this helped lead to the financial crisis of 2008.

Since the crisis, the pace of regulatory investigations and their scope has widened on both sides of the Atlantic. Over recent years regulators have conducted investigations into Libor rigging and Forex manipulation by some of the world's biggest and most profitable corporations, leading to record fines and reputational damage. One participant predicted that the pensions sector may be the next area of investigation, telling the conference: "Financial institutions must now stay ahead of the curve. Clean up where the investigations are going next.''

Is regulation effective and what are its consequences?

The need for regulation is universally accepted, however the form it takes and its scope is not. Furthermore there is disagreement as to how far it can change and modulate behaviour within industries and sectors. One participant told the conference that in order for regulation to be effective it needs to transcend national boundaries and ultimately there is a limit to how far issues can be resolved with regulations, arguing that the sectors and industries ultimately need to remedy their internal problems.

"If the industry wants a license to operate, it's activities must be socially acceptable,'' the panellist said. "It is not just a question of law but having business practices that society accepts.'' The audience was told that in the Netherlands the system had less of an emphasis on regulation and more focus on appropriately qualified people in the sector, while simultaneously requiring financial institutions to sign up to moral and ethical standards.

The participants heard that while banks have been amongst the most heavily regulated institutions in the fall out of the 2008 crisis they still remain profitable and innovative.

About us

As an advisor to many of the world's leading businesses, Baker & McKenzie has seen the theme of Trust developing in different ways all around the world. In October 2014, Baker & McKenzie hosted its **Trust Matters** forum, bringing together senior executives from across the world to explore how organisations can build trust in order to meet the expectations of the law, their stakeholders and the communities in which they operate. Drawing on our global legal expertise as well as the experience of senior business and other industry leaders the forum provided insights into the execution of policies and procedures that, not only deliver business imperatives, but deliver them in a way that builds Trust.

A number of sessions were held at the forum, including **Building trust with regulators**. The outputs from each of these sessions have been collated to produce a summary of the discussions on each topic.

For more information, please visit:
www.bakermckenzie.com/trustmatters

Contacts

Arun Srivastava
Partner
arun.srivastava@bakermckenzie.com
+44 20 7919 1285

Jeremy Pitts
Principal
jeremy.pitts@bakermckenzie.com
+81 3 6271 9737

Beatriz Araujo
Partner
beatriz.araujo@bakermckenzie.com
+44 20 7919 1789