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Contents

2 'Roadmap' to Reshape Supervision: A First Look
BY CARLO COMPORTI AND RAFFAELE COSIMO

6 A Framework for Assessing Global Benchmark Rates
BY ANTHONY MURPHY

12 China's IPO Sponsors Should Prepare for New Environment
BY RONALD GOULD

15 Data-Security Breaches: Preparing for the Inevitable
BY MARC LOEWENTHAL

18 Insurers, Compliance, and Trust
BY WILLIAM J. TOPPETA

A Competitive Advantage Through Compliance

Regulators are gearing up to finish the implementing regulations for the Dodd-Frank Act. However, with all good will, this process will take many months — and even when the regulations are written, they will beget guidance and further refinements that will take years to finish. Furthermore, the current climate promises new post-Dodd-Frank laws and regulations in this country and abroad. Anticipating these changes will provide a true competitive advantage.

This issue of *Sightlines* offers some key insights into what's driving the changes to come. The European Union recently released its plan to establish a consolidated banking supervisor for the euro area; Carlo Comporti and Raffaele Cosimo took a first look at the new "roadmap" and found a meaningful shift underway, even though the limits of the new supervisor's authority remain unclear.

Tony Murphy's analytical framework for benchmark rates measured Libor and six potential alternatives against the essential criteria that make a benchmark a benchmark. He concluded that reforming Libor — under tighter regulatory scrutiny and incorporating transaction and other market data — may be preferable to the rate's outright replacement.

Ron Gould in our Hong Kong office examined the 2011 drop in China's IPOs due to investors' lack of confidence in corporate representations. Regulators in Hong Kong and in mainland China have embarked upon a campaign to restore confidence through tough new rules governing disclosure and conduct. IPO sponsors must prepare for the substantial reforms or risk serious penalties.

Regulators are also responding to increasing threats to customer data. While only the biggest lapses end up in the headlines, breach incidence remains high. The Federal Trade Commission is still the primary enforcer, but the Consumer Financial Protection Bureau has developed extensive examination criteria. Marc Loewenthal offered advice on avoiding breaches, and in responding should one occur.

Finally, Bill Toppeta reminded us that thoughtful compliance can be its own reward. He sized up expanding compliance requirements for insurance companies in privacy, solvency, and combating money laundering, and proposed responses. The takeaway: Doing it better than the company next door has compelling business advantages.

We hope these articles help you anticipate and respond to the many changes that lie ahead.

Gene

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BY CARLO COMPORTI AND RAFFAELE COSIMO

'Roadmap' to Reshape Supervision: A First Look

This article originally appeared in Sightlines European Regulatory Developments on September 13, 2012.

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European policymakers continue to demonstrate collective will in moving toward a regional regulatory apparatus, even if they invariably face structural and technical roadblocks — and often-fleeting political consensus — in its pursuit.

Banks in the euro area are therefore confronting a meaningful transformation through which they will increasingly be subject to the supervision of the European Central Bank. How that transformation will be rationalized with regulations on bank capital, resolution, deposit guarantees, liquidity, and conduct, among other things, will be decided in the coming months.

According to the details announced 12 September,[1] the ECB will assume exclusive supervisory responsibility over all credit institutions in the euro area through a phased-in approach that concludes on 1 January 2014. The proposal is a milestone in what the commission refers to as its "Roadmap towards a Banking Union."[2] (The European Commission released all documents related to the proposals on its Financial Supervision Web page.[3])

The ECB will carry out its mandate through a new Single Supervisory Mechanism composed of the ECB itself and national banking supervisors — to which important day-to-day tasks will be delegated under a mechanism that has not yet been spelled out. Other supervisory responsibilities, including consumer protection and combating money laundering, will remain within the purview of national banking supervisors, and for now, crisis response and deposit insurance will also remain with relevant national authorities. Yet the new supervisor will have licensing authority that will affect banks of all sizes in all countries.

Banks in the euro area that have requested or received public financial assistance will be the first to come under ECB supervision, followed by the euro area's "most significant" banks. These banks will need to take great care in establishing and maintaining the new supervisory relationship, and should take steps now to prepare. Banks should also expect less divergence among euro-area countries on the implementation of key rules, including capital, liquidity, and model validation. This leveling of the playing field could have spill-over effects beyond the euro area, with potential consequences for business strategy.

Banks should also consider reviewing group structure, legal entities, and geographical footprint for potential effects on major banking functions — treasury, trading, liquidity, and funding, among others. And, as the ECB's approach to supervision and regulatory reporting will likely differ from current practice, banks may wish to reconsider the structure of their regulatory-affairs operations.

The transition date is further in the future for the great majority of institutions — those not considered the "most significant" of Europe's banks — but they may feel the presence of the new supervisor well before then. National supervisors are likely to anticipate the eventual transition and begin harmonizing their own efforts with policies and decisions adopted by the ECB.

STILL UNCLEAR

The 12 September proposals leave many important questions unanswered. Over time, banks will look for greater clarity on:

- Allocation of responsibilities, decision-making, interaction, and exchange of information between the ECB, the SSM, and the European Banking Authority;

[1] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/953&format=HTML&aged=0&language=EN&guiLanguage=en
[2] http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510_en.pdf
[3] http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1

- The functioning of the SSM, and particularly the relationships between the ECB and the national banking supervisors to which it delegates certain functions;
- The banks that will be among the euro area's "most significant" credit institutions, which in aggregate are expected to represent at least half of the banking market;
- Relationships of various national authorities, including those in the euro area, those in other EU member states, and those outside of the European Union altogether;
- How national authorities will carry out their residual functions going forward, and particularly whether over time they will emphasize certain responsibilities — possibly including consumer protection and combating money laundering — among those left to them;
- How certain policies and regulatory requirements, including recovery and resolution plans, will move forward in the absence of a centralized mechanism for crisis management and deposit insurance.

WHAT'S IN THE PROPOSAL

Following is a summary of the key features of the proposal:

ECB Powers and Responsibilities

The ECB will assume exclusive prudential supervision for all 6,000 credit institutions of the euro area (EU-17) in three steps:

- 1 January 2013 for distressed banks;
- 1 July 2013 for the "most significant" banks; and
- 1 January 2014 for all other banks.

The ECB's powers on transition dates cover only prudential supervision, including credit-institution authorization and acquisition reviews. To discharge its responsibilities, the ECB will have investigatory powers, including on-site inspections, as well as the ability to take enforcement actions and levy sanctions.

Supervision of the "most significant" and distressed euro-area banks is expected to be largely centralized in Frankfurt, whilst midsize and small banks, at least for now, will largely remain supervised locally. The ECB currently does not have expertise in microprudential banking supervision, and it is expected to draw from national authorities to forge a new culture and model of European supervision. National authorities in the euro area will assist the ECB in that effort, with particular regard for local markets, languages, and customs.

The 10 other EU member states can opt in to the supervisory regime on a voluntary basis.

The ECB currently does not have expertise in microprudential banking supervision, and it is expected to draw from national authorities to forge a new culture and model of European supervision.

Responsibilities of National Supervisors

National governments retain responsibility for resolution and deposit insurance until anticipated EU legislation building out the European Banking Union is ready. Appropriate national supervisors will retain oversight of all other aspects of banking, including capital-markets activities, payments systems, consumer protection, and anti-money-laundering regulations.

Ramifications for EBA

The EBA's regulatory responsibilities in principle remain unaffected, and even reinforced, given its powers to adopt binding decisions for those cases in which the ECB has signaled that it does not intend to comply with an EBA directive.

The ECB will have responsibility for stress testing that previously resided with euro-area national supervisors, which is likely to standardize the exercises and improve comparability of results. The EBA will maintain its current powers and role for stress-testing for all banks in the European Union, pending an assessment due early in 2014 that will determine whether the EBA's stress-testing powers need strengthening. The commission said it wanted to "avoid making the authority too dependent on information and contribution by those authorities competent for assessing the effective resilience of the banking sector across the Union." The EBA will continue to ensure consistency of detailed rules (the "Single Rule Book") and their implementation (the

"Handbook") at the EU level, particularly with stress tests conducted by the Bank of England and its Prudential Regulatory Authority, as well as those conducted by the ECB.

The proposal would change governance and decision-making at the EBA to preserve the rights of EU members outside the euro area, effectively preventing the EU-17 acting as a bloc (under the coordination of the ECB) from dictating policy for the entire EU.

Governance

The ECB will seek to avoid conflicts of interest with its monetary-policy functions by establishing a separate Supervisory Board that at this point has 23 members composed of:

- A chair elected by the Governing Council from the members of the Executive Board (with the exception of the President) and a vice chair elected by and from the members of the Governing Council of the ECB;
- One representative of all national banking supervisors of the euro area; and
- Four representatives of the ECB appointed by its Executive Board.

IMPLICATIONS FOR BANKS

This week's proposals are part of a larger move to a European Banking Union that will eventually include a truly European crisis-resolution framework and deposit-insurance scheme. Unifying these powers is likely to prove more effective than a network of national authorities. Until that point, crisis response will remain rooted at national level, though pending legislative proposals promise enhanced international coordination.

More changes could emerge from the High Level Expert Group chaired by Erkki Liikanen, which is studying whether additional structural reforms would strengthen stability and consumer protection. Any comprehensive assessment of what coming reforms will mean must take into account all these regulatory measures and their interactions, including the forthcoming CRD IV — the final adoption of which has been delayed in order to align it with the reforms announced 12 September.

When banks come under the SSM, they will have to establish new relationships with — and pay new fees to — the ECB, although they will remain under the control of national authorities for all activities apart from prudential supervision. They will have to reflect the SSM's evolving expectations for those activities that fall under its purview. That is likely to mean additional

RECOMMENDED FIRST STEPS

Senior management of all banks in the European Union, and particularly in the euro area, should monitor developments and, given the short timeframe for implementation:

Prepare an internal review of the legal structure of the group, including an assessment of geographic footprint;

- The review, supported by scenario analysis, should focus specifically on whether subsidiaries within or outside of the euro area should be transformed into branches;
- Evaluate the potential effect on major functions, including treasury, trading, liquidity, funding, and compliance.

Determine what actions would speed the development of a relationship with the new supervisor, starting with an internal review of current resources and their capacity for the new supervisory framework;

Assess areas of regulatory risks related to:

- The practical definition of capital, such as silent participations, deduction of insurance participations, definition of defaults, target ratios, and other national exemptions relevant to geographic location of activities;
- Liquidity arrangements;
- Internal models; and
- Organization and business model.

costs, and an expansion of the internal resources necessary to accommodate the additional supervisor, as well as the changing supervisory culture.

From 1 January 2013, all euro-area banks in critical financial condition and unable to raise capital can rely on the safety net and financial assistance from the European Stability Mechanism.

"Most Significant" and Distressed Banks

The ECB by 1 March 2013 will define what constitutes the "most significant" banks based on size, cross-border activity, and European systemic importance. Banks that have requested or received public financial assistance will fall under ECB supervision on 1 January 2013. These banks should expect:

- Meaningful changes to the supervisory model, particularly on capital, liquidity, and model validation, given the progressively level playing field;
- Determination of thresholds of regulatory capital, where allowed by EU rules, to fall to the ECB, rather than national authorities;
- Narrowed scope of national discretions and protectionist interventions. Similarly, the national supervisors' capacity to intervene with structural measures appears very constrained under the new framework;
- Home-host relationships (e.g., on liquidity) to be governed by the ECB and implemented through binding instructions to national banking supervisors;
- Colleges of supervisors within the euro area to have little or no role, though they may be transformed into a "cooperative tool" organized by the ECB. Future stress tests will be conducted by the ECB within the euro area, under overall EBA coordination at the EU-wide level;
- Possible improvements on ratings issued by credit-rating agencies, particularly related to sovereign downgrades in their home countries.

Midsize and Small Banks

Midsize and small banks will naturally see changes that flow from ECB decisions for the entire euro area, with a quick phase-out of special or local treatment. Though national supervisors will remain, in the short and medium term at least, largely responsible for day-to-day supervision, they will have to adhere to measures adopted by the ECB. Decisions for the "most significant" banks will likely be applied to midsize and small banks under the proportionality principle.

Other EU Banks

EU banks outside the euro area are likely to find that the ECB plays a much stronger and coordinated role as home or host supervisor in their colleges of supervisors. Similarly, the consolidation of various supervisory approaches into a common and unique euro area model will establish an obvious benchmark for other EU member states contemplating convergence. The EBA will retain responsibilities to ensure full convergence within the EU, but its role may not be necessarily simplified by these changes, particularly as CRD IV recognized some new national flexibilities.

Non-EU Banks

Finally, non-EU banks that operate in the EU will also be affected by the change since they will have to establish relationships with a new supervisor, including within their colleges.

The direction of the changes to come is clear, although the specifics of how and when each institution will be affected remain uncertain. Banks will need to be vigilant, and as flexible as possible in responding. But while the proposals still fall far short of answering the important questions, they at least give banks enough information to start asking them. ■

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BY ANTHONY MURPHY

A Framework for Assessing Global Benchmark Rates

This article originally appeared as a Sightlines InFocus on July 23, 2012.

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The recent regulatory settlements of claims of attempted Libor manipulation have generated a wave of widely reported calls to reform how benchmark interest rates are determined. The importance and urgency of those calls cannot be overemphasized, given the $350 trillion of financial contracts worldwide that are indexed to Libor, according an estimate by the British Bankers' Association, the trade association for banks in the UK that oversees the Libor process.

If Libor is to remain an important benchmark rate, it is important for new measures to help restore market and public confidence in it. Current discussions include strengthening governance and regulation in the interest-rate determination process, using actual transaction data rather than less precise best-estimate quotes in setting benchmarks, and imposing new internal controls within the banks that set rates. However, some believe the Libor calculation process is irreparable and have called for Libor's outright replacement. The consequences of changes to Libor calculation methodologies, let alone a replacement of the index itself, are potentially enormous, particularly if contracts outstanding must be renegotiated as a result.

The purpose of this report is twofold. The first is to suggest a framework to assess to what extent various measures — including Libor — qualify as reliable benchmarks. We start by offering a set of criteria to help assess Libor alongside some of the alternatives that have been publicly discussed. The second purpose is to propose how the Libor process might be improved to restore its credibility, assuming Libor remains the preferred benchmark. These measures may also be relevant were a new benchmark system based on one of the alternatives to be introduced.

Currently the British Bankers' Association calculates and publishes Libor daily. It is supposed to reflect the rate at which a typical large, creditworthy bank could borrow money from another bank in the London inter-bank market on an unsecured basis, a benchmark or global standard against which many large loans and transactions are priced.

Libor is calculated by soliciting quotes from a panel of banks each day at 11am London time. A separate panel, typically consisting of between 10 and 20 banks, provides quotes for each of 10 currencies. Each bank submits quotes of the rate at which they could borrow funds for a range of 15 terms, from overnight to one year.[1]

The quotes from each bank are ranked from high to low for each currency and term. Outliers are discarded according to a prescribed formula, and the remaining quotes are averaged to produce the final published rate. In US dollars, the four highest and four lowest quotes from among the 16 panel banks are excluded; the remaining eight quotes are averaged to arrive at US dollar Libor at each term. The quotes from the individual contributing banks are also published daily.

Importantly for the current discussions on Libor, the actual quotes submitted do not have to reflect the rates on specific transactions. Rather, they are intended to represent a bank's best estimate of the rate at which it could borrow money at the time of the fix. While transaction data would be expected to inform the quotes, the final determination is left to the judgment of the

[1] The terms published are overnight, one and two weeks and monthly from one to 12 months.

KEY CRITERIA FOR BENCHMARKS

FOUNDATIONAL	1. RELEVANCE	Reflects the broad terms of the contracts for which it is intended to be the foundational rate. For private-sector credit extension, the benchmark should reflect the terms on which high-quality credits can transact among themselves with minimal structural contract terms.
	2. HOMOGENEITY	Based on contracts using similar terms and among counterparties with broadly common credit characteristics. Avoids basis risk and benchmark distortion that arise from an over-broad spread of credit and contractual differences.
	3. MULTICURRENCY	Available in a broad range of currencies on comparable bases to guarantee acceptance across markets, geographies, and contracts.
	4. TERM STRUCTURE	Available term structure at key dates through one year to allow for contract flexibility while minimizing interest-rate term risk.
RECOMMENDED	5. LIQUIDITY	Based on high-volume markets that support large transactions and are not dominated by a handful of major participants, all of which minimize the ability of a single participant or a group of participants to influence the rate. Allows for efficient management of market risk in contracts that reference the benchmark, and guarantees that the benchmark reflects available market information.
	6. MARKET-DRIVEN	Reflects free-market conditions, rather than an administered rate tied to or heavily influenced by government monetary policies or operations.
	7. DIRECTLY OBSERVABLE	Direct quotation in the underlying market, rather than inferred or derived values, promotes transparency. Also minimizes basis risks and model dependencies.

rate submitters. The absence of a linkage to actual transaction data makes the process difficult to audit in order to ensure that the rates truly reflect actual borrowing costs.

WHAT MAKES A BENCHMARK A BENCHMARK?

Fundamentally, a benchmark is a reference rate from which other rates are quoted. Libor, and similar rates such as Euribor, evolved over the past 30 years as benchmark interest rates for extending credit to the private sector. In essence, Libor was considered to be the lowest private-sector lending rate, because it was viewed that banks were safe and the rates they charged each other were most likely the lowest market rates. It was also believed that the number of transactions between banks was sufficient to determine the rate with a reasonable amount of accuracy. Initially, Libor was used as a benchmark rate for the large, international corporate lending market, but it is now a reference rate for a wide variety of loans and contracts in both wholesale and consumer markets.

An underlying premise of this report is that a global benchmark should meet several criteria to qualify for international use and acceptance. These criteria can be grouped into two categories: Foundational, representing contractual terms, and Recommended, representing characteristics to ensure the quality of the benchmark.

LIBOR ALTERNATIVES

Libor's weaknesses emerged during the financial crisis. Recent investigations by the UK Financial Services Authority and the US Commodity Futures Trading Commission have drawn increased attention to potential alternatives, with speculation coalescing around the following handful of alternatives:

General Collateral Repos

Highly liquid repo markets with government securities as collateral exist for most major currencies. Occasionally, the supply and demand of a particular security can distort its repo rate (with the security then being termed "special"), but government securities generally serve as a generic collateral pool with closely aligned repo rates — hence the term "general collateral."

While it would be necessary to anchor the rate to an underlying short-term cash rate and contract terms would need redefining, it is theoretically possible to develop benchmarks using a combination of futures and cash rates.

Government Securities

Markets for short-term government securities in all major currencies are deep. Until the maturing of the swaps markets in the past 20 years, rates on government bonds were the reference for much private sector borrowing.

Overnight Indexed Swaps

In an Overnight Indexed Swap, counterparties exchange a fixed interest rate for the average overnight interbank funding rate. Very active markets in all major currencies have developed in the past 15 years, based on the US dollar federal funds rate, Euro Overnight Index Average, and Sterling Overnight Interbank Average Rate, among others. As the floating leg of the swap is based on overnight lending rates and no principal is exchanged, OIS rates are close to a risk-free rate, with little credit or liquidity sensitivity. Indeed, market observers closely tracked the spread between Libor and OIS during the credit crisis as an indicator of credit and funding stress in the banking system.

Commercial Paper

Commercial paper is an important alternative source of short-term funding for banks, and the rates are closely tied to general wholesale funding rates; CP rates for highly rated banks could potentially serve as a benchmark.

Short-Term Interest Rate Futures

The futures markets in short-term interest rates — the Eurodollar, Euribor, and Short Sterling contracts, and their equivalents in other currencies — are among the most liquid global markets. Notional volumes in these futures are typically multiples of those in the underlying cash markets, so while the contracts in principle are ultimately settled against current Libor/Euribor fixings, price information in the futures markets is arguably more reliable than in the cash markets. While it would be necessary to anchor the rate to an underlying short-term cash rate and contract terms would need redefining, it is theoretically possible to develop benchmarks using a combination of futures and cash rates.

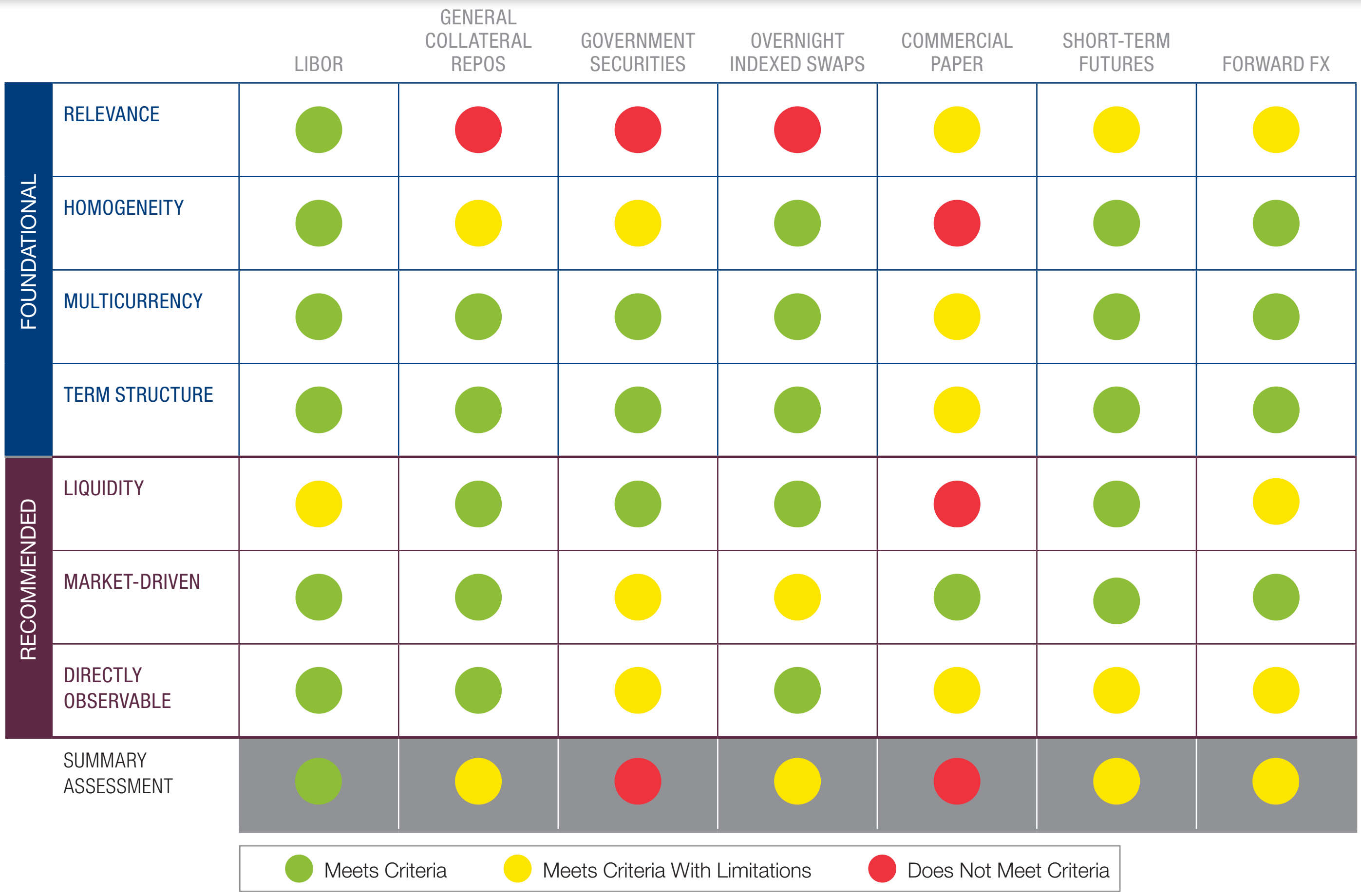
Forward Foreign Exchange Swaps

The market for forward foreign exchange has the potential to provide important price information for short-term interest rates. Transaction volume in forward FX is substantial and wholesale banks active in the cash markets are major participants. The pricing of a forward FX contract depends on interest-rate differentials between the two currencies, so establishing a benchmark interest-rate curve in one currency allows the interest-rate curve in the second currency to be inferred. The base-currency interest-rate curve would still need to be established from other sources, so a full suite of benchmark interest rates cannot be derived from the forward FX market alone, but important price signals exist in the market that could be used to test other potential benchmarks.

BENCHMARKING THE POTENTIAL BENCHMARKS

The potential utility of an alternative can be measured by assessing whether it meets the key benchmark criteria detailed above. The matrix gives particular weight to relevance, homogeneity, and liquidity.

BENCHMARK ASSESSMENT MATRIX



Libor generally meets the technical criteria as a suitable benchmark. Liquidity in the unsecured cash market has been on a secular decline relative to other bank funding sources, particularly at longer tenors, and the financial crisis exacerbated the trend. But on all grounds, Libor and its equivalents generally remain well matched for benchmark consideration.

General Collateral Repos, as a form of collateralized lending, score poorly on the relevance criterion as a benchmark for general unsecured lending agreements. Also, in the Euro markets specifically, repo rates are sensitive to the type of sovereigns used as collateral.

Government securities have liquid and high-volume markets but are not well suited as a benchmark for private-sector lending rates, because they are instruments of monetary policy and, during periods of "flight to quality" market stress, they are poor proxies for conditions in private-sector lending. Significant spreads between securities issued by eurozone countries also complicate the choice of a benchmark.

Overnight Indexed Swaps effectively strip out the credit component in Libor. That may provide a purer interest rate, but it makes the quoted rates less relevant to private-sector unsecured lending.

Commercial paper lacks the scale of liquidity and homogeneity to be suitable as a global benchmark. Short-term interest-rate futures require a cash-market "anchoring" and cannot serve directly as a benchmark. However, their liquidity, particularly at the longer maturities, provides important supplementary price information. They may be useful as a cross-check on cash-market benchmarks.

Forward FX also requires an interest-rate benchmark curve in the base currency. Similar to short-term interest-rate futures, forward FX can be an important cross-check against benchmarks derived from other sources.

WAYS TO REFORM LIBOR

Moving to a new benchmark in place of Libor should be weighed against the costs and market disruption that such a change would engender. Market participants may favor remediating the weaknesses in determining Libor over replacing it.

Reforms designed to prevent the systemic distortion of Libor submissions are likely to require a greater role for government oversight and the hard-coded use of a wider range of market inputs. Smaller-scale manipulation is a risk in almost any benchmark-setting process, and remains so even when rates are derived from real transactions. Reforms to prevent such manipulation ideally should focus on control and mitigation measures at the individual-bank level, under an umbrella of stronger regulatory surveillance.

A fundamental, comprehensive reform of Libor might focus on the following five elements:

1. **Governance**

   Improved governance would help protect Libor's credibility as a benchmark. In the near term, this may involve direct oversight by a public-sector regulator rather than an industry consortium. Also important would be subjecting the entire benchmarking process to independent audit and review. A more permanent solution could involve an oversight board with both regulatory and industry representatives, which would balance a market-driven benchmarking approach with independent supervision to ensure the integrity of the process.

2. **Regulation**

   Regulatory principles, such as those promoted by the UK Financial Services Authority, already provide a broad, if implicit, framework for reform.[2] Within this framework, benchmarking could be made an explicitly regulated process and contributing banks could be subject to specific authorization and oversight. Regulatory examinations could feature process reviews measured against a defined set of best practices. Regulation, and possibly legislation, could be strengthened to include well-defined sanctions for manipulation or other actions that damage market integrity.

3. **Scope of Benchmark**

   Regulators' investigations have intensified questions about whether Libor reflected banks' true borrowing costs during the crisis. Considering definitional changes to Libor to include all of a bank's unsecured wholesale borrowings, as suggested by the International Monetary Fund, could be a strong step in preventing that from happening in the future. The intent of Libor is to reflect banks' marginal unsecured funding costs, so the benchmark scope could be broadened to encompass commercial paper, FX swaps, jumbo certificates of deposit, OIS-based structures, and other funding sources. Doing so might be desirable in any event because term interbank deposits continue to shrink as a proportion of banks' funding sources. A definitional change would have to be limited to ensure that existing Libor-referenced contracts are not invalidated.

   Broadening the panel of contributing banks could also better calibrate the benchmark's reflection of market conditions. The rate would be less exposed to the circumstances of a single bank, and less vulnerable to any attempt to manipulate it. However, preserving the credit homogeneity of the benchmark may require limits on the number of contributing banks. Banks with lower credit ratings would likely report higher borrowing costs, pushing the average rate up, and undermining Libor's utility in measuring the base rate among banks of the highest credit quality.

4. **Transaction versus Quote Basis**

   Some reformers have suggested replacing estimates of funding costs with average rates from actual market transactions. This reform would require the establishment of a reporting mechanism for interbank transactions to a central authority and an averaging process over a defined period in advance of rate determination. It would also require confidentiality protections. Study of rates already set by transaction-reporting

[2] http://fsahandbook.info/FSA/html/handbook/PRIN

mechanisms — the USD Federal Funds Effective rate, EONIA, and SONIA, among others — could prove valuable in this regard.

Moving fully to a transaction-based approach, however, could pose practical difficulties. Liquidity in the interbank market is heavily concentrated in shorter maturities, up to one month, and volume at longer tenors or in minor currencies may be limited during the determination period. Determinations might be more volatile, particularly in times of market stress when a reliable benchmark is of greatest value. Reforms may need to consider the use of average quotes from a wide panel of banks if transaction volumes during the determination period fall beneath a predetermined threshold.

A transaction-based approach might still be vulnerable to manipulation, particularly in low-volume environments. Sophisticated review processes and monitoring tools to detect and prevent attempts at "painting the tape" might be essential, similar in scale and scope to the control processes in an enhanced quote-based approach.

Blending quote- and transaction-based approaches may prove to be the most practical solution. Under a blended approach, quotes would remain the basis for the daily determinations. Potential validation processes might include:

- Requiring contributing banks to give significant weight to recent transactions in developing their quotes, and document having done so to establish an audit trail for independent examination.
- Having sponsoring authorities cross-reference quotes against pricing and transaction data from adjacent exchange-based markets, such as those in the short-term interest-rate futures;
- Requiring consistency checks against quotes from other adjacent markets such as FX swaps and OIS.

5. Internal Controls at Contributing Banks

The above reforms are targeted at preventing systemic distortion and would to some extent deter micro-manipulation. However, to prevent micro-manipulation more directly, be it shading quotes under a quote-based regime or "tape painting" under a transaction regime, it may be necessary to strengthen internal controls at contributing banks:

- Information firewalls between the units responsible for providing quotes and executing interbank funding transactions and other trading units whose positions are sensitive to the fixing rates.
- Formal supervisory oversight arrangements for the unit responsible for the determination processes, backed by a second line of independent oversight.
- Documentary audit trails for the formal contributions to rate fixings as well as for the decision drivers used to arrive at the contributions.
- Incorporation of internal audit review of benchmark-fixing processes.

Blending quote- and transaction-based approaches may prove to be the most practical solution.

SUMMARY:

- Libor appears to meet most of the proposed criteria that define market-driven global benchmarks, while some of the potential alternatives do not appear to offer sufficient advantages in relevance, liquidity, or homogeneity to mitigate the costs and potential disruption of replacing Libor.
- Comprehensive reform at both the market and individual-bank levels could help restore confidence in Libor as a global benchmark.
- Possible reforms include meaningful regulatory oversight, stronger governance and internal controls at participating banks — and of particular importance — incorporating transaction and other market data in transparent rate determinations. ■

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China's IPO Sponsors Should Prepare for New Environment

This article originally appeared as a Sightlines InFocus on August 10, 2012.

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Hong Kong and Beijing each recently announced reforms to initial public offerings in response to high-profile incidents that have undermined investor confidence in Chinese companies. The reforms place stronger controls on the underwriting process, raise the bar on investor-protection standards, and require more robust due diligence. The new rules also include greater autonomy in levying sanctions for rule violations — a point that Hong Kong's Securities and Futures Commission recently emphasized by fining a Taiwanese securities firm and prohibiting it from acting as a sponsor for future IPOs.

The steps taken in Hong Kong and Beijing portend a new environment for China IPOs for which banks and broker-dealers acting as sponsors should prepare. This note briefly reviews the recent history of Chinese IPOs, as well as some of the implications of the new rules and a more active regulatory stance.

BACKGROUND

KEY TAKEAWAYS

- New IPO rules from both Beijing and Hong Kong raise the bar for IPOs in both jurisdictions
- Firms acting as sponsors may need to improve due diligence, information transparency, and IPO management
- Stronger investor protections are a regulatory priority. Local resistance has not prevented the new requirements and higher penalties in Hong Kong

The Hong Kong Exchange has been the largest single IPO market for several years, pulling in more than $35 billion in new issues in 2011 — once again exceeding the New York Stock Exchange and the London Stock Exchange. IPOs launched on domestic Chinese exchanges were even larger in 2011; IPOs in Shanghai and Shenzhen raised a combined $42 billion. Access to investors is therefore important to Chinese companies, and the IPOs represent big business for securities firms.

Despite the big numbers put up in home markets, the environment for Chinese companies listing in foreign markets has deteriorated sharply since 2010 due to repeated allegations of misstated accounts, inaccurate investor information, and false assertions in listing documents. At the heart of these problems were Chinese companies listed in the United States, many of which avoided the usual IPO vetting through reverse mergers with listed US companies.

Investors have always been urged to use special care in examining accounts of Chinese companies, but the potential of the companies frequently trumped investors' reservations — until recently. Investor perception reached a tipping point in 2011, during which Chinese IPOs in the US dropped to 12 from 41 in 2010, and the value of US-listed Chinese companies fell an average of 48%. The "China story" apparently is no longer sufficiently strong to compel investors to accept a lack of confidence in company representations as the price of entry.

The change has been as sweeping as it was sudden. Almost all Chinese companies became suspect; investors generally have not distinguished between them despite what appears to be substantial differences in the quality and reliability of their representations. Auditors, including all of the Big Four firms, have confirmed investors' fears by resigning positions at Chinese companies, apparently concluding that they could not verify information to their satisfaction and thus couldn't carry out successful audits.

Some market observers have worried that the pattern of scandal followed by eroded investor confidence could spread to Chinese companies listed in Hong Kong and China itself. Faced with the risk of an investor "strike," regulators recently launched initiatives to address the challenges that its companies and markets face. They appear convinced that real reforms are necessary to improve transparency and establish a degree of trust.

RECENT EVENTS

Securities and Futures Commission (Hong Kong)

Investor scrutiny of listed firms in Hong Kong has increased recently. The SFC has been pushing for sponsors to assume greater responsibility for due diligence and investor disclosure, effectively encouraging sponsors to adopt a more serious "gatekeeper" role for market access. The commission's inspection last year of 17 IPO underwriters uncovered a number of problems and abuses, including weak due diligence and inadequate internal controls.

The commission this spring published a consultation paper[1] on new regulations for listing sponsors, including substantial powers to levy fines. The new rules have now been finalized, but they require revisions to the Securities and Futures Ordinance — the SFC's primary regulatory framework — as well as other company laws in Hong Kong. This process could take some time to complete.

The SFC also announced[2] it revoked the license of Mega Capital, a Taiwanese brokerage, to advise on corporate finance in Hong Kong or to act as a sponsor for IPOs. The decision, which was accompanied by a HK$42 million fine, was based on the commission's review of the Hontex International IPO, in which it found Mega Capital had failed to discharge its duties as a sponsor and performed inadequate and substandard due diligence. The fine was the largest ever imposed by the SFC.

The SFC has made clear it intends to pursue a more active and aggressive enforcement approach under its current rules. In both public and private pronouncements they have underscored the importance of more stringent due diligence. Similar enforcement actions are likely to be forthcoming.

China Securities Regulatory Commission

About a week after the SFC announced its plans for more stringent IPO rules in HK, the CSRC followed suit with a far more detailed announcement[3] of its new rules. The rules follow an earlier focus on price-monitoring oversight — a particular concern in China, where retail trading activity accounts for about 90% of Chinese trading volume. The rules stipulate that IPOs priced at a price-to-earnings ratios of more than 25% greater than their sector average must release a risk analysis and a wide range of pricing information. The CSRC said the same day that it had also approved new rules intended to improve the quality of financial information disclosed by IPO companies.[4]

The commission has also communicated greater scrutiny of irregular market activity by senior executives of IPO companies, and that it will investigate inaccurate profit forecasts and other misleading information in IPO prospectuses. Sponsor representatives who sign

2011 IPO LEAGUE TABLE

Exchange Deal Value (US$ billions)

1	HONG KONG	36.1
2	NEW YORK	31.4
3	SHENZHEN	26.2
4	LONDON	19.2
5	SHANGHAI	16.3
6	NASDAQ	10.7
7	SINGAPORE	7.6
8	SPAIN	5.3
9	BRAZIL	4.4
10	KOREA	3.6

Source: Dealogic

[1] https://www.sfc.hk/sfcConsultation/EN/sfcConsultFileServlet?name=sponsorrglt&type=1&docno=1
[2] http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=12PR39
[3] http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201207/t20120717_212782.htm
[4] http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201207/t20120718_212848.htm

off on an inaccurate prospectus can be investigated for business malpractice, a potentially serious crime in China. The CSRC expects its new guidelines will strengthen information disclosure and improve procedures for pricing IPOs, as will its new directive requiring earlier release of a preliminary prospectus to give the public more time to analyze it.

The CSRC is also beginning to pursue efforts that will expand the role of foreign institutional investors in Chinese markets and make a larger percentage of new issues available to them.[5] Up to 50% of a new issue will now be available to institutional investors, a substantial increase from the current 20% limitation on offerings of fewer than 400 million shares. The CSRC will also lift the current lock-up period barring institutional investors from purchasing shares for 90 days after an IPO.

The new CSRC guidelines seek better quality and transparency of prospectus disclosure by encouraging greater involvement of law firms in the drafting process. The guidelines more clearly stake out the responsibilities of issuers, sponsors, law firms, accountants, and other intermediaries in the IPO process.

SUMMARY

The new rules in Beijing and Hong Kong are a clear signal that regulators in those markets intend to encourage investor participation through a more transparent and reliable IPO process. The steps they are taking have significant consequences for sponsors, advisers, law firms, and accountants that perform due diligence or otherwise play a role in the process. Sponsors in particular should review their procedures, as the potential cost of inadequate work is rising sharply.

The market for IPOs in greater China is currently limited by low investor demand, but both regulators and exchanges have made clear they want a better quality IPO market and are prepared to enforce it. This is good news for investors, and will likely benefit sponsoring broker-dealers who can live up to the higher standards expected of them. ■

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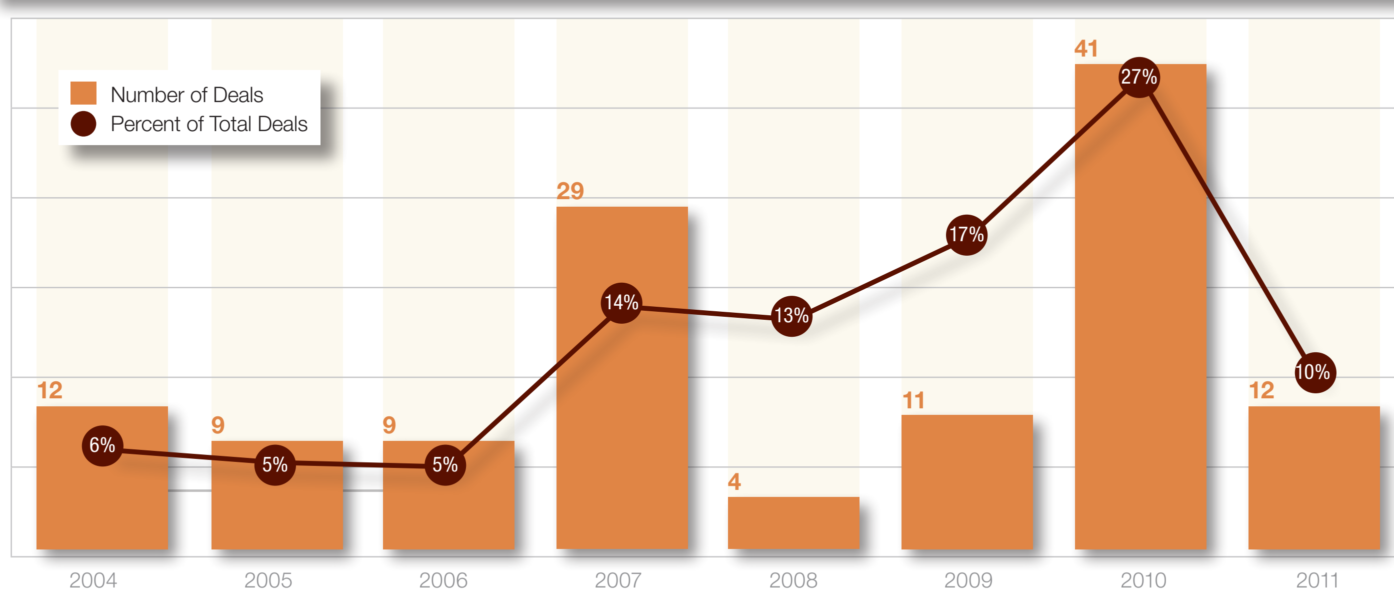
[5] http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201206/t20120629_212128.htm

US-LISTED CHINESE IPOs RETREAT IN 2011



Source: RenaissanceCapital.com

Data-Security Breaches: Preparing for the Inevitable

This article originally appeared as a Sightlines InFocus on September 5, 2012.

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The public turns its attention to data-security breaches only when a catastrophic lapse puts millions of personal records at risk. For most companies, however, the threat is constant and ubiquitous, and the reputational fallout from failing to meet customers' expectations of confidentiality is substantial.

The Identity Theft Resource Center has documented more than 200 publicly disclosed data breaches in the first six months of 2012, exposing at least 8.5 million records.[1] The data companies keep about their customers, potential customers, clients, vendors, and competitors is increasingly valuable and easily monetized. Particularly as the adoption of mobile technology surges, the risk of a data breach only figures to escalate.

"Anyone that thinks they're not going to be breached is being naïve," Heartland Payments Systems CEO Bob Carr said in a recent interview.[2]

Best practices in data security are therefore as much about responding to breaches as preventing them. Companies should build and maintain their information-technology platforms with these priorities in mind — not only as a matter of protection, but to meet regulatory expectations.

THE REGULATORY AND LEGISLATIVE ENVIRONMENT REMAINS ACTIVE

The regulatory response at both the state and federal level has scaled commensurately with the incidence of data security breaches. The Federal Trade Commission has emerged as the prime enforcement agency; it has recently taken actions against companies for failing to secure bank account information and neglecting to encrypt sensitive stored information. The commission's consent orders commonly require companies to develop comprehensive information-security management programs and make frequent progress reports. It may also require the companies to offer customers up to 20 years of credit monitoring.

The stringent requirements are consistent with the FTC's drive to make businesses proactive in protecting customer data. It advocated in a recent report that businesses build privacy initiatives into every stage of product development — a principle it calls "Privacy by Design."[3] It has also urged companies to adopt programs that limit data collection of customers' online activity, and pushed for greater transparency in disclosing the data they gather and how they use it.

The Consumer Financial Protection Bureau has developed extensive examination criteria around privacy and information security, and companies that fall under its supervisory purview should expect some attention to these issues during examinations. But because the FTC has ample authority to pursue enforcement actions involving security breaches, the new agency may be inclined to keep its own enforcement efforts focused on areas that have generally been perceived as neglected during the mortgage-bubble era.

State attorneys general have been equally active; 46 states now have data breach laws that require notice to victims and remediation. Several states — Massachusetts, New York, Maryland, and California, among others — require notice to the attorney general and to victims

[1] http://www.idtheftcenter.org/ITRC%20Breach%20Stats%20Report%202012.pdf
[2] http://www.bankinfosecurity.com/interviews/heartland-ceo-on-breach-response-i-1531
[3] http://www.ftc.gov/os/2012/03/120326privacyreport.pdf

AVERAGE COST OF DATA BREACH: 2005–2011

Cost Per Stolen Record (US$)

2005	$138
2006	$182
2007	$197
2008	$202
2009	$204
2010	$214
2011	$194

The cost of a data breach has generally been rising — but a recent downtick may suggest firms have improved their breach-response protocols

Source: Ponemon Institute

about the circumstances of a breach. State AGs have been rigorous in investigating and taking enforcement action when breaches are frequent or serious.

Recent security breaches involving hospital records[4] have triggered notifications required by the Health Insurance Portability and Accountability Act and the Health Information Technology for Economic and Clinical Health Act. The Department of Health and Human Services is likely to investigate these breaches, with possible enforcement actions in the offing.

The Securities and Exchange Commission has also become more active in pursuing broker/dealers and investment advisors who suffered breaches. It recently issued regulations requiring the disclosure of potential security threats and exposure to cyber incidents.

Public policy regarding breaches is still evolving. Congress is currently weighing 26 pieces of legislation that reference data and information security, though substantive legislation during the remainder of 2012 is not very likely. One of the bills envisions a uniform notice for breaches — likely a welcome development for companies that potentially must deal with requirements of 46 states when a breach occurs.

THE PII LANDSCAPE IS SHIFTING

The theft or exposure of personally identifiable information (PII) is the crux of a data-security breach, and the triggering consideration for notifications to victims. Several recent legal decisions have taken an expansive view of what constitutes PII.

A U.S. District Court in Massachusetts in January ruled that even a fragment of a cardholder's address (a ZIP code, in this case) can constitute PII.[5] That case followed a California Supreme Court ruling from 2011 which — taking a broad view of consumer privacy rights — similarly held that ZIP codes are PII when they can be used to match a credit card number to an address for marketing purposes. A breach of that information therefore requires notification under California law.[6]

The changing PII landscape warrants an abundance of caution and a proactive approach to handling breaches. Zappos, the online footwear retailer, chose to treat email addresses as PII for breach-notification purposes following a recent, high-profile incident. More recently, when professional social networking site LinkedIn suffered a major breach of its customers' passwords, it promptly urged users to change their account passwords. The LinkedIn breach is still being evaluated and legal action is pending. One suit seeking class-action status accused the company of failing to use longstanding encryption protocols for its user database.

EU'S STRICTER DATA PROTECTION DIRECTIVE

Companies operating in, offering services to, or working with third-party vendors based in the European Union should be aware of even stricter across-the-board data security standards.[7] The European Commission's proposed EU Data Protection Directive would significantly enhance the enforcement regime for PII breaches. Breach notification would be required within 24 hours in most cases. Fines would be increased; businesses suffering security breaches would be subject to penalties up to 2% of annual global revenues.

Each EU member would also have enforcement rights against data controllers and

[4] See, e.g., http://www.ag.state.mn.us/Consumer/PressRelease/120119AccretiveHealth.asp for recent patient-privacy enforcement actions.
[5] Tyler v. Michaels Stores, Inc., 2012 WL 32208 (D. Mass.; Jan. 6, 2012)
[6] However, under the controlling statute (Song-Beverly Credit Card Act of 1971 (Civ. Code, § 1747.08)), ZIP codes are permitted to be used for identification purposes for the completion of credit-card-related transactions, i.e., for authorization purposes
[7] See *Sightlines InFocus*, "EU's Tough Privacy Standards About to Get Tougher," May 9, 2012, http://www.promontory.com/uploadedFiles/Articles/Insights/PFG_Sightlines_InFocus_EU_GDPR_050912_FINAL.pdf

processors. Enforcement could conceivably be taken in multiple jurisdictions and therefore make cross-border data flows more difficult; differing jurisdictional standards heighten compliance difficulties and make enforcement actions tougher to avoid. This underscores the need to have good preventative information security programs in place.

INCIDENT MANAGEMENT IS IMPERATIVE

Breach prevention is an important consideration, but far from the only one. The ability to monitor and control a verified breach is more important than ever. An incident-response plan is paramount and should include a cross-functional team quickly assembled to identify and analyze the breach causes and sources. The plan and the team should include mechanisms to track and control the extent of the breach.

The team must also be prepared to respond to inquiries from customers, regulators, the media, and its employees, and have plans in place to recover and mitigate the damage caused by the breach — as well as prevent future ones. The members of an incident response team will vary by the nature of the business, but should include staff from compliance, legal, human resources, information technology, and business operations.

An incident-response plan is paramount and should include a cross-functional team quickly assembled to identify and analyze the breach causes and sources.

BREACH INSURANCE CAN MITIGATE COST

Traditional business insurance does not cover the costs of notification, remediation, and other liability-related damages if a business is victimized by a security breach. However, a growing number of insurers are offering policies for cyber-related risks, and premiums are declining as firms refine their pricing structures. Coverage options include:

- **Privacy liability** for harm from unauthorized disclosure of PII and failure to provide adequate privacy-related notifications
- **Network security liability** for breaches stemming from a failure of the business' network security
- **Identity theft** for customers' monitoring and remediation costs for breach-related ID theft
- **Commercial general liability** for legal costs in breach-related lawsuits

Businesses should consider these policies to mitigate the risk of fallout related to breaches.

ASSESS YOUR EXPOSURE TO A BREACH

Companies assessing their vulnerability to a data security breach should, at a minimum:

- Review privacy notices and information-security policies and procedures to determine, among other things, whether they meet international, federal, and state regulations.
- Evaluate whether actual business practices match company representations with regard to protecting PII.
- Develop an incident-response plan. Companies without such plans complicate breach fallout with a disjointed response, at the precise moment when methodical, consistent, and transparent action is necessary to preserve customer confidence.
- Review training materials. Breaches are often caused by employee negligence or ignorance about the requirements to protect confidential information. Frequent employee training is often the best preventive measure for security breaches.
- Review insurance coverage to determine if cyber risk and other breach coverage is included. ■

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BY WILLIAM J. TOPPETA

Insurers, Compliance, and Trust

This article originally appeared as a Sightlines InFocus on August 6, 2012.

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Insurance is based on trust. A life insurer, for example, asks a policyholder to pay premiums for decades based on the representation that the insurer will pay out after the policyholder dies — a representation that, by definition, the policyholder can't verify. The purchaser of a policy must believe that in the distant future the insurer will be in business, able to pay claims, and do the right thing.

Wise consumers will do some due diligence on the insurer's financial soundness and track record, but no matter the amount of research, purchasing a policy is implicitly an act of trust. Being trustworthy, and communicating as much to the market, should be a core competency for insurers. But the recipe for building trust has none of the certainty of an actuarial table.

How can insurers engender trust? At a minimum, they should be law-abiding and compliant. But beyond that, they can commit to superior compliance and adopt rigorous compliance processes as a bedrock principle, and feature their compliance actions and results in marketing themselves to customers, shareholders, and other companies. Trust is a byproduct of effective compliance because effective compliance makes companies trustworthy.

Compliance for insurance companies demands strict adherence to laws and regulations that apply specifically to them, particularly those relating to capital, solvency, sales, and claim settlement. Increasingly, however, business-model evolution and other factors are exposing companies to new regulatory risks, as insurers find themselves subject to a much broader range of legal rules — including those that typically apply in banking, securities, taxation, and trade regulation.

POTENTIAL COMPLIANCE ISSUES

The International Association of Insurance Supervisors has signaled that requirements of other financial regulatory regimes are beginning to creep into insurers' compliance architecture. Its July 2012 working draft of the Common Framework for Supervision of Internationally Active Insurance Groups[1] acknowledges that insurers' supervisory colleges may include banking and securities supervisors, as well as law-enforcement agencies and authorities dedicated to fighting money laundering and terrorist financing.

While global regulators have generally said they will not indiscriminately apply banking regulation to insurers, they have also indicated that it may be appropriate in some instances. Compliance risk management is one area in which insurers may anticipate some importation of banking regulatory concepts.

The Federal Reserve Board addressed compliance risk management programs in supervisory letter SR 08-8.[2] Though specifically directed at large banking organizations with complex compliance profiles, the letter laid out concepts that could be applied to insurers, as well. Its central thrust is that firms should establish a formal program to manage compliance risk and document policies, procedures, and standards.

The letter includes in "compliance policies" both firm-wide, business-conduct policies that apply to all employees, as well as more detailed policies specific to lines of businesses.

[1] http://www.iaisweb.org/__temp/ComFrame_Concept_Paper_Final.pdf
[2] http://www.federalreserve.gov/boarddocs/srletters/2008/SR0808.htm

“Compliance procedures” are those designed to implement compliance policies. “Compliance risk management standards” apply to compliance staff fulfilling their day-to-day responsibilities.

The approach outlined in SR 08-8 would likely compel companies to inventory all applicable laws and regulations, document compliance policies, procedures, and standards, and build and monitor controls. For now, of course, adopting such an approach would be entirely voluntary for most insurers, but using them as best practices is worth considering for companies looking to establish a competitive advantage in compliance.

Other emerging regulatory issues of importance to insurers include standards of conduct for broker-dealers and investment advisers providing services to retail customers. The Dodd-Frank Act required the Securities and Exchange Commission to evaluate these standards and gave it rulemaking authority to address them. SEC staff in its evaluation recommended a uniform fiduciary standard for investment advisers and broker dealers to act in the best interests of the customer — without regard to the interests of the broker-dealer or investment adviser providing the advice.

This is an important matter for life insurers. Many of their retail sales representatives must also be registered as representatives of broker-dealers in order to sell products deemed securities — variable life insurance and annuities, for instance. If the SEC adopts the new fiduciary standard, it is likely to have ramifications for insurance products, representatives’ compensation, and insurers’ overall business model. Insurers should keep a close eye on the development of the SEC’s rule.

The Foreign Account Tax Compliance Act, which is designed to curb tax evasion by US citizens holding assets abroad, could also have implications for insurance companies, particularly for American insurers with overseas operations and foreign insurers doing business with US citizens. The Internal Revenue Service is still implementing the law, certain parts of which will be enforced beginning next year.

Additionally, the European Union has proposed a series of legislative changes to improve consumer protection in the financial services industry. It seeks to ensure proper consumer advice and create common standards in insurance sales through its revision of the Insurance Mediation Directive.

EXISTING COMPLIANCE REQUIREMENTS

Several regulatory requirements already in place impose compliance requirements upon insurers, including some that are specific to the industry. Selected regulatory imperatives are listed in the accompanying table along with operational responses insurers should consider. A more detailed discussion of a few of them may be useful.

Fit and Proper

Fitness & Probity requirements applying to insurance company board members and corporate officers are not new, but in the aftermath of the global financial crisis they are becoming more widespread and assiduously enforced than ever before. Jurisdictions as far-flung as the United Kingdom, Ireland, Pakistan, New Zealand, Hong Kong, Seychelles, Malaysia, and Trinidad and Tobago all have such requirements.

Requirements are being applied broadly, not only to group parent companies but also to wholly owned subsidiaries. Preparing for these requirements — including internal vetting, background and interview preparation, and specific training — will expedite implementing organizational changes and business plans. The Solvency II framework directive[3] includes explicit fit and proper requirements for "persons who effectively run the undertaking or have other key functions." These requirements are already embedded in the regulatory framework of most European Union countries.

Anti-Money-Laundering Rules and Sanctions

US anti-money-laundering rules apply to insurers that issue products with cash value or investment features. The rules require insurers to establish a risk-based AML program, integrate their agents and brokers into the program, and monitor their compliance.

Insurers must designate compliance officers responsible for implementing AML programs that document policies, procedures, and internal controls. Insurers also must gather relevant customer-related information and conduct ongoing training of employees, agents, and brokers. Insurers are required to test their programs and report results to management and the US government.

There are also related sanctions rules, such as those administered by the Office of Foreign Assets Control of the US Department of the Treasury. Many countries have their own sanctions lists — Japan maintains an anti-social forces list — which prohibit companies from doing business with any person on the list. Companies, including insurers, must have a process to compare applicant and customer lists with all of the various country sanction lists.

Similarly, the European Third AML Directive[4], which is aimed at preventing the financial system from being used for money laundering and terrorist financing, sets a common framework across the European Union. Under the framework, financial services firms, including life insurance companies, must adopt a risk-based approach to identifying and managing money laundering.

Failure to comply with AML and sanctions rules undermines customers' confidence that they are doing business with a law-abiding company. The reputation risks are enormous.

Bribery

The US Foreign Corrupt Practices Act makes it illegal for US companies and certain foreign firms to make certain payments to foreign officials solely for the purpose of obtaining or retaining business. The law also has accounting provisions that require covered corporations to record transactions and maintain adequate internal controls.

The UK Bribery Act in several respects goes even further by prohibiting commercial bribery and "facilitation payments," and requiring companies to work actively to prevent their associates from committing bribery. However, the law does provide a full defense for organizations that can prove they have adequate anti-bribery procedures in place.

These statutes promote free and fair competition and benefit consumers. Complying with them is essential in building and retaining clients' trust. Insurers should implement programs to prevent and detect any improper payments by their employees or agents.

[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:EN:PDF

[4] http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_309/l_30920051125en00150036.pdf

Because these laws also apply to bribes made through intermediaries, companies should take necessary precautions to ensure that their partners are reputable. Due diligence may include investigating potential foreign representatives and joint-venture partners. Determining qualifications, personal or professional ties to governments, and the reputation of their clientele may be instructive. Both the US and the UK governments advocate checking relevant diplomatic and business channels in this effort.

Sound expense controls and transparent accounting for external payments will help prevent or detect bribery, as unusual payment patterns or financial arrangements may be red flags for illicit activity. In the insurance business especially, unusually high commissions paid to an intermediary — particularly those without special technical or business expertise — may be a tip-off.

Companies with specific questions about whether certain practices are lawful under the FCPA can pose them to the US Department of Justice and request an opinion. The DoJ regularly releases answers to these questions through an Opinion Procedure Release.[5] The UK Secretary of State for Justice has provided guidance for commercial organizations putting procedures in place to prevent bribery.[6] It articulated six principles: proportionate procedures, top-level commitment, risk assessment, due diligence, communication, and monitoring and review.

Making Compliance a Competitive Advantage

Insurers can fairly easily determine what laws require of them. How to comply in ways that produce competitive advantages is a challenge, but insurers have the opportunity to set themselves apart from their peers by organizing their businesses differently and establishing rigorous compliance processes and procedures.

The tone from the top, as always, is important, but pronouncements of policies from senior management alone are not sufficient. More critical and more difficult, but also more competitively rewarding, is how insurers "operationalize" their compliance strategy and plans. Also, the marketing of their compliance efforts and results can be an important competitive differentiator.

A few straightforward steps should help achieve the desired outcome.

- Describe key rules in terms of how they affect and benefit customers. Demonstrate how your firm is in tune with the spirit and purpose of regulation — to foster consumer confidence in financial institutions and systems — and not just with the technical requirements.
- Take a team approach, with clear leadership and accountability. Team composition will vary by company and project, but frequently includes representatives from business lines, legal, compliance, government relations, technology, operations, and communications/marketing.
- Structure the company to increase the level, quality, and speed of communication among all managers throughout the organization that have compliance responsibilities. Require managers to take full ownership of their responsibilities and emphasize that

Describe key rules in terms of how they affect and benefit customers. Demonstrate how your firm is in tune with the spirit and purpose of regulation — to foster consumer confidence in financial institutions and systems — and not just with the technical requirements.

[5] Opinion Procedure Releases can be found at http://www.justice.gov/criminal/fraud/fcpa/opinion/

[6] http://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf

COMPLIANCE FOR INSURERS

Laws and regulations in these areas deserve insurers' attention

RULE	PURPOSE	INSURER RESPONSE
FIT AND PROPER	Ensure individuals in key positions do not pose a risk to the insurer or its stakeholders	Vetting, background and interview preparation, training
SOLVENCY – GOVERNANCE, RISK MANAGEMENT, REPORTING, AND DISCLOSURE	Ensure that risk assessment and management play a central role in governance and internal control; market discipline through disclosure	Implement risk governance standards and internal control systems
GROUP SUPERVISION	Ensure that regulators are able to assess the enterprise risk and its impact on insurers in the group as well as the risks borne by the group as a whole, including those of nonregulated entities	Preparation for work with supervisory colleges, including group-wide capital assessment and adequate protection of group information
AML	Ensure that insurers are not used as a vehicle for money laundering	Establish, maintain, and monitor an AML program incorporating agents and brokers
FOREIGN CORRUPT PRACTICES ACT/UK BRIBERY ACT	Prohibit making payments to foreign government officials to assist in obtaining or retaining business; UK act also prohibits commercial bribery	Assess risk across organization; establish bribery prevention policy from top; conduct due diligence of business intermediaries; implement good internal expense controls and accounting records (follow the money); establish required communication and training; monitor and evaluate program
PRIVACY	Protect the privacy of clients and ensure the security of their data	Establish, implement, and communicate privacy policies; establish and maintain data security, including conduct of due diligence on data management contractors

the goal is not just to follow the rules, but to establish positive customer experiences as a competitive requirement.

- Clearly define compliance goals. Specify budgets and timetables, and commit to strong project management. Build in mechanisms for periodic review and continuous improvement of compliance procedures.
- Recognize limitations. If the company lacks necessary capabilities, it should hire full-time employees or consultants to address those needs.
- Keep the marketing department involved. The essence of marketing is to keep the focus on the customer, and keeping the marketing team in the loop will ensure that operational changes reap customer benefits — and that those benefits are communicated in ways that help grow the business.
- Keep in mind the importance of distributors and vendors. A great deal of insurance is sold through independent distributors, who choose insurers for which they will sell. Distributors include banks, securities dealers, insurance brokers and independent financial advisers.

This last point merits emphasis. Potential insurance clients frequently are first a client of a distributor — a bank, for example — that is likely to remain the client's primary business relationship. The processes of the insurance company are therefore meaningful to the bank. This is particularly true in areas of potential sensitivity, such as protecting the client's privacy. The failure to address these concerns puts the insurer's relationship with the bank at risk. An insurer that has superior compliance processes has a competitive advantage, not only with the client, but also with potential distributors. The insurer should market this advantage to potential distributors and clients alike.

A couple of caveats are worth consideration. First, marketing compliance capabilities can be risky, especially if those capabilities are questionable. Few things are worse than being proven false, be it in a court of law or of public opinion. Thus, good legal and marketing advice should be sought to manage the downside risks. And think twice about making representations that are difficult to verify.

Second, companies doing business in varied regions under multiple regulatory regimes face additional complexity because they must have processes and controls that enable them to meet standards in each market in which they operate, but that also give them oversight and control at the group level.

Legal and regulatory changes requiring new compliance approaches are inevitable. Insurers should view these changes as opportunities to create and market competitive advantages. ■

An insurer that has superior compliance processes has a competitive advantage, not only with the client, but also with potential distributors.

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