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# COST OF COMPLIANCE 2016

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## TABLE OF CONTENTS

EXECUTIVE SUMMARY	3
INTRODUCTION	4
COMPLIANCE FUNCTION: BUDGET AND RESOURCES	6
PERSONAL LIABILITY	9
TYPICAL WEEK OF A COMPLIANCE OFFICER	12
REGULATORY CHANGE	13
REPORTING	17
ALIGNMENT WITH OTHER RISK AND CONTROL FUNCTIONS	18
LIAISON WITH REGULATORS	19
MANAGING REGULATORY RISK	20
OUTSOURCING	22
TECHNOLOGY	23
CHALLENGES COMPLIANCE OFFICERS ANTICIPATE IN 2016	24
CLOSING THOUGHTS	26

# EXECUTIVE SUMMARY

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Thomson Reuters has undertaken its annual survey into the cost of compliance and the challenges firms expect to face in the year ahead. Compliance professionals from more than 300 financial services firms worldwide, including most of the largest global systemically important financial institutions (G-SIFIs), took part. The report builds on annual surveys of similar respondents conducted over the last seven years and, where relevant, highlights year-on-year trends and developments.

The survey has become a voice for practitioners, and the frank concerns and views shared by participants have consistently given them an insight into the reality and challenges faced by their peers in all industry sectors. Thomson Reuters extends its thanks to all respondents along with a continued assurance that the responses will remain confidential.

As with previous survey reports, the findings are intended to help regulated firms with planning, resourcing and direction, and to allow them to benchmark their own practices and experiences to determine whether their resources, strategy and expectations are in line with those in the wider industry. The experiences of G-SIFIs are analyzed where these can provide a sense of the approach being taken by the world's largest financial services firms.

The responses show the breadth of the role and concerns of compliance officers. The red flag raised in last year's report about resource constraints is beginning to show signs of crystallizing with all firms no matter what their size, highlighting a potential reduction in the resources firms have available for compliance activities.

The main points to note are:

- **No letup in change:** Compliance officers are clearly still experiencing regulatory fatigue and overload in the face of ever-changing and growing regulations. Consistent with the previous year's expectations, 69 percent of firms (70 percent in 2015) are expecting regulators to publish even more information in the coming year, with 26 percent expecting significantly more.
- **Tracking regulatory change:** More than a third of firms continue to spend at least a whole day every week tracking and analyzing regulatory change. There has been a gradual decline in firms spending more than 10 hours tracking change every week, whether due to efficiencies or resource constraints. That said, there has been no letup in the volume of regulatory change that firms need to track.
- **Resource challenges:** One of the major challenges firms face is the continued scarcity of skilled compliance personnel, forcing firms to do more with less and putting a focus on the development of existing staff. Consistent with 2015 results, two-thirds (67 percent) of firms overall are expecting senior staff to cost more in 2016, largely due to the demand for skilled staff and knowledge (84 percent), and the need for additional senior staff to manage volumes of regulatory requirements (59 percent). Of the G-SIFI firms, 83 percent expect skilled senior compliance staff to cost more.
- **Outsourcing:** A quarter of firms have opted to outsource at least part of their compliance functionality. Two reasons cited are lack of in-house compliance skills and the need for additional assurance on compliance processes.
- **Focus on regulatory risk:** In line with 2015, three-quarters of firms are expecting the focus on managing regulatory risk to rise in 2016. This is largely due to the greater regulatory demands on the management of conduct risk. For G-SIFIs the main influence is the impact of harsher regulatory penalties.
- **Personal liability:** In line with last year's results, 60 percent of respondents (59 percent in 2015) expect the personal liability of compliance officers to increase in the next 12 months, with 16 percent expecting a significant increase. Twenty-seven percent of G-SIFIs expect a significant increase in personal liability in 2016.
- **Technology and reporting:** Technology presents a bigger challenge for compliance officers than ever before. The insight provided on challenges made clear that its impact is wide-ranging. Regulatory developments are driving technological change with the remit of compliance broadening to cover cyber risks, as well as the assessment of new technology to help manage many aspects of firm-wide compliance. Additionally, there are an increasing number of information requests from regulators, which respondents called out as the overriding reason for an expected increase in liaison with regulators.
- **Coordination between control functions:** Over the seven years of the survey, there has been little change in the reported interaction and alignment between control functions. Firms may be missing opportunities to leverage scarce resources with only half (50 percent) of compliance functions spending more than an hour each week with internal audit.



REUTERS/Carlos Barria

## INTRODUCTION

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Thomson Reuters Regulatory Intelligence carried out the survey between December 2015 and February 2016. Responses were received from individuals in Africa, the Americas, Asia, Australasia, Europe and the Middle East. Respondents represented firms across all sectors of financial services including banks, brokers, insurers and asset managers.

### THE RESULTS

The results reinforce a number of themes: concerns about the volume of regulatory change, the need to focus on the implementation of new rules and the obligation for compliance functions to do “more” have been raised for a number of years now. In 2015, there were early warning signs that the level of investment in compliance was decreasing, and this year’s survey suggests that this is beginning to crystallize.

These resource constraints come at a time when the specter of personal liability is rearing its head, and the breadth of expertise now expected of compliance functions shows no sign of abating. The adequacy and availability of resources is seen as a particular compliance challenge for 2016 and may well encourage firms both to make more use of technology and to outsource some or all of their compliance functionality.

Good compliance skills have always been at a premium but firms must continue to invest in in-house compliance knowledge and skills; otherwise, they will find it distinctly challenging to implement changes such as the new fiduciary rules in the United States, the European Data Protection Regulation and the Markets in Financial Instruments Directive II (MiFID II) and associated regulation, or to deal with the international focus on enhanced due diligence and anti-money laundering/counter-terrorist financing.

That said, there is a limit to firms’ ability to increase their compliance budgets. Firms may need to think more creatively about how to meet changing regulatory expectations, whether that is through investing in compliance technology (sometimes dubbed “RegTech”), providing training for existing compliance

staff, targeted recruitment, considered outsourcing or enhanced levels of coordination with other risk and control functions.

The legislative changes are significant, but the defining international regulatory theme for 2016 will be conduct risk. As just one example, at the Thomson Reuters Pan Asian Regulatory Summit in October 2015, the audience was polled on the biggest areas of focus for regulation in Asia during 2016. Conduct risk came out on top. Anti-money laundering was in second place. In the UK, conduct risk and the need for consistently good customer outcomes has become a regulatory mantra, while in the United States, the conduct of individuals and the culture of firms has been a feature of many regulatory speeches and publications.

Some firms had considered the concept of conduct risk as an international regulatory theme to be something of a flash in the pan – another buzzword that would gradually disappear if ignored for long enough. They were mistaken. Conduct risk is here to stay as a regulatory concept and expectation, and it presents considerable challenge for compliance officers and requires skilled resources.

The nature of conduct risk, particularly when accompanied by the stronger focus on individual accountability, also puts the 2016 spotlight on the need for high-quality regulatory relationship management. Firms are still struggling to define exactly what conduct risk means to them (in the 2015/16 Thomson Reuters Conduct Risk Report, 64 percent of firms did not have a working definition of conduct risk), and are working to develop methodologies to measure, evidence and explain the “how” as well as the “what” of all business undertaken.

Senior managers, briefed by a skilled, well-resourced in-house compliance function, must be able to discuss the impact of all relevant regulatory changes, customer-centric strategies and the firm-specific working definition of conduct risk with regulators, as well as the approach taken to monitoring and reporting on all risk issues.



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# COMPLIANCE FUNCTION: BUDGET AND RESOURCES

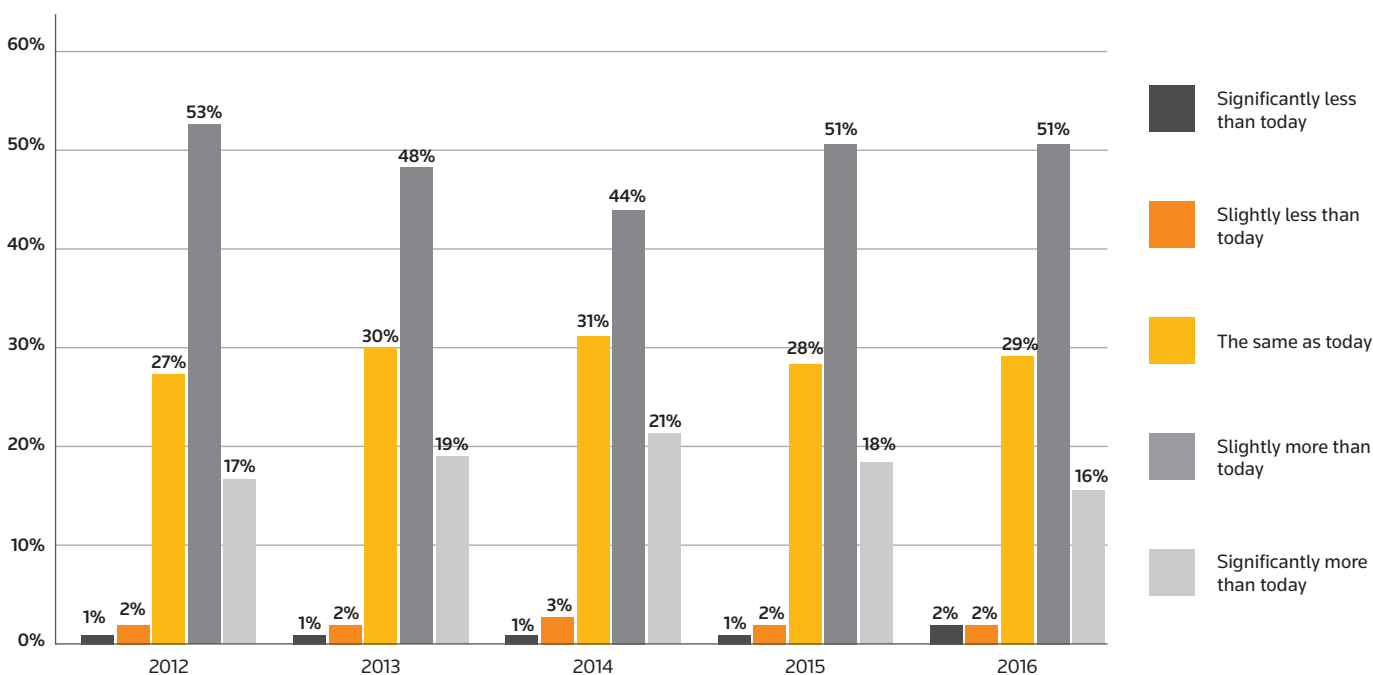
If regulated firms are to thrive in the medium and longer term, they will need to make appropriate investment in their risk, compliance and control functions. A skilled, high-quality compliance function is expensive to build, but it will be one of the best investments (if not insurance policies) for firms and their senior managers. Many firms have employed additional compliance staff, but there is a growing need for more experienced compliance officers.

Firms' ability to develop and maintain an adequately resourced compliance department will be determined in part by the availability of high-quality compliance officers with deep experience. There is a lack of good compliance skills in the marketplace, which has driven up the costs of senior compliance professionals in particular and may in turn make it harder for firms (and indeed regulators) to keep hiring ever more compliance staff. That said, the situation may itself be the result of major investment in firms' compliance functions over the past couple of years.

The results of the survey show an expectation that the costs of skilled compliance staff will continue to rise, but the growing issue is in the availability of high-quality skills and experience. If recruitment resources are limited, firms may wish to implement their own compliance training programs to begin to develop compliance and risk skill in-house. Overall, two-thirds of firms are expecting skilled staff to cost more, although there are a number of regional and G-SIFI variations.

Expectations have remained consistent that the cost of senior compliance staff will continue to rise. The increase is more pronounced in the G-SIFI population, where 61 percent of respondents expect senior compliance staff to cost slightly more and 22 percent significantly more. Overall, in the general population, 67 percent expect the cost of senior compliance staff to rise in the coming year compared with 83 percent for G-SIFIs. The major reason cited for the expected increase is the demand for skilled staff and knowledge.

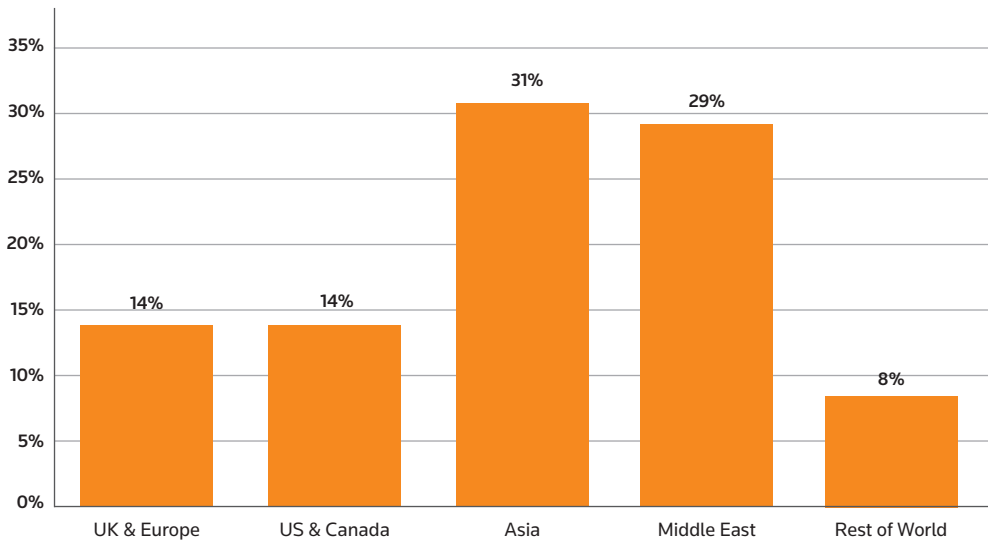
EXPECTED COST OF SENIOR COMPLIANCE STAFF 2012-2016



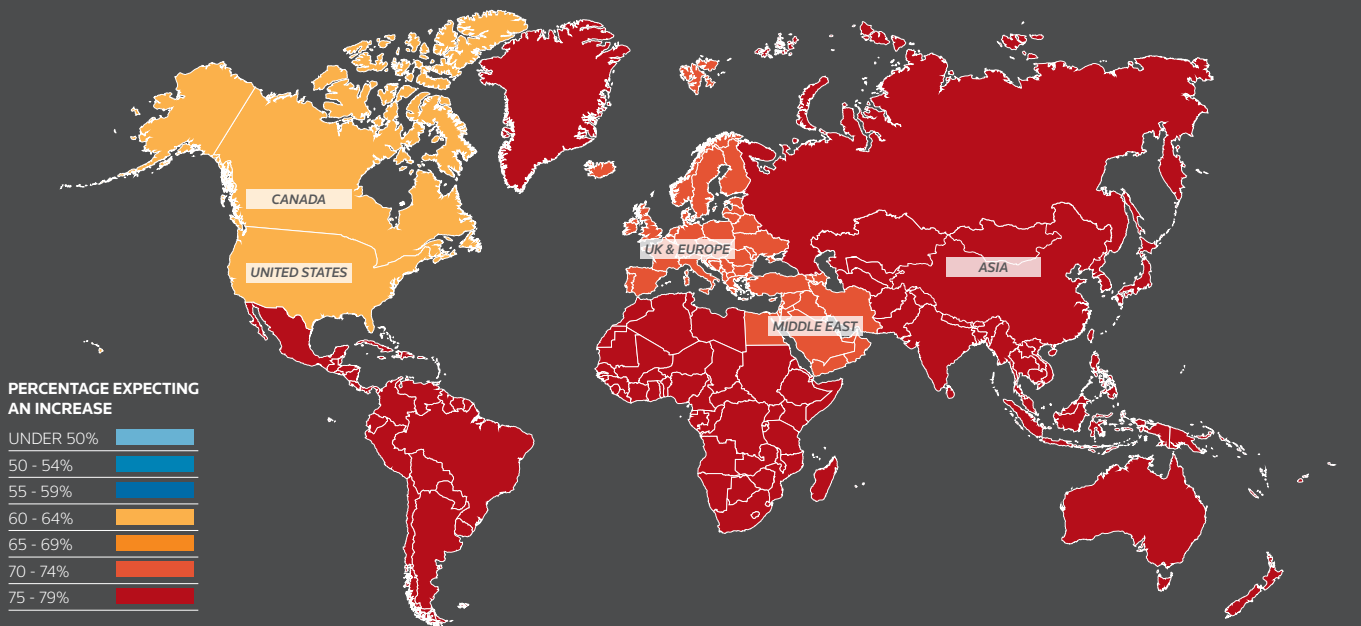
There are regional variations in the expectation that senior compliance staff will cost more in 2016 with some regions expecting the cost of compliance resources to rise significantly.

A larger percentage of respondents in Asia (31 percent) and the Middle East (29 percent) reported such concerns compared with other regions.

EXPECTATION THAT SENIOR COMPLIANCE STAFF WILL COST SIGNIFICANTLY MORE IN 2016



REGIONS EXPECTING THAT COSTS OF SENIOR COMPLIANCE STAFF WILL **INCREASE SLIGHTLY OR SIGNIFICANTLY** IN THE COMING YEAR

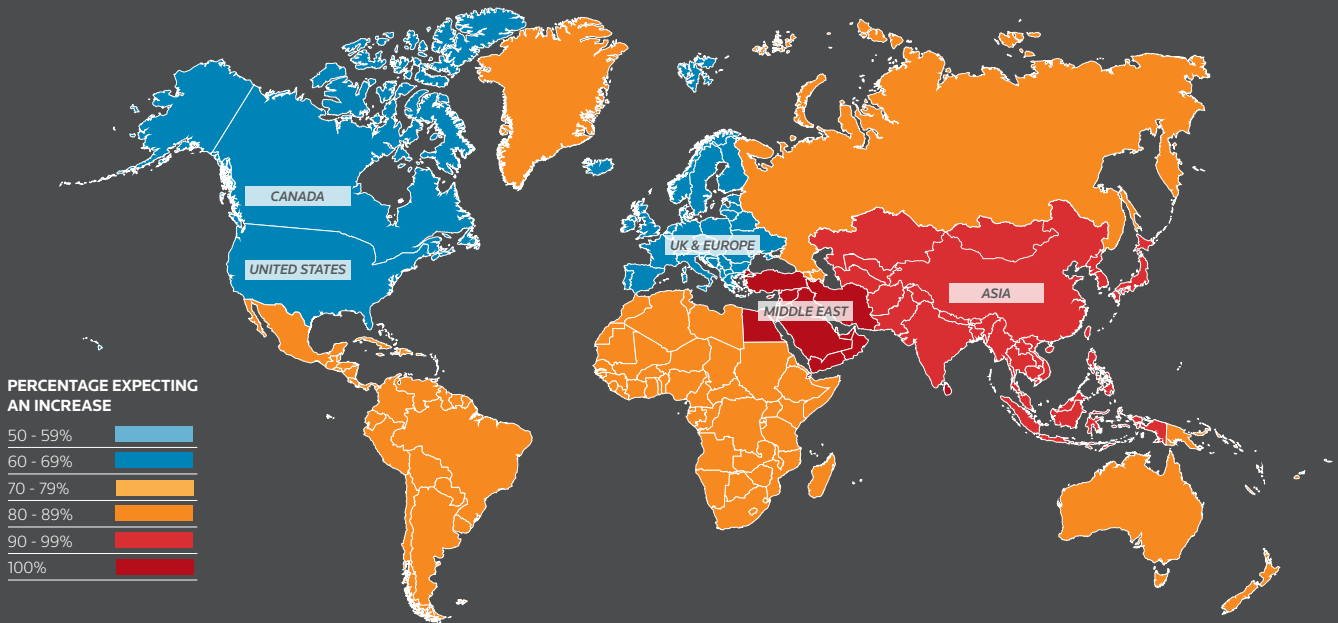


Over the next 12 months, I expect the cost of senior compliance staff to be...	UK & EUROPE	US & CANADA	ASIA	MIDDLE EAST	REST OF THE WORLD
<b>More than today</b>	<b>70%</b>	<b>60%</b>	<b>77%</b>	<b>72%</b>	<b>79%</b>
The same as today	26%	34%	20%	28%	17%
Less than today	4%	6%	3%	0%	4%

Expected costs of senior skilled compliance staff are likely to rise, but the positive news for the profession is that financial services firms are still committed to investing in compliance, with more than two-thirds (69 percent) of respondents expecting an overall increase in the available budget.

More than half of compliance professionals (54 percent) and G-SIFIs (56 percent) expect their total team budgets to increase slightly over the next 12 months. Fifteen percent in the full population and 17 percent of G-SIFIs are expecting a significant increase in the total compliance budget.

# REGIONS WITH HIGHEST EXPECTATION THAT COMPLIANCE TEAM BUDGETS WILL **INCREASE** IN THE COMING YEAR



**PERCENTAGE EXPECTING AN INCREASE**

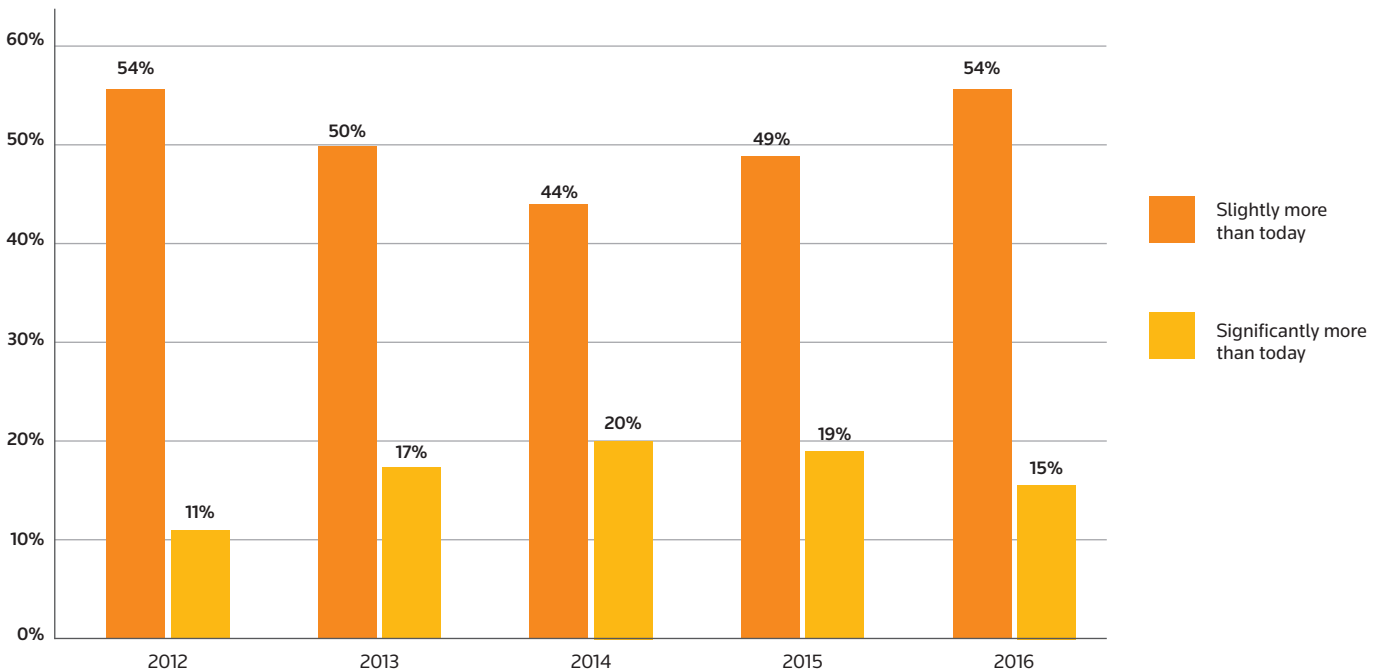
50 - 59%	Light Blue
60 - 69%	Medium Blue
70 - 79%	Orange
80 - 89%	Dark Orange
90 - 99%	Red
100%	Dark Red

Over the next 12 months, I expect our compliance team budget will be ...	UK & EUROPE	US & CANADA	ASIA	MIDDLE EAST	REST OF THE WORLD
<b>More than today</b>	<b>64%</b>	<b>63%</b>	<b>91%</b>	<b>100%</b>	<b>84%</b>
The same as today	28%	28%	6%	0%	8%
Less than today	8%	9%	3%	0%	8%

The budgetary and cost expectations appear to be broadly in line on a regional basis. A squeeze on resources means firms will need to ensure that they are spending their investment wisely in terms of both skills and technology. They must also ensure that

resources continue to meet the changing needs of the business both in terms of the shift to implementation of some big pieces of regulation and the digital challenges of cyber and fintech.

## EXPECTED INCREASE IN THE TOTAL COMPLIANCE BUDGET OVER THE NEXT 12 MONTHS 2012-2016





# PERSONAL LIABILITY

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Regulators have made clear the rationale behind their drive to hold individuals to account. The impact on the cost of compliance and whether it exacerbates the challenge and cost of recruiting individuals to serve in higher-stakes compliance roles remains to be seen. What is certain is that greater personal liability will become reality in 2016 in many jurisdictions. In theory, individuals could already have routinely been held accountable, but it was often simpler, quicker and easier for regulators to pursue firms. As a result, regulators have themselves been criticized for failing to discipline senior individuals for failings that contributed to the financial crisis.

“Ultimately, we need more individual accountability. Good corporate governance is forged by the ethics of its individuals. That involves moving beyond corporate ‘rules-based’ behavior to ‘values-based’ behavior. We need a greater focus on promoting individual integrity. In the Aristotelian tradition, virtues are molded from habit – developing and nurturing good behavior over time.”

**Christine Lagarde, managing director, International Monetary Fund, speech, “Ethics and Finance: Aligning Financial Incentives with Societal Objectives” (May 2015)**

Regulators have stated that the intention is not to increase levels of enforcement but to encourage improved risk awareness, leading to more consistently good customer outcomes. One of the most challenging methods employed by regulators is the use of personal attestations, which are seen as a good way to focus senior managers’ attention. If the signatory either fails to give the required attestation or a compliance breach is found in the attested area, it is then a relatively simple matter to pursue enforcement against the senior manager involved.

“Earlier this month, we introduced the new Senior Managers Regime. The aim of this regime is to establish clear responsibilities for senior managers, including chairs of Board Committees. This is not to create new responsibilities, but rather to be clear on what those responsibilities are, and then to supervise to hold individuals to those responsibilities. In the previous regime, we had too many examples of individuals shirking their responsibilities. My strong view is that senior figures cannot delegate responsibilities. We will then direct our supervision to support this new regime operating effectively.”

**Andrew Bailey, chief executive, UK Prudential Regulation Authority, speech, “Defining the objectives and goals of supervision” (March 2016)**

The UK has perhaps taken the most decisive steps toward changing expectations of senior managers. Since March 2016, banks and the largest asset managers (UK Prudential Regulation Authority-designated investment firms) have been subject to the new Certification and Senior Managers Regime (SMR),

which requires firms to allocate prescribed responsibilities to individuals and document the accountabilities in formal “responsibilities maps.” The UK SMR rules are part of the suite of civil requirements, although the UK has also shown its willingness to use the criminal courts, most notably following the Libor scandal when a 14-year prison sentence was handed down to trader Tom Hayes for fraud.

The United States, Canada and Australia have also made policy moves. In the United States, the “Yates memo” drew a straight line between individual accountability and corporate wrongdoing and resulted in the U.S. Attorneys’ Manual being updated in November 2015.

In a statement of regulatory expectations, Sally Quillian Yates, deputy attorney general at the U.S. Department of Justice, said, “One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing. Such accountability is important for several reasons:

- it deters future illegal activity;
- it incentivizes changes in corporate behavior;
- it ensures that the proper parties are held responsible for their actions; and
- it promotes the public's confidence in our justice system.”

The need for better behavior by senior individuals in firms is seen as a prerequisite for a more stable and enforcement-free future.

This point was also made by Norman Chan, chief executive of the Hong Kong Monetary Authority, when he said in April 2015, “Regulators can set standards and provide some external checks and balances. But there is no substitute for internal governance and controls that are designed to achieve the desired behavioral change across the entire firm.”

The need to hold, and to be seen to hold, senior managers personally responsible for breaches and corporate wrongdoing needs to be handled with great care by regulators. Credible deterrence driving better risk-aware, customer-centric behavior is desirable but must be applied evenhandedly. There has already been a backlash in the United States, where the perceived targeting of compliance officers now risks driving talented individuals out of the industry.

In 2014, the Canadian Office of the Superintendent of Financial Institutions (OSFI) published a revised guideline for regulatory compliance management (often known by its rule designation of OSFI E-13), which includes revised provisions on responsibility and regulatory expectations.

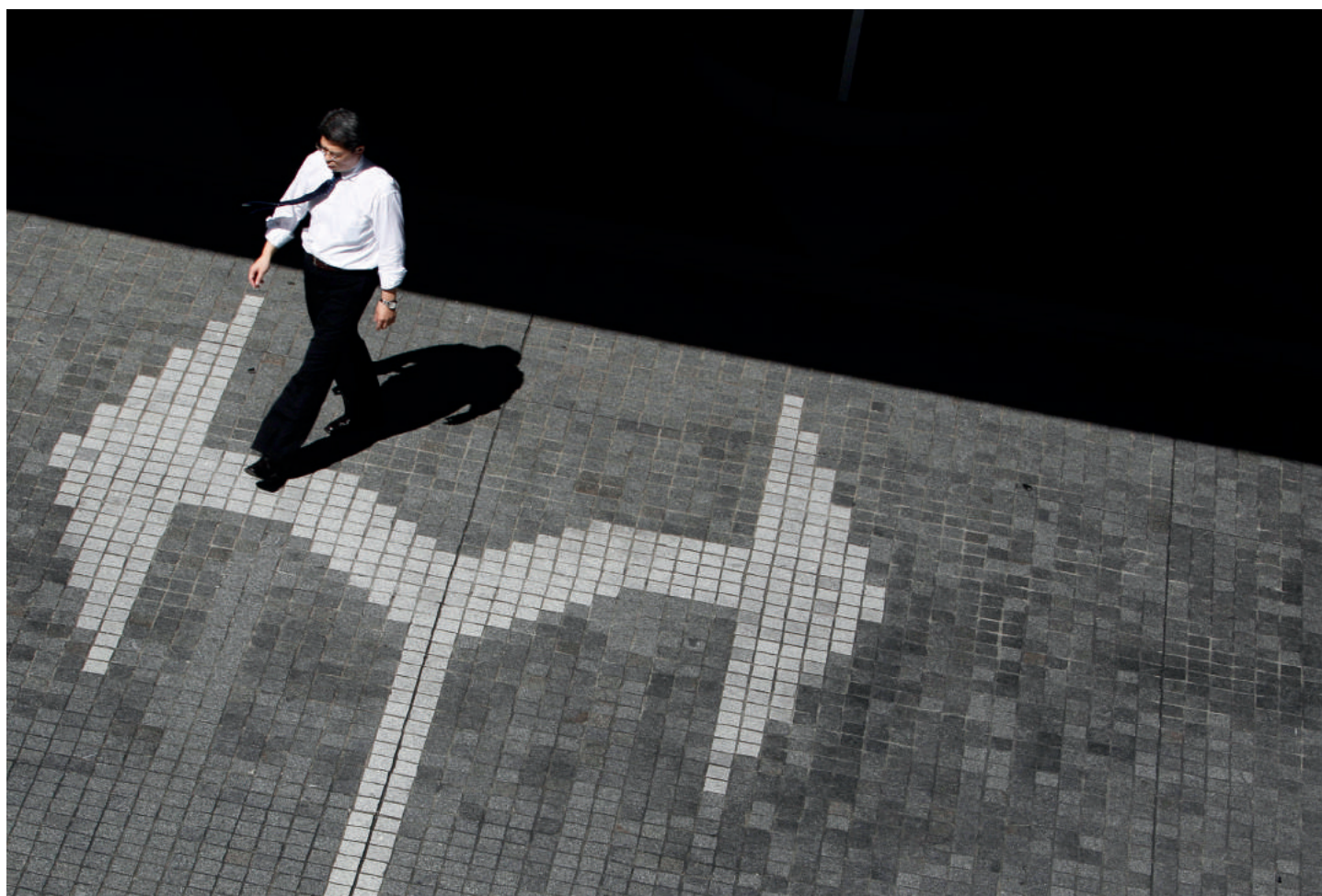
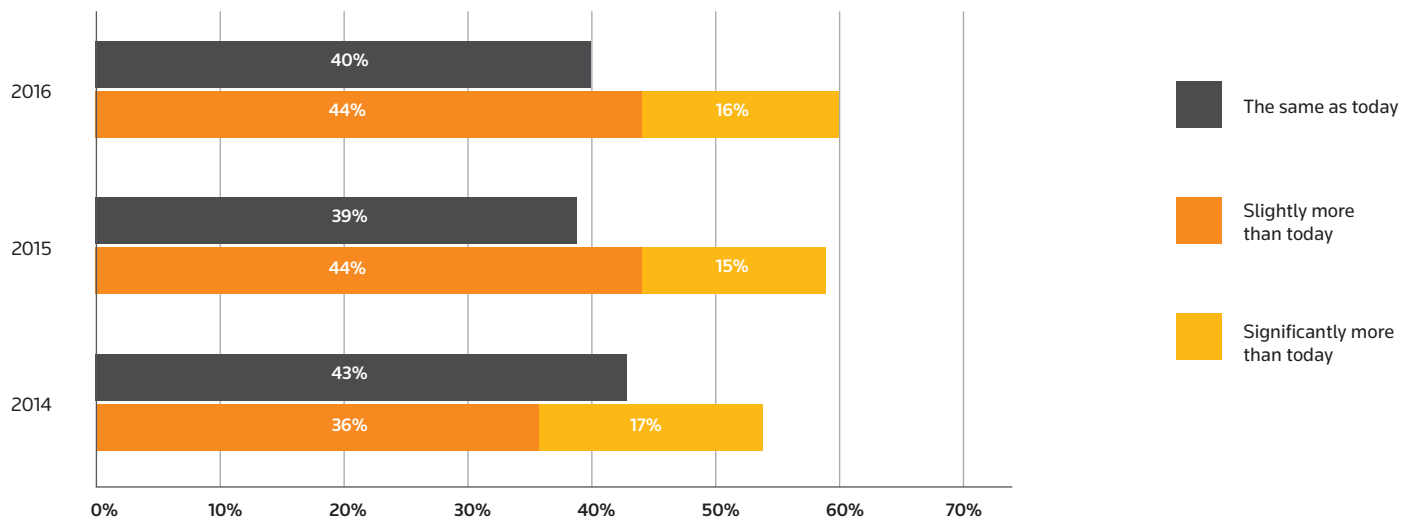
In Australia, Greg Medcraft, chairman of the Australian Securities and Investments Commission (ASIC), has said ASIC is planning to incorporate culture into its role as a conduct regulator, implying that ASIC will use cultural failings as a factor in assessing personal liability for wrongdoing.

Given that regulatory personal liability is here to stay, compliance officers will need to assess for themselves what “good” looks like in terms of their own personal regulatory risk management, which in turn, can be used as the blueprint for everyone else. There are several benefits for compliance officers who think

through in detail how best to manage their own personal regulatory risk. They will have a better chance of staying out of trouble. Other benefits include being able to advise fellow senior managers around the world on best practice. Once they have the infrastructure and protocols in place to manage their own risk, they will be able to devote more attention to overseeing the firm's compliance.

Compliance officers are aware of the likelihood of greater personal liability for themselves and their fellow senior managers. The survey results have been consistent on this point for the last two years, although in the G-SIFI population, 27 percent expect the personal liability of compliance officers to be significantly greater in the coming year.

**COMPLIANCE PROFESSIONALS WHO, OVER THE NEXT 12 MONTHS, EXPECT THAT THEIR PERSONAL LIABILITY WILL BE THE SAME AS OR MORE THAN TODAY**



REUTERS/Kim Kyung-Hoon



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# TYPICAL WEEK OF A COMPLIANCE OFFICER

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To some extent, the typical week of a compliance officer has changed little over the seven years of the survey. Over a third of a compliance officer's time is spent tracking and analyzing regulatory developments, reporting to the board, amending policies and procedures and liaising with other control functions. What has changed out of all recognition is the range of other things that compliance officers may now be expected to fit into the other half of their time.

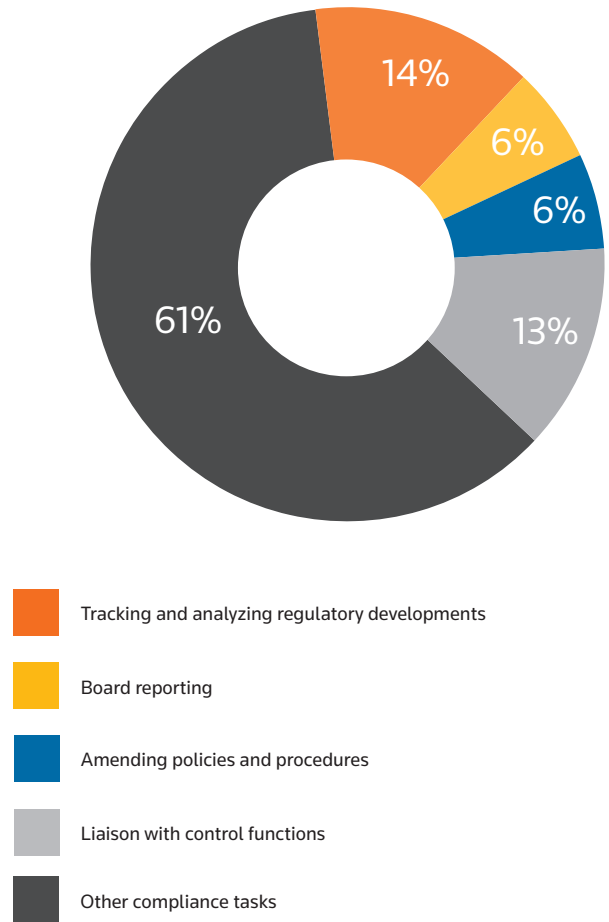
In the chart at right, 61 percent of a compliance officer's time is spent on "other compliance tasks" such as:

- Interaction with regulators
- Maintenance and renewal of licenses and registrations for regulated business activities and individuals
- Regulatory inspections and examinations
- Regulatory reporting
- Management of regulatory implementation projects
- Compliance monitoring
- Compliance training
- Past business reviews and assessing lessons learned from industry peers
- Leading on implementing cultural change
- Advising the business on regulatory change and requirements
- Lobbying and influencing emerging regulatory change
- Assessing regulatory solutions
- Oversight of conduct risk issues that affect customers, including cyber resilience
- Recruitment and retention of skilled compliance staff
- Acting as money laundering reporting officer (MLRO) and data protection officer (DPO)

Compliance officers have had to reinvent themselves and their skill sets numerous times in the last decade. The expectations of firms have grown and changed, with everything from conduct risk challenges to the ramifications of cyber risk needing to be identified, managed and mitigated, and more often than not the compliance function has to lead the way. Over time, the survey has tracked the ebbs and flows of compliance concerns, but the growing expectations regarding resources may be one of the toughest challenges yet for compliance functions to manage.

The list above suggests that compliance officers are "leading on implementing cultural change." In some firms, this may

TYPICAL WEEK OF A COMPLIANCE OFFICER



suggest a mind set that everything that emanates from the regulator is the responsibility of compliance. This may have been appropriate historically, when regulators were interested exclusively in compliance with the rules, but today's regulators are interested in everything from strategy to the behavior of individual staff members.

Compliance should be able to oversee cultural change and assist with its implementation. Leadership for cultural change must, however, remain firmly with the firm's board and senior management, without which cultural change is unlikely to happen.

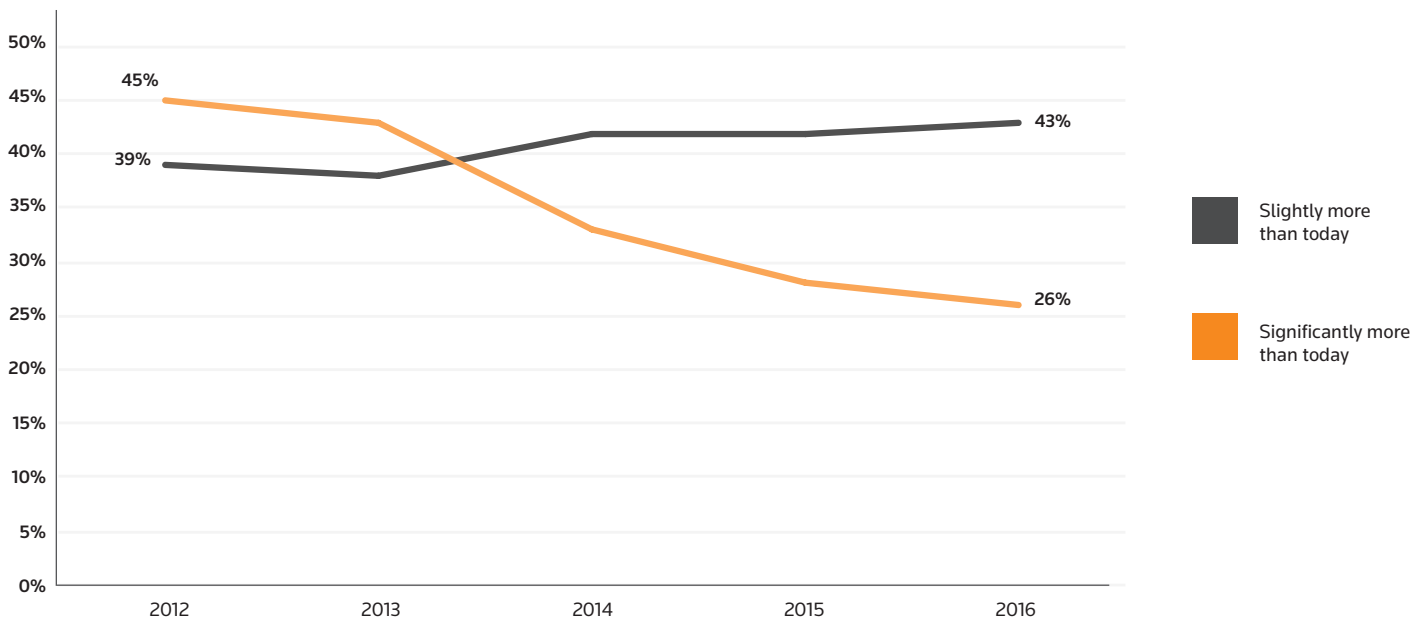
# REGULATORY CHANGE

There is no immediate letup in the complexity of change programs worldwide, although the overall volume of big new regulatory changes has started to ease. Many of the larger reforms are moving into the implementation phase, which means firms have to devote skilled resources to interpreting the planned changes and then putting them into action.

Perhaps the most time-consuming example is the European Markets in Financial Instruments Directive II (MiFID II) and associated regulation. Regulators have published thousands

of pages of detailed consultation, covering everything from complaints handling to best execution to market structure, all aimed at firms undertaking investment business. Many of the practical implementing measures are (as of Q2 2016) yet to be finalized, which has led to the effective date being put back a year to January 2018. The delay does give firms more time to prepare, but without the technical detail of the underlying standards, it is almost impossible to design, build and resource the required project change plans.

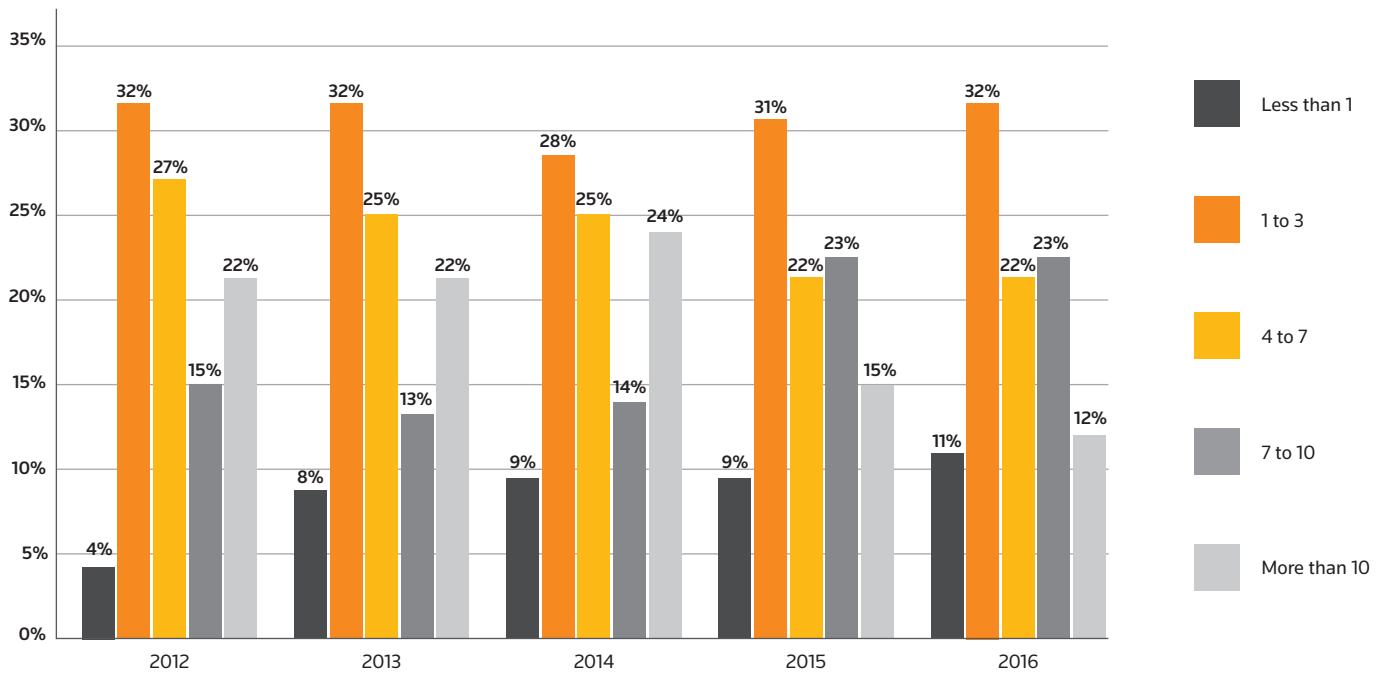
## EXPECTATION THAT THE VOLUME OF REGULATORY INFORMATION PUBLISHED BY REGULATORS AND EXCHANGES WILL INCREASE OVER THE NEXT 12 MONTHS



There has been a steady decline in the number of firms reporting that they expect the amount of information to be published by regulators and exchanges over the next year to be significantly more than today. This is broadly matched by the decline in the number of firms devoting more than 10 hours per week to tracking and analyzing regulatory developments.

There are some regional variations, with the number of compliance professionals in the UK and Europe (42 percent), the United States and Canada (42 percent), and Asia (60 percent) expecting the amount of information published by regulators and exchanges in 2016 to be slightly more than today.

IN AN AVERAGE WEEK, HOW MUCH TIME DOES YOUR COMPLIANCE TEAM SPEND TRACKING AND ANALYZING REGULATORY DEVELOPMENTS? (IN HOURS)



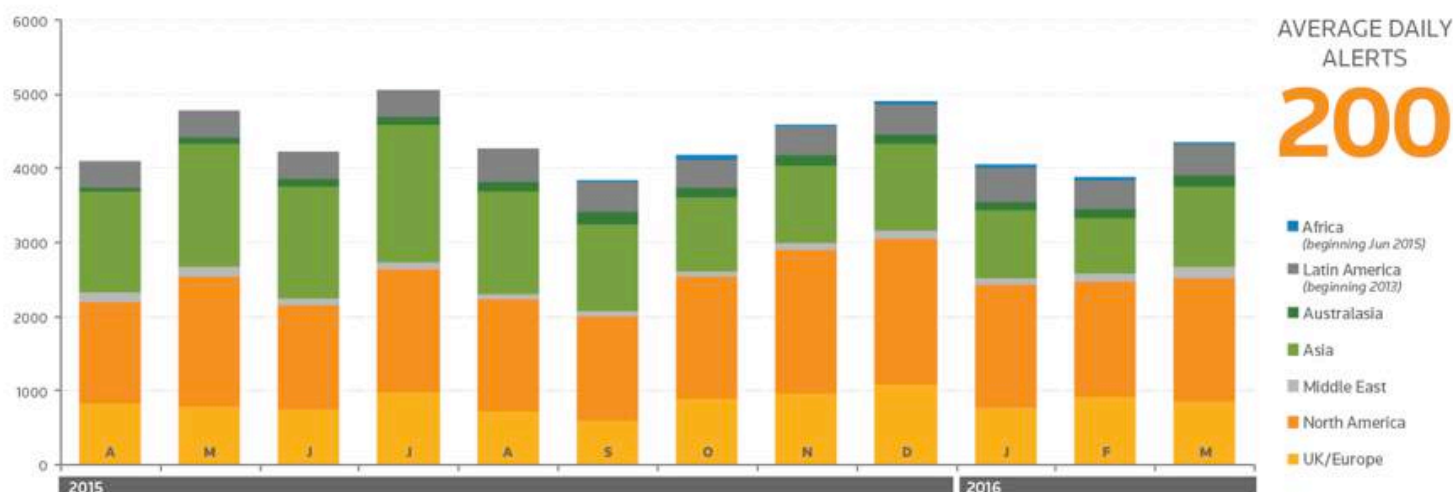
Overall, the total number of hours compliance teams expect to spend per week on tracking and analyzing regulatory developments has remained relatively static although, as noted above, there has been a general decline in firms spending more than 10 hours a week tracking and analyzing regulatory developments. In 2016, 32 percent of compliance teams expect to spend between one and three hours a week tracking and analyzing regulatory developments, compared with 31 percent in 2015. In contrast, 23 percent of the G-SIFI population expect to spend between one and three hours per week tracking and analyzing regulatory developments, while 32 percent expect to spend between four and seven hours per week, perhaps driven at least in part by the sheer size and scope of their business activities and the availability of more substantial compliance resources.

There are regional variations, with compliance teams in Asia (14 percent) and the Middle East (14 percent) expecting to spend more than 10 hours a week tracking and analyzing regulatory

developments. In addition, more than a quarter of compliance teams in Asia expect to spend more than seven hours in an average week amending policies and procedures to reflect the latest regulatory rules (28 percent), compared with the United States and Canada (13 percent) and the UK and Europe (9 percent).

The expectation that more – in terms of both volume and complexity – will be published by regulators and exchanges has become the norm for compliance teams. There has been no letup over the last few years in the expectation that every year more regulatory material will be published, all of which will need to be reviewed and much of which will require action. This expectation has been matched by an increase in the number of regulatory changes picked up by the Thomson Reuters Regulatory Intelligence tracking service. As an example, in 2015-16 an average of 200 international regulatory publications, changes and announcements were captured daily.

REGULATORY ACTIVITY TRACKED, 2015-2016



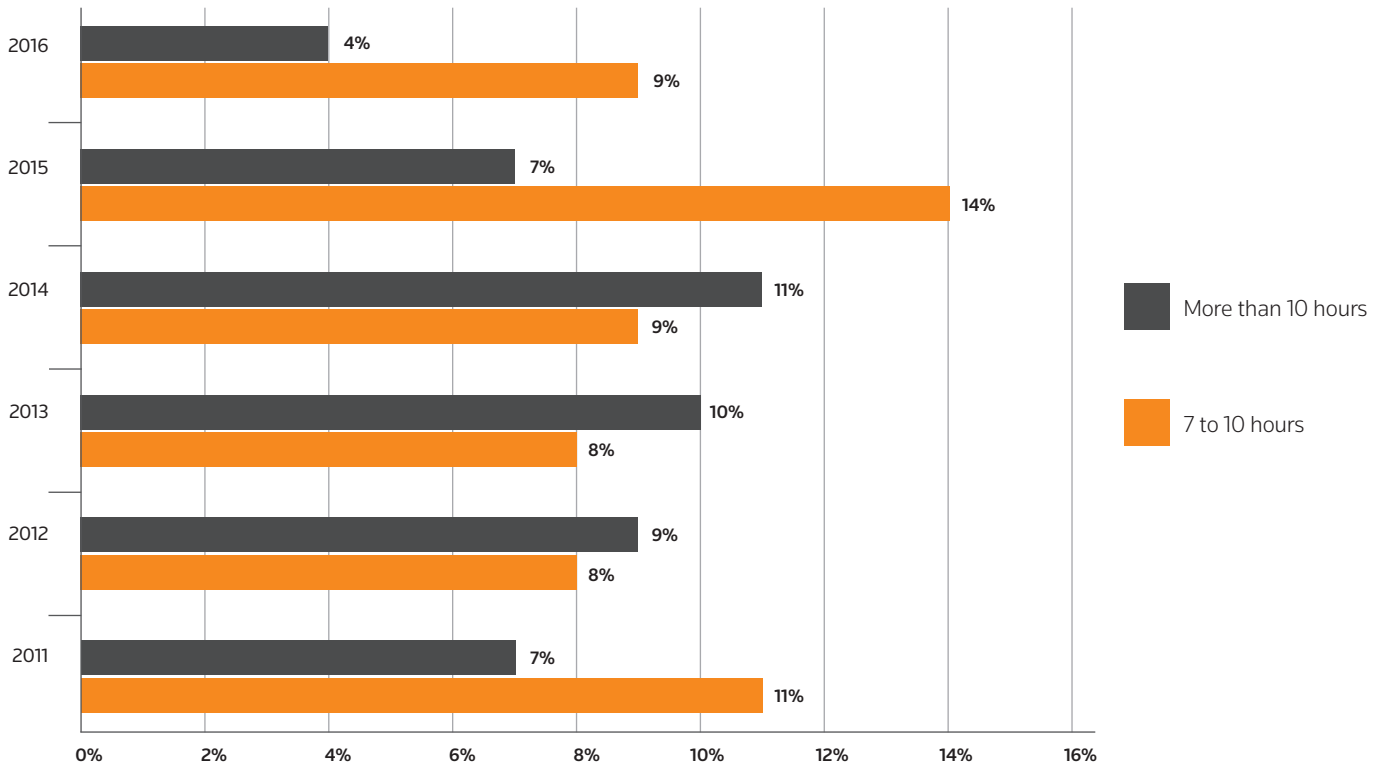
TOTAL YEARLY ALERTS



Firms continue to face challenges with regard to both the speed of change and the need to implement and comply with international regulations that may conflict or otherwise overlap with local requirements; the regulatory mismatches in the treatment of over-the-counter derivatives between the United States and the EU is an example. There has been a trend for jurisdictions to seek to implement rules with extraterritorial impact (the planned European Data Protection Regulation is another more recent example), leading to an additional level of complication for many firms.

Some policy makers are seeking to assess the effectiveness of recent swathes of rule changes rather than considering yet more sweeping changes. This emphasis on implementation may be one of the reasons why the number of compliance teams spending more than seven hours a week on amending policies and procedures to reflect the latest regulatory rules fell by eight percent in 2016 (reflecting the overall drop from 21 percent in 2015 to 13 percent in 2016).

COMPLIANCE TEAMS SPENDING MORE THAN SEVEN HOURS A WEEK AMENDING POLICIES AND PROCEDURES TO REFLECT THE LATEST REGULATORY RULES



“Responding to each new regulatory development or emerging issue with a corresponding new or extended compliance and reporting process would achieve little more than longer board meetings and more voluminous board papers. It is therefore incumbent on boards to develop and maintain a cohesive approach to oversight. New and changing demands on the board should lead the board to keep under constant review how it will optimally function and the board dynamics. They should not merely increase board activity.”

**Datuk Nor Shamsiah Mohd Yunus, deputy governor of Bank Negara Malaysia, opening speech at the launch of the Director’s Remuneration Report 2015 (December 2015)**





# REPORTING

Reporting, both internally and externally, is an essential part of the compliance function. Done well, it provides a critical information flow which evidences a compliant, risk-aware business. Done poorly, it creates huge problems and provides a signal for regulators to initiate a wider investigation of the firm's activities and potentially even enforcement action.

The need for boards and senior managers to have a clearer understanding of risk management and compliance is likely to drive improvements in internal reporting, particularly as they seek to reduce their own personal liability. It is also critical in ensuring they are in a position to discuss risks with their regulators.

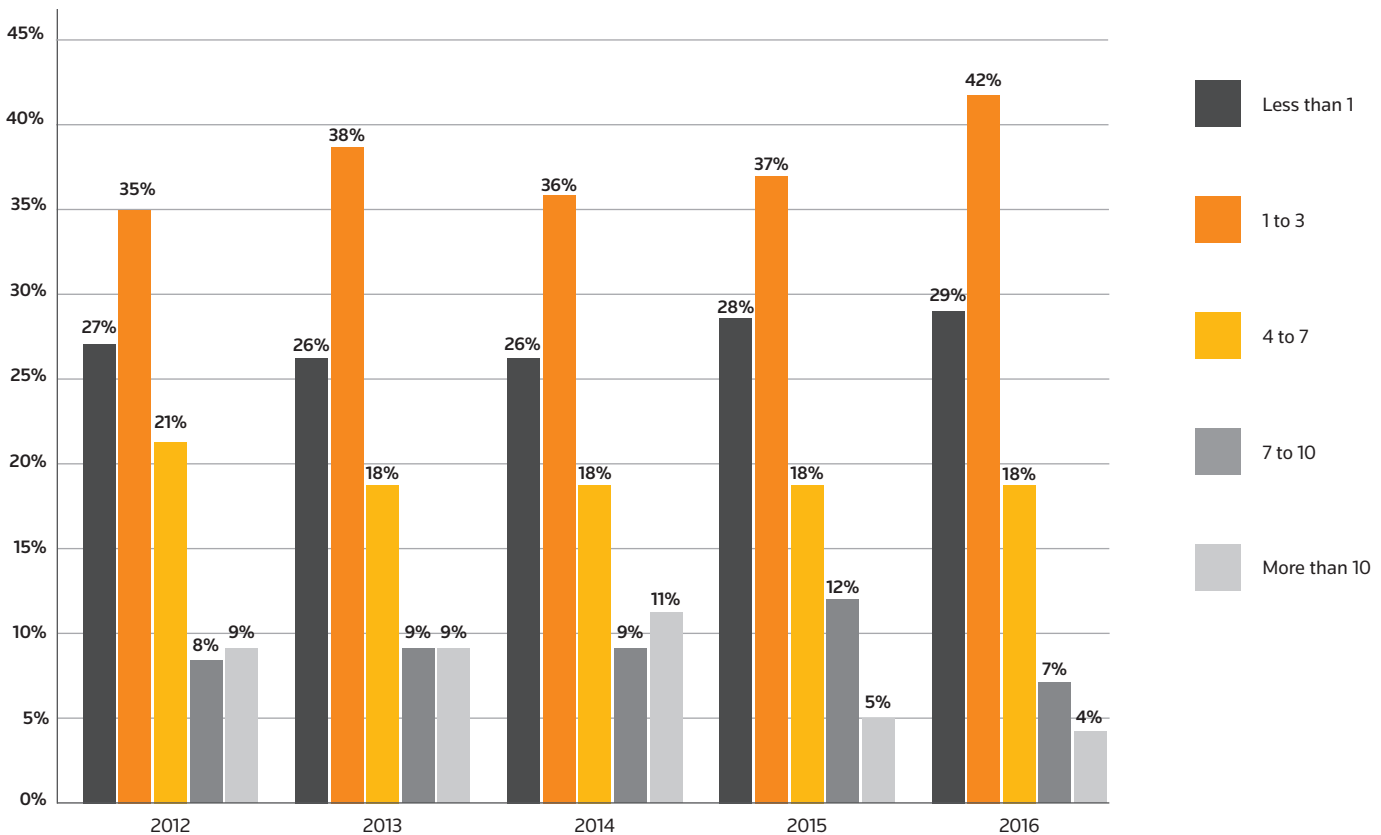
External reporting that is driven by regulators is growing. Respondents called out increasing information requests as the overriding reason for an expected increase in liaison with regulators. Changing regulation is impacting the scope of reporting; for example, external reporting will need to change to reflect increasing transparency expectations from regulators and changes in pre- and post-trade reporting, as well as specific pieces of legislation such as the EU Transparency Directive.

In the full population, across all regions, there was a slight increase in the number of compliance teams spending between one and three hours a week creating and amending reports for the board (42 percent in 2016 compared with 37 percent in 2015).

As with a number of other findings, the G-SIFI population appears to be doing "more," with 13 percent of firms reporting that they spend more than 10 hours a week creating and amending reports for the board. This is in comparison with four percent in the full population. It could be argued that G-SIFIs are by definition more complex, thereby increasing the complexity of their reporting, but the findings highlight significant differences in time spent on reports to the board.

Cutting the results another way, 52 percent of G-SIFIs spend more than four hours a week on board reporting compared with 29 percent of the full population. Non-G-SIFIs may be spending all the time they can spare on reporting to the board, but they still need to ensure that they present senior managers with a complete, fully evidenced picture of the state of the firm's compliance on a regular basis.

IN AN AVERAGE WEEK, TIME SPENT BY COMPLIANCE TEAMS CREATING AND AMENDING REPORTS FOR THE BOARD (IN HOURS)



# ALIGNMENT WITH OTHER RISK AND CONTROL FUNCTIONS

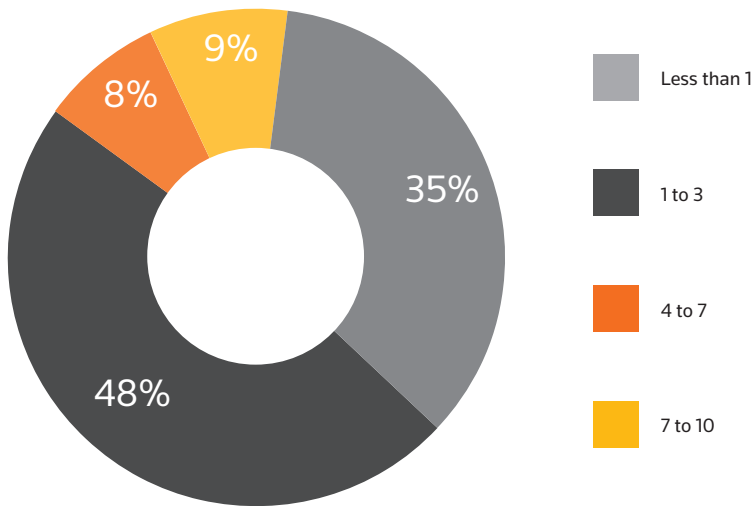
Alignment between compliance and other risk and control functions has been a perennial poor relation in terms of time allocated to it. Risk, compliance, internal audit and legal all have roles to play in the management of a financial services firm. For those roles to be most effective, and the firm to obtain the best value from often scarce skilled resources, there needs to be alignment, cooperation and coordination between the risk and control functions to ensure there is coverage of the main risks to the organization and all associated reporting is consistent.

The amount of time that needs to be devoted to inter-risk function coordination will vary from one organization to another, but firms should be aware of the potential benefits that greater liaison and cooperation may bring.

In the last year, there has been a slight increase in the number of compliance teams spending less than an hour a week consulting with the legal, internal audit and risk functions on compliance issues. Taken over time, around half of compliance functions routinely spend less than an hour a week with their internal audit colleagues.

A regional outlier is the Middle East, where 70 percent of compliance teams report that they spend less than an hour a week consulting with the internal audit function, more than half spend less than an hour a week consulting with the legal team (57 percent) and just half (50 percent) spend less than an hour a week with risk colleagues.

IN AN AVERAGE WEEK, TIME SPENT BY COMPLIANCE TEAMS WITHIN G-SIFIs CONSULTING WITH INTERNAL AUDIT ON COMPLIANCE ISSUES (IN HOURS)



The picture reported by the G-SIFI population is an improvement with “only” 35 percent spending less than an hour a week with internal audit. There is a similar improvement for risk, with 14 percent spending less than an hour a week with risk (36 percent in the wider population) and 26 percent spending less than an hour a week with legal (38 percent in the wider population).

IN AN AVERAGE WEEK, HOW MUCH TIME DOES YOUR COMPLIANCE TEAM SPEND CONSULTING WITH THE LEGAL, INTERNAL AUDIT AND RISK FUNCTIONS ON COMPLIANCE ISSUES? (IN HOURS)

	YEAR-ON-YEAR																	
	LEGAL						INTERNAL AUDIT						RISK					
	2011	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015	2016
<b>Less than 1</b>	31%	30%	28%	30%	28%	38%	51%	52%	46%	44%	48%	50%	32%	30%	34%	32%	31%	36%
<b>1 to 3</b>	32%	37%	38%	31%	35%	32%	29%	28%	33%	30%	32%	30%	31%	36%	35%	32%	37%	35%
<b>4 to 7</b>	17%	18%	17%	19%	20%	17%	12%	12%	12%	15%	10%	10%	22%	19%	17%	18%	19%	14%
<b>7 to 10</b>	12%	7%	7%	8%	11%	10%	4%	4%	5%	6%	7%	7%	6%	7%	5%	9%	9%	10%
<b>More than 10</b>	9%	8%	10%	11%	6%	3%	3%	4%	5%	5%	3%	3%	9%	8%	10%	7%	5%	5%

At a time when the adequacy and availability of skilled resources is a challenge, compliance officers need to ensure they can make the best use of time spent with other risk and control functions. Better alignment will help to drive high-quality

management information and reporting, which is not only a regulatory expectation but also a critical means to demonstrate the discharge of personal liability.

# LIAISON WITH REGULATORS

Compliance officers have been at the forefront of the relationship between firms and their regulators. The focus on conduct risk, personal liability and a “judgment-based” approach to

supervision means now, more than ever, firms need the skills and experience to build and maintain strong working relationships with all relevant regulators.

## OVER THE NEXT 12 MONTHS, I EXPECT THE TIME SPENT LIAISING AND COMMUNICATING WITH REGULATORS AND EXCHANGES TO BE:

	2011	2012	2013	2014	2015	2016
Significantly less than today	1%	1%	1%	3%	2%	2%
Slightly less than today	3%	2%	3%	4%	3%	2%
The same as today	25%	28%	31%	31%	34%	39%
Slightly more than today	43%	41%	39%	37%	40%	38%
Significantly more than today	28%	28%	26%	25%	21%	19%

As in previous years, the expectation is that in the next 12 months, more time will need to be spent liaising with regulators and exchanges. In 2015, 61 percent expected they would need to spend more time on this, and 21 percent expected to spend significantly more. For 2016, the results have eased slightly, with 57 percent expecting to spend more time liaising with regulators and exchanges and 19 percent expecting a significant increase. The main reason for this was the anticipation of more information requests from regulators.

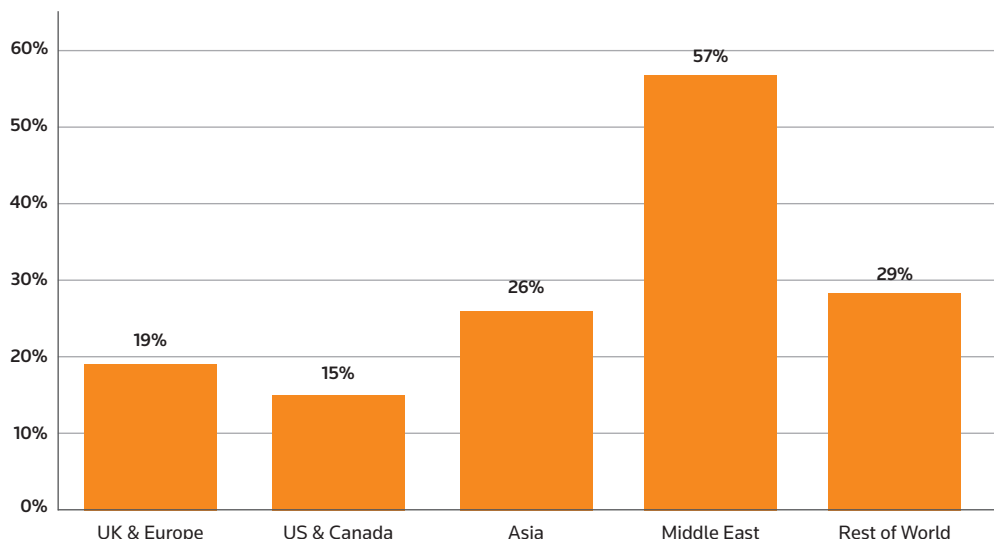
Over the last few years, the main influence for the continued increases has oscillated between more onerous regulatory and reporting requirements and a higher number of information requests from regulators. These results emphasize once again

that reporting, in all its forms, is a critical task for the compliance function.

In the G-SIFI population, 68 percent of respondents expect to spend more time in the next 12 months liaising with regulators and exchanges (27 percent significantly more). In contrast to the wider population, the main cause of the increase was seen to be more intensive supervision, perhaps reflecting the continued regulatory focus on G-SIFIs and the “too-big-to-fail” challenge.

There were distinct regional variations in the results, with the Middle East a notable outlier in that 57 percent expected to spend significantly more time liaising with regulators and exchanges in the next 12 months.

## EXPECTATION THAT COMPLIANCE PROFESSIONALS WILL SPEND SIGNIFICANTLY MORE TIME LIAISING WITH REGULATORS AND EXCHANGES OVER THE NEXT 12 MONTHS



# MANAGING REGULATORY RISK

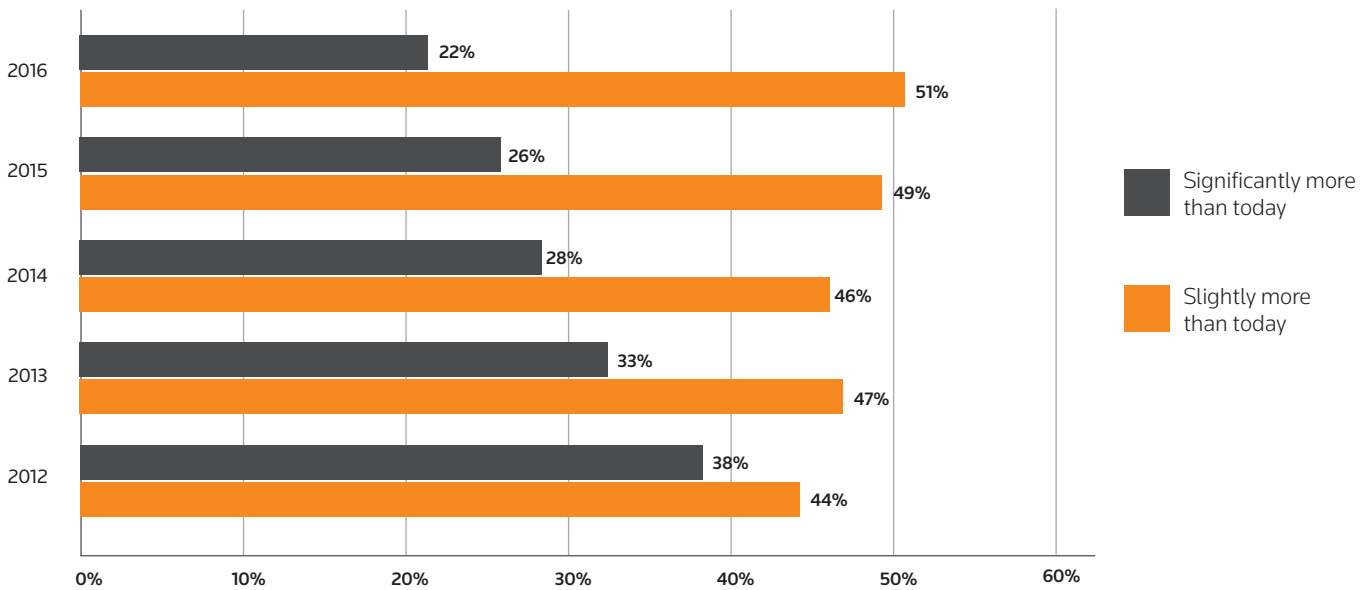
Firms' capacity and capability to manage regulatory risk has never been more important. The compliance function also has a critical role to play in helping senior managers to understand and manage regulatory risks. This is reflected in the 73 percent of respondents who expect the regulatory focus on managing regulatory risk to increase in the coming year (22 percent expect a significant increase).

The main reason given for the expected increase is the regulatory focus on conduct risk, which is echoed by the fact that 74 percent

of respondents expect more compliance involvement in the implementation of a demonstrably compliant culture and tone from the top in the coming year.

The position is exacerbated in the G-SIFI population where 72 percent expect an increase in the focus on managing regulatory risk and 36 percent expect a significant increase, with most respondents citing harsher regulatory penalties and super-sized fines as the main reason for the expected increase in focus on regulatory risk.

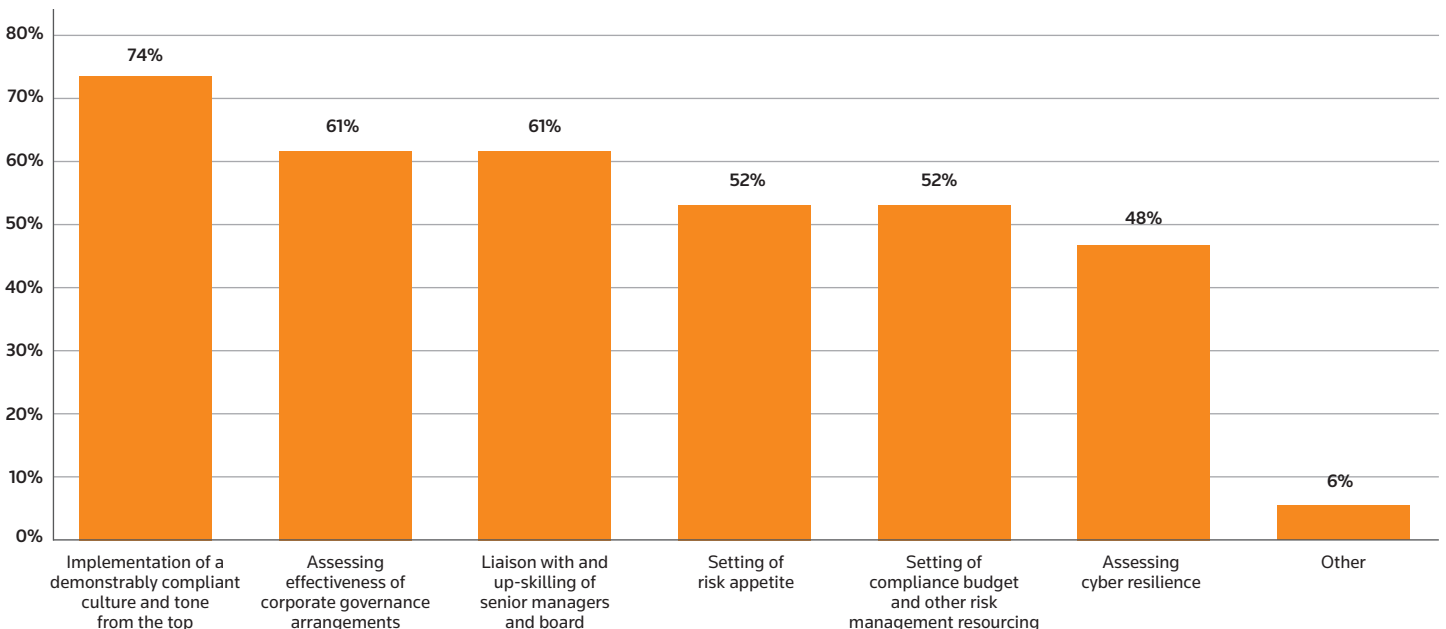
## EXPECTATION THAT REGULATORY FOCUS ON MANAGING REGULATORY RISK WILL INCREASE OVER THE NEXT 12 MONTHS



Respondents expect this focus on regulatory risk to continue for some years to come. The growth in the range of regulatory risks, which not only require compliance involvement but also necessitate expert compliance knowledge and skills, shows no sign of abating. This also interlinks with respondents' concerns about the adequacy and availability of skilled resources.

Tone from the top, conflicts of interest, ethics, corporate governance and culture are all qualitative, and therefore distinctly challenging to measure. Firms must be able to demonstrate a positive culture and associated good customer outcomes, and must ensure that they can draw on the appropriate expertise to help them do so.

## OVER THE NEXT 12 MONTHS, I EXPECT MORE COMPLIANCE INVOLVEMENT IN:





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# OUTSOURCING

Outsourcing the compliance functionality can be an efficient and cost-effective way to supplement in-house resources, but it must be delivered appropriately to be of real benefit. In November 2015, the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations published a National Exam Program Risk Alert on the outsourcing of the compliance function. The concerns were widespread and highlighted issues such as poor communication, lack of resources and empowerment, as well as the use of standardized (rather than business-specific) approaches to compliance policy, procedures and monitoring.

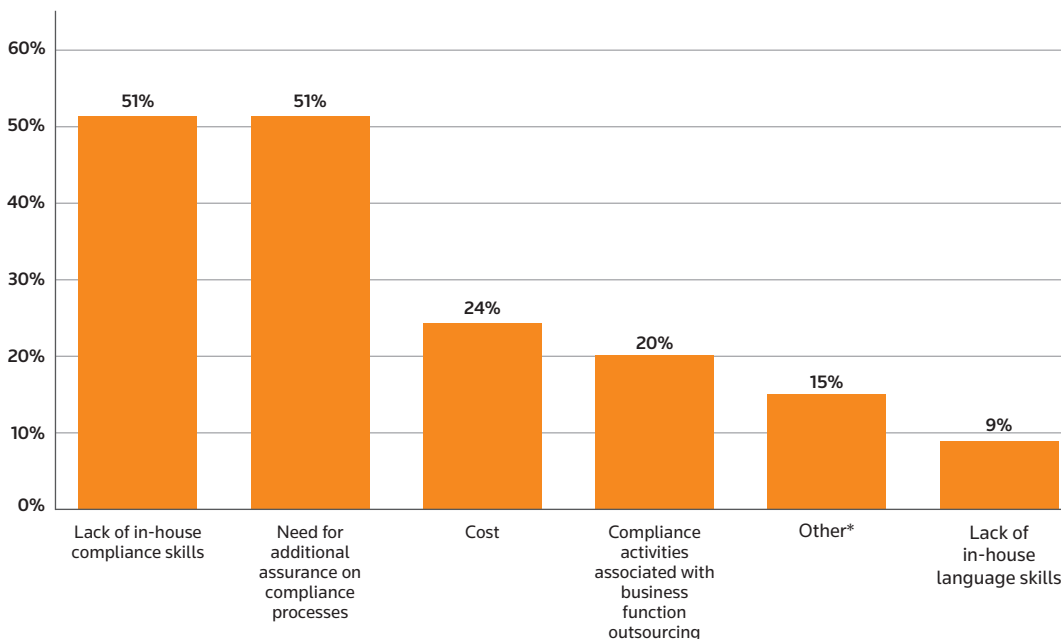
The Risk Alert concluded by stating, "A CCO, either as a direct employee of a registrant or as a contractor or consultant, must be empowered with sufficient knowledge and authority to be effective. Each registrant is ultimately responsible for adopting and implementing an effective compliance program and is accountable for its own deficiencies." Firms were encouraged to use the Risk Alert to evaluate whether their business and

compliance risks had been appropriately identified to ensure that their policies and procedures were appropriately tailored in the light of their business and associated risks, and that their chief compliance officer was sufficiently empowered within the organization to perform his/her responsibilities effectively.

In the survey, 25 percent of firms responded that they outsource some or all of their compliance functionality. There were two main drivers: the need for additional assurance on compliance processes and, of potentially greater concern, a lack of in-house compliance skills. The sheer range of activities that compliance functions are now expected to perform may be an underlying reason for the perceived dearth of skills in-house.

It is good that those compliance functions have recognized the skills gap, but firms need to keep the balance between in-house expertise and any outsourcing under review. Firms must continue to invest in all aspects of their risk and compliance infrastructure, an essential part of which is the skill set of the compliance function.

## KEY DRIVERS FOR OUTSOURCING (SELECT ALL THAT APPLY)



### \*Other, including:

- Board request
- Part of group structure
- Increase in litigation
- Need for specialized knowledge in certain areas
- Need for technology solutions
- Removal of administrative functions to enable compliance staff to focus on regulatory requirements
- Small compliance team that needs support from overseas
- Workload management

In November 2015, the UK Prudential Regulation Authority (PRA) fined R. Raphael & Sons Plc £1.3 million for potentially putting its safety and soundness at risk by failing to manage an outsourcing arrangement properly. The PRA considers that although a firm may outsource important operational functions (for example, for reasons of efficiency or prudent financial management), it should only do so "if it remains mindful of its regulatory obligations and gives due regard to the impact of the proposed outsourcing on its ability to meet, or continue to meet, such obligations."

In addition, the PRA expects a prudently managed firm to:

- Carry out suitable due diligence on the counterparty to which it intends to outsource
- Set appropriate parameters with regard to the division of responsibilities and powers

- Have in place adequate arrangements for the proper oversight of the outsourced function
- Ensure all of the above are documented properly

The PRA also reiterated that "while a firm may outsource the practical aspects of the outsourced function, it may not outsource its regulatory responsibilities as they relate to the outsourced function."

Outsourcing between firms in the same group is commonplace and, done well, with sufficient in-house skilled personnel to manage any outsourcing arrangements; it can be cost-effective for the firm and its customers. Done poorly, as in the case of Raphael, it can be an expensive mistake as the firm finds itself needing to quickly rebuild or move in-house skills and capacity, repair damage done to customer relations and deal

with regulatory action as well as potential wider supervisory ramifications.

The golden rule for successful outsourcing is that while activities can be moved to a different group, company or a third party, the skills to manage those activities must be retained in-house. This may be less obvious in an intra-group outsourcing scenario – but for a separate legal entity with a separate license, it is essential. Equally, if there is a branch or other structure involved, then the firm needs to consider the efficacy of the outsourcing arrangements and the skills, governance and local responsibilities of the branch.

Risk, compliance and internal audit functions would be well-advised to include outsourcing in all their monitoring plans. Elements to consider for testing are:

- The need for upfront due diligence on the outsourcing provider (even when it is a group company), together with a detailed written agreement specifying all aspects of the outsourced arrangements.
- The ability to access physically the offsite outsource location: Every effort should be made to carry out at least an annual on-site visit to all major or material outsourcing providers to assess the level, timeliness and quality of the information flows.
- The likely impact of changes to data protection legislation: The main risk at the moment comes from the proposed changes to the European Data Protection Directive. Some have expressed concern about the potential for the proposed European Data

Protection Regulation to create a “fortress Europe” for data, not to mention the challenges associated with concepts such as the “right to be forgotten,” which is likely to be in place in 2018.

- The resilience of the outsourcing provider: While most firms will undertake comprehensive due diligence at the start of the relationship with an outsourcer, it is less common to undertake continuing checks to ensure that the outsourcing provider remains effective. All firms should have comprehensive, tested contingency plans to deal with the failure of an outsource provider.
- The right (as should be set out in the outsourcing contract) to be informed before any of the firm’s data or activity is outsourced from the outsourcing provider. Too many firms have found that their data has been passed on and away from their original outsourcer to numerous other entities, thereby increasing possible loss, contagion, reputational and concentration risks.
- The inclusion of outsourced arrangements in any recovery and resolution plans; this is particularly pertinent for any firm required to create a “living will” but will also be critical for all business continuity and disaster recovery plans.
- The maintenance of all in-house skills and expertise to oversee the activities outsourced.
- As a matter of course, any review undertaken on outsourced activities should be reported to the board as part of the firm’s overall risk reporting.

## TECHNOLOGY

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Technology affects the compliance function in a number of ways, for instance, the need for compliance to be involved in managing the potential impact of cyber risks. Cyber resilience is no longer the preserve of the IT function; the potential detriment to customers and increasing regulatory expectations mean that it is also part of the compliance function’s remit. The rise of virtual currencies, robo-advice, digital ledger technology (such as blockchain) and fintech means that compliance teams are also helping their business to adapt to new forms of digital technology.

New regulations are requiring often extensive systems changes to enable the new levels of transparency now required by regulators, and compliance teams are actively involved in researching, assessing, implementing and embedding compliance technology tools to help them manage their growing workloads.

In February 2016, the UK government Treasury Committee published a series of “suggestions” regarding IT following systems failures at a number of banks between June and November 2015.

The suggestions, which will steer the future regulatory and supervisory approach to IT in UK financial services, are in outline:

- Banks need greater IT expertise at main board and subsidiary board level
- Far more resources should be devoted to modernizing, managing and securing banks’ IT infrastructures

- Legal, regulatory, structural and cultural changes need to be made to the way banks manage their cyber security risks

“The current situation cannot be allowed to continue. IT risks need to be accorded the same status as credit, financial and conduct risk. They are every bit as serious a threat to customers and overall financial stability. More, and higher quality, investment is probably required.”

**Andrew Tyrie MP, chair of UK Treasury Committee, correspondence with banks and regulators (January 2016)**

The suggestions are aimed in the first instance at UK banks but are relevant to all firms. The consistent thread throughout is the need for better and more in-house IT skills. Both the Treasury Committee and the FCA have expressed concern about the use of consultants with regard to IT.

Specifically, the Treasury Committee has made the point that firms “need enough skilled people throughout their IT management structure to enable them to be largely independent of consultants for crucial expertise.” Firms would be well-advised to undertake an IT skills audit that highlights and begins to remediate any gaps and ensures that they are prepared when

regulators ask about skills at the board and other levels, and about the potential (over)use of consultants. The audit should cover IT skills throughout the entire firm, not just in the IT department, to ensure that all functions have the appropriate levels of IT expertise for their roles.

The regulatory focus on technology covers not only existing systems, but also the future in the shape of fintech. The scope of fintech activities encompasses: automated trading systems; financial product investment and distribution platforms, including robo-advisors; financing platforms, such as peer-to-peer (P2P) lending and equity crowdfunding platforms; and the use of distributed ledger technologies, such as blockchain, by licensed intermediaries.

A number of international regulators have launched initiatives to support and encourage the next generation of innovation in financial services. The UK FCA introduced Project Innovate, ASIC launched its Innovation Hub in March 2015, the Japanese FSA launched a fintech support desk, the Monetary Authority of Singapore formed a fintech and innovation group responsible for regulatory policies and development strategies to facilitate the use of technology and innovation in the Financial sector, and the U.S. Consumer Financial Protection Bureau (CFPB) launched Project Catalyst aimed at small firms.

In a similar vein, in March 2016, the Hong Kong Securities and Futures Commission (SFC) set up a fintech contact point to act as a dedicated channel to encourage businesses involved in fintech development to engage with the regulator about where they might fit into the existing regime. The SFC has also established a fintech advisory group to focus on the opportunities, risks and regulatory implications of new developments.

The SFC has said that big data, data analytics and artificial intelligence will be relevant to its work when used to support firms' front- and back-office operations. It said some solutions were being developed to address compliance, risk and regulatory issues, including forms of technology that support regulatory compliance, regulatory reporting and know your client, as well as cyber and data security technologies.

The need to revamp IT systems (including expressly the approach to cyber risk) and the scope of fintech will stretch even the most technologically aware compliance function. Many firms will need to invest heavily in IT skills and resources, and this will include the risk, compliance and internal audit functions.

## CHALLENGES COMPLIANCE OFFICERS ANTICIPATE IN 2016

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The survey asked about the biggest compliance challenges expected in the coming year. For 2016, the breadth of responses once again demonstrates the spectrum of issues facing compliance officers. Firms may take some comfort in the fact that their peers are facing similar challenges, or indeed may find that there are challenges on the horizon that have not yet hit their risk radar.

The greatest regulatory challenges were highlighted as:

- Alternative Investment Fund Managers Directive (AIFMD), Europe
- Bank Secrecy Act, United States
- Base Erosion and Profit Shifting (BEPS), United States
- Basel III, International
- Common Reporting Standard, International
- Directive on Undertakings for Collective Investment in Transferable Securities (UCITS V), Europe
- Dodd-Frank Act, United States
- Fiduciary Rules, United States
- Financial Markets Conduct (FMC) Act, New Zealand
- Foreign Account Tax Compliance Act (FATCA), United States
- Fourth Money Laundering Directive and AML Action Plan, Europe
- General Data Protection Regulation, Europe
- Insurance Distribution Directive (IDD), Europe
- International Financial Reporting Standards – Financial Instruments (IFRS 9), UK
- Market Abuse Directive and Regulation (MAD/R), Europe
- Markets in Financial Instruments Directive II and Markets in Financial Instruments Regulation (MiFID II/R), Europe
- Money Market Reform, United States
- Packaged Retail and Insurance-based Investment Products (PRIIPS), Europe
- Pension Reforms, UK
- Senior Managers Regime, UK
- Solicitors Regulation Authority (SRA) Code of Conduct, UK
- Solvency II, Europe



THE GREATEST COMPLIANCE CHALLENGE(S) I EXPECT TO FACE IN 2016 IS/ARE:



"While we would observe that boards are giving more attention to issues of culture, I think it also fair to say that they are still grappling with how best to do this in a robust and systematic manner."

Wayne Byres, chairman, Australian Prudential Regulation Authority, at House of Representatives Standing Committee on Economics, Canberra (March 2016)

Respondents were also asked what the biggest challenges for their boards would be in the year ahead. Although there are distinct similarities in the challenges expected, boards have a greater focus on the required implementation of regulatory change programs, together with the need to balance compliance

and commercial demands with cyber resilience. The adequacy and availability of skilled resources again emerges as an important theme and will be critical to the efficient delivery of the regulatory change program and the many other compliance challenges expected in 2016.

THE GREATEST COMPLIANCE CHALLENGE(S) THE BOARD EXPECTS TO FACE IN 2016 IS/ARE:



"Boards should also think more broadly about the emerging problems of tomorrow and what issues they may be missing. In doing their jobs in 2016, directors need to consider whether the current composition of their boards includes individuals with the necessary diverse skills, experience and expertise and whether to hire subject matter experts as consultants to the board. As areas such as cyber security, derivatives, liquidity, trading, pricing and fund distribution become increasingly complex, boards need to assure that they are equipped to address those challenges."

Mary Jo White, chair, U.S. Securities and Exchange Commission, keynote address, "The Fund Director in 2016" at the Mutual Fund Directors Forum 2016 Policy Conference (March 2016)

## CLOSING THOUGHTS

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One positive aspect of the chaos created by the financial crisis was that the value of the compliance function — particularly a highly skilled and appropriately resourced one — gained widespread recognition. However, compliance officers and their boards are finding it increasingly difficult to secure appropriate levels of resources, suggesting perhaps that there is a limit to firms' ability and willingness to continue to expand their risk functions.

Compliance officers have always had to be creative in terms of their approach, and to try to do more with less. At some point, however, creativity needs to give way to innovation, if not revolution, in terms of how limited compliance resources are deployed. Firms cannot rely on simply hiring more compliance staff as the solution to all problems.

"High-quality capital and robust capital ratios have always been, and will remain, the keystone in the Basel framework. But high-quality capital must be complemented with effective governance and appropriate culture, strong risk management processes and internal controls, and a broad view of risk that encompasses all of a bank's activities."

**William Coen, secretary general, Basel Committee on Banking Supervision, speech "The global policy reform agenda: completing the job" (April 2016)**

Greater use of sophisticated and tailored technology is one alternative, although it must not be considered a panacea. Firms will need to make considerable investment in both knowledge and skills if they are to reap the full benefit of technological

innovations. This may be tough to achieve with already stretched resources.

That said, without the input of significant compliance expertise, technological solutions cannot hope to safely replicate or replace (and hence free up) scarce compliance personnel to concentrate on the more "value-add" areas of risk and compliance.

The resource challenge may be one of the main reasons behind the level of compliance outsourcing that respondents highlighted. For some firms, outsourcing may be an interim solution to enable in-house resources to focus on regulatory change implementation programs. The changes to Dodd-Frank in the United States are beginning to draw to a close, but several pieces of major European legislation will require implementation in 2018. MiFID II/R and the European Data Protection Regulation, both of which have extraterritorial impact and both of which will require widespread changes, are just two of the regulatory reforms with which firms must contend. Many compliance functions have also needed to add project and program management skills to an already expert knowledge base.

Firms need to ensure that they invest in, and value, compliance. Equally, senior managers must be seen to value expert compliance resources, particularly in a world where personal liability is increasing. A case in point is Lloyd Blankfein, chief executive of Goldman Sachs, who said the investment bank's ramp-up in compliance resources had a "Y2K feel" about it and went on to say that "once we catch up and once automated, we probably will be able to reduce that head count and some of these costs." While investment in technological solutions should, if done consistently well, enable enhanced compliance, firms must be careful that any reduction in skilled compliance head count does not have unintended regulatory consequences.

## About the authors

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