

## Compliance Risk in the Evolution of the Investment Services: an Empirical Study

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The aims and the characteristics of the Compliance function in banks and financial intermediaries are the subject of various normative suggestions: from preparatory jobs of the Basel Committee for banking surveillance, to the Surveillance Instructions of the Bank of Italy (July 2007), and the MiFID Directive with its related enforceable regulations. The risk of compliance or even worse, of non-compliance, “*is defined as the risk of legal or regulatory sanctions, material financial loss, or loss of reputation*”<sup>1</sup> a bank or an investment company may suffer as a result of its failure to comply with laws, regulation, rules, related self-regulatory organization standards and codes of conduct applicable to its activity.

This study analyse the state and the evolving scenario of the Compliance function by banks and investment companies. It is the first time that in an empirical study Compliance risk focuses on the evolution of the investment services, showing the contribution of the Compliance function during the implementation phase of the MiFID European Directive<sup>2</sup>, within the reality of different companies, established in Italy. The research has looked at the present state and the progressive scenario of how banks and investment companies have put compliance into practice. It is the first time that in an empirical investigation, the subject of compliance risk focuses on the advancement of investment services<sup>3</sup>. Thirty-five financial firms took part in this investigation which was carried out in banks and investment companies. Due to the large number and variety of the sample, it was possible to differentiate the results using a double set of criteria: a) Financial intermediaries (FI) frequently working either internationally or domestically; b) Intermediary typology, this is to say banks or other financial intermediaries (asset management companies and investment companies)<sup>4</sup>.

With reference to the contents, the research is split up into four survey areas: 1) positioning of the compliance function in the organizational structure; 2) roles

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attributed to the Compliance function; 3) methodologies for measuring, transferring and mitigating Compliance risk in investment services; 4) mode of interaction between the Compliance function inside and outside the structure.

### ***1. Positioning of the Compliance function within the organizational structure***

The first survey area for this research was aimed to determine the effective authority of the Compliance function inside the organization as defined by the operational mechanisms, hierarchical and functional relationships, by the quali-quantitative profiles of the human capital involved in the activity.<sup>5</sup> According to the principles of flexibility and proportionality, each intermediary is free to choose the most appropriate arrangement according to size, structure and mode of operation. The investigation wanted to represent the models adopted by individual company situations in their actual configuration, in an attempt to lead them to certain basic choices that can represent as many references for the unit's organizational planning. For this purpose, the research have been mapped out: a) the positioning of the function within the organizational structure; b) the interdependency with other company functions, of control and line of business; c) the microstructure, data from the internal communication for the roles, responsibilities and area of expertise; d) the characteristics of the strategic planning process, the available resources and the relative way of using them. Overall, in the analysed sample, numerous elements of internal similarity emerge, which prove that there is a common course and a basic clarity with respect to the finality and the role of Compliance within a company. Moreover, there are also different specificity traits, which especially characterize the international matrix models.

***a) Positioning of the Compliance function in the organizational macrostructure.*** "Compliance starts at the top"<sup>6</sup>. In most situations, the Compliance role is given to someone within the Board of Directors or, even if working within an audit or legal office, this person reports directly to the Board, without formal filters from the General Management. There are, nevertheless, other company situations where Compliance, made equal to risk management, depends on the General Manager, who has the task, based on the internal controls of the system, to make effective control processes of compliance, based on the guide lines defined by the Board of Directors. The decentralized organizational model – from corporate centre to business units – is more diffused than the totally centralized one. One does, however, observe a variable morphology, from one case study to the next, in terms of existing Compliance presidium even at single business unit level, with varying levels of working autonomy. The centralized solution is typical, to a certain extent, of the national situation, while in international firms, which are multinational, there is a tendency towards more articulated solutions based on the specificity of the different working realities of the group.

**b) Interdependencies between Compliance and other company functions: the internal network.** The intensity of the technical interdependency with other company functions – of governing, control and working – should be a determining factor of the impact of Compliance on the firm's activities but is in general not high. The functions which interact in a more direct manner with the compliance function are the control units: those at the top foremost (Regulatory Organ ex 231/01, Syndicate, Board of directors) and, after these, the other control organs or with competence in legal-judicial subjects (Legal Office, Internal auditing). With regards to the connection with internal auditing and the legal office, there was a difference between the intermediaries working in a predominantly domestic situation to those doing so internationally. The latter seem to understand that Compliance is a function that is very different from internal auditing, thus rendering one independent from the other.

In the entire sample, although there are large differences from one case to the next, the operative connection between the business functions and the other support units (Organisation, Personnel, Information Systems, Risk Management) does not seem to be very important. In fact, certain models that are typical of an internal network emerge reflecting as many Compliance operating models within the company. In certain situations, for example, Compliance takes on a key role in risk assessment procedures, determining the modifications made to the operative procedures and to the internal control systems. In other circumstances, that can moreover be referred to in a prevailing way to the investment service industry, one sees that there are models that express the strong impact of Compliance on the processes of innovation and construction of new products that lead to strategies and operating policies inspired by the basic principles of compliance.

In both situations, the operational nature of the connection is further maintained by the informality of the relation, which does not imply a flux of structured reporting that is imprinted on the regulatory obligations, but more on an exchange of information and responsibilities useful to the company's demands.

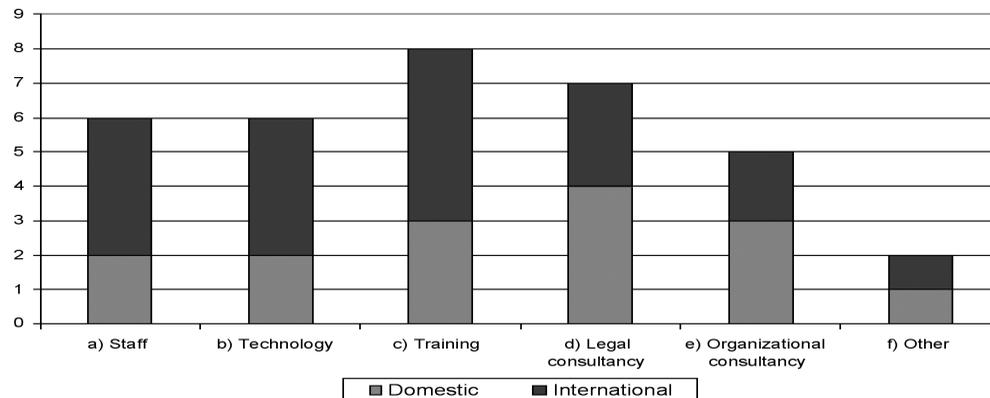
**c) Microstructure of the Compliance function.** Analysis of the internal structure of the Compliance function was carried out by taking into consideration both the dimensions of the unit and the internal distribution of the tasks. The Compliance function is present in the majority of cases as an articulated unit; only for the smaller situations (branches or branch offices of international banks and specialized financial firms) does one find monocratic solutions or of very small size. In 7 out of the 35 cases examined (equal to 20% of the sample), moreover, there was a specialized function or someone in charge of Compliance in offering investment services. With regards to this profile, there are other intermediaries, where a similar specialization is found in one out of three cases. Instead, international intermediaries and banks had a share of specialized solutions that was lower (15.38% in the former; 14.29% in the latter). The average number of employees in the Compliance function was between 1 and 5 full-time, equivalent to 60% of the situations. The function appears to be on average larger for domestic situations and banks but there were numerous cases in which there was

not even one full-time employee covering the role of Compliance. This was generally the case of intermediaries that had not yet put into the system a specialized function and entrusted the tasks of Compliance to single individuals within the audit unit or the legal office.

The duties and responsibilities within a function follow a number of criteria. The choices of microstructures are naturally conditioned by the size of the unit. If it is a monocratic function, there is no specialization, except when the entire function has a specific vocation, as for example, the activities focussed on investment services. There are, however, also situations in which one decides to align all the staff within the function on common competency profiles, so as to guarantee an inter-exchange and flexibility in managing the diverse basic themes as they turn into priorities. In the sample examined, the articulation of the Compliance function moreover followed a mixed regulatory criterion, by business area and by front and back office criteria. In one third of the examined situations, the regulatory line of specialization was the prevailing one, while the subdivision of the tasks according to the business area was chosen by about 20% of those who replied.

**d) Planning of the activity of Compliance and the choice of resources.** Along the lines of the usual procedure for auditing and risk management, also the Compliance function produced a plan of action in the majority of cases (65%), of which 78% had a yearly time span. The plan is often revised every six months (63%), with regards to the latest regulations which impose new priorities and to the result of the check-ups carried out. 21% of the companies that produced the plan had a tendency instead of producing a document every three years. This was the case for four banks; two were domestic and two international. The plan is agreed to by the Board of Directors and with the Managing Director (CEO), often with internal auditing; and in only one case with the Regulatory Organ ex 231/01, in three cases with the Syndicate and the supervisory board. It was rare to find the participation of business managers, it occurred only with a multinational bank. If there is a centralized Compliance function if the holding, it occurs in the evaluation of the plan of the decentralized unit. For the planning and management of its own participations, the Compliance function does not generally have an independent budget. This is very much so for domestic and non-banking intermediaries (59% and 57% respectively for the two groups) than for those which work at an international level or banks (for these last two groups the results were respectively of 46% and 52%). Of the 11 companies with an independent resource budget, 8 (equal to 72.73%) stated they could count on a sum which was less than 500,000 Euros. Only one international bank managed an amount between 500,000 and a million Euros. Such sums of money are mainly destined to training and legal consulting. For the international sample, the investment in training is far more important (Graph 1). In the domestic banks, one invests particularly for external legal opinions (27%) and another 15% of the budget covers the consultancy fees on organizational matters. The investments in technology to support Compliance represented only 13% of the cost.

*Graph 1. How the budget of the Compliance function is structured in the international and domestic intermediaries*



## **2. Compliance function roles**

To understand the effectiveness of the Compliance function one has to look beyond the structural design, the placing of the specialized organ and the various interdependencies (hierarchical, functional operative, cultural) that exist between it and the other departments in banks and intermediaries. It is necessary to consider the human resources (people) and the technical resources (the information systems – hardware, software - and communication networks) that are used. Only in this way is it possible to bring light into the *black box* of this new function, contributing to stimulate a debate – already very dynamic in financial intermediaries – on what and how to render it an element of competitive advantage, and not only a sort of “surveillance burden”. The analysis in this part of the research tries to:

- 1) identify the level of awareness of the expertise (in terms of know-how, skills and experience) that is used to carry out the function;
- 2) verify the allocation of the commitment of staff assigned to the function with different tasks and on different contents, also indicating the perceived tendencies after three years;
- 3) determine the degree and the type of diffusion of IT supports used to carry out the activities of the function, and to estimate its value in terms of dedicated investments;
- 4) indicate the main factors of change expected for the function to be carried out, and to estimate the expectations of its management based on the relative expenses of the next three years.

What arises from the qualitative comparison of the expertise profiles, the time

dedicated to the activity, the availability of IT support and other relative instruments, the factors of change and the forecasting of expenditure to be sustained to carry out the function, are some primary indicators on the resource policies (human and technical) that need to be followed in order to maintain and/or develop the level of effectiveness of the Compliance function.

**a) Competence level and time allocation of those assigned to the Compliance function.** Overall, the representation of the Compliance function that comes out in the part of the survey dedicated to human resources can be summarised as follows:

- It is a function that needs differentiated skills, partly complementary, to sustain a commitment that has been growing during the past three years. This seems necessary to be able to face up to the known challenges presented by the laws and the growing competition in the saving investment services internationally.
- It is a function that at present seems to be highly developed among those intermediaries working internationally as far as competences and tasks to be carried out are concerned. The greater attention given to training that they show is a clear signal of the importance of creating a very varied culture on Compliance, based on the knowledge of the laws as well as a strong and widespread ethical sense.
- It is a function that because of its tasks and much differentiated content areas requires qualitatively and quantitatively adequate staff. The definition of *ad hoc* training courses for those involved in different activities on different contents has to be the opportunity for letting a true culture on Compliance occur and it cannot be only the sum of the pre-existing cultures (above all legal, audit, risk management) and least of all be identified with any one of these. All these mechanisms of personnel management (selection, development, career, evaluation, apart from the system of incentives, which will be discussed in the third part of this survey report) have to be used in the best possible way to increase know-how, capacity and the experiences within the newborn Compliance function (especially in the domestic intermediaries and in holding companies of large and medium-sized bank groups).

This representation is not only linked to the data, but also comes from the numerous contacts with the professional of the function that occurred during the survey. In synthesis, for the Compliance function, a successful future depends primarily of the ability to adjust the profile of the staff expertise to the needs presented by the activities and the areas attributed to the function, in the various situations of the company, of the market and of regulations. We think that domestic intermediaries could benefit from learning from the best international experiences.

**b) Diffusion and investment on IT for the Compliance function.** The Compliance function deals with widespread activities and areas of participation. Moreover, it is characterized by a diffuseness within the intermediary organizations and banks. As such, it greatly resembles the function of operative risk management. For Compliance function to carry out the expected activities to its best, it is fundamental to have

technical resources (dedicated applications, capacity of elaboration and of data transmission) available. These become more important as the size, the degree of diversification and the spatial spread of the intermediary market increases with the function. In this part of the survey the aim was to collect certain initial information on the IT profiles of the function and on the relative investments carried out.

Generally, a little over half the sample did not use dedicated applications. Those intermediaries who work internationally answered affirmatively in a percentage that was much higher compared to their domestic counterparts. Apart from the possible *bias* resulting from the international and domestic intermediaries, this datum shows once again the higher development of the function within the international context. The difference between banks and other intermediaries is not as strong, but it is still present: the latter, to a larger extent, tend to chase after dedicated applications.

Should there be no dedicated applicative systems, the information relative to the Compliance function is dealt with by the information systems of the company and the relative procedures. Apart from certain differences, generally the most used sources were the systems and procedures used for operational risk, or the autonomous and personalised extractions from other company information subsystems. It is mainly the national intermediaries and the banks that used these *ad hoc* extractions, compared to the international financial intermediaries and other ones. The partial overlap of Operational Risk Management and Compliance compared to certain events which can lead to risk and their monitoring, justifies the answers given. One must however note the just as frequent recurrence to *ad hoc* extractions can definitely render less efficient the process of a function that is so widespread and hence, by definition, required a wide and systematic use of collection, elaboration, synthesis and transmission of the numerous phenomena which fall under its supervision. This last consideration is certainly valid when the size of the managed transactions is small with a high frequency. The intermediaries who work through more “tailored” operations can have less need for dedicated applications for the monitoring.

The dedicated technological applications, where present, concern the following main activities, in order of how they were signalled: I) Market Abuse; II) Money-laundering; III) Monitoring investment limits; IV) Monitoring (in general).

Overall, the use of IT – in both qualitative and quantitative terms – and the relative investment policies show, in almost half the cases examined, that the Compliance function is still at an initial stage. Only a number of international and other intermediaries seem to have focussed the relevance of the technological supports for the effective and efficient development of the multiple activities foreseen by the function being studied. Domestic banks, especially group leaders and almost all of them seem to be late. From this standpoint, the low number of replies with regards to the existence of an investment in IT dedicated to this function also demonstrates the limited attention to it. Thus it is hoped that in the process of buying, those responsible of IT in the banks will receive support from the Compliance function, since it should know better what the real requirements are.

*c) Factors of change and expected course of the costs of the Compliance function.* To complete this part of the survey dedicated to human and technical resources of the Compliance function, the main factors of change expected by the running of the function were looked, and the expectations on the course of the relative costs during the next three years were estimated.

With reference to the factors of change, the answers supplied showed that there was generally a predominance of the normative factors of context, placing the development of the European and domestic normative at the same level, followed at a certain distance by the perception of sanctions from the control authorities. In fourth place was the will to improve the quality of the service rendered to the client. In order, the best sector practices, the interventions of the Basel Committee, the technological changes (confirming the scarce sensitivity on the subject) had scores that were inferior to the mean.

The international intermediaries always gave inferior mean scores than the domestic ones (apart from the development of the European normative, on which they placed themselves at the same level as the domestic intermediaries). This practically confirms the more advanced state of the Compliance function of these compared to what occurs for those intermediaries strictly working on the Italian market. One responder, in fact, stated when giving a score to the factors of change: "The Compliance function has always had particular relevance in the Company and relevant changes are not expected."

Considering the factors of change that have just been mentioned, and the tendencies of the human and technological resources mentioned in previous questions, it is interesting to note what are the expectations with regards to the course of the costs of the Compliance function in the next three years. According to what could have been expected, in general the main replies indicated an increase in the costs of the Compliance function (Graph 40): 55% of the intermediaries stated a fast (35%) and (20%) a slight increase.

In synthesis, considering the answers given on competences, tasks and contents of the Compliance function on the one hand, and the answers given to IT investments and expected costs on the other, according to this survey what emerges is an overall situation of uncertainty and caution with regards to investments that have to be carried out within the function, which do not seem justified considering the numerous challenges that are to be expected in this area by intermediaries in the years to come.

### ***3. Methods of measurement, transfer and mitigation of Compliance risk in investment services***

From an organizational and a technical point of view, to effectively face up the Compliance risk it is required to define its features. The definition enables one to also point out the approach the intermediaries might have to use to face the legal risk, rather than the financial one, or even use a risk management solution.

The participants were asked how Compliance risk was defined within their function. 37,1% of intermediaries did not specify the definition or did not answer the question at all. Among these, there were even large-sized intermediaries. 11,4% participants define the compliance function as the respect and minimization of the inadequacies of law, regulation, surveillance, self-regulation and business risk. Another 17,1% intermediaries believe that compliance should face important judicial, administrative and financial sanctions.

According to 14,3% players, compliance risk has to be given the more general definition of operational risk or, anyway, must be tackled within the ORM project. Finally, 20% among banks and financial intermediaries were more sensitive to the reputational impact that the lack of respect for compliance could generate. Some of them stated the *mission* of Compliance conditions the behaviour of all those who can change the external awareness of the quality of the service offered, namely: “Avoid any reputational risk” and “Our reputation is everything”.

**a) Measurement of Compliance risk.** The prevalence (58%) of the intermediaries does admit not to have any qualitative or quantitative model through which measuring Compliance risk. This evidence switches over if we consider international intermediaries, among which 66,7% states to use a methodology to measure the risk. The measurements were carried out in the following steps:

- a) Identification of the risk factors;
- b) Estimation of exposure;
- c) Estimation of the probability of occurrence;
- d) Estimation of the *severity*;
- e) Estimation of the expected loss;
- f) Estimation of the unexpected loss;
- g) Estimation of the capital at risk;
- h) other.

As was to be expected, the percentage of the sample decreased with the complexity of the measuring step.

Table 1 shows that only 40% of the domestic intermediaries had mapped out Compliance risks, while for the international ones, the value grew to 67%. The difference between the international and the domestic sample more than doubled when referred to the exposure estimate, probability of occurrence and of impact (or *severity*).

Few cases show the capability to associate a capital management for the compliance risk. This was specifically the case for those intermediaries who associate Compliance risk to operational risk. The Operational Risk Management process would therefore enable process owners to estimate even Compliance more completely.

Table 1. Measuring phases of Compliance risk

	a) Identification of risk factors	b) Estimate of exposure	c) Estimate of probable occurrence	d) Estimate of severity	e) Estimate of expected losses	f) Estimate of unexpected losses	g) Estimate of capital risk	h) Other
<b>TOTAL</b>								
Yes	50,0%	25,0%	28,1%	15,6%	21,9%	9,4%	6,3%	11,8%
No	50,0%	75,0%	71,9%	84,4%	78,1%	90,6%	93,8%	88,2%
<b>INTERNATIONAL INTERMEDIARIES</b>								
Yes	66,7%	41,7%	41,7%	25,0%	25,0%	8,3%	0,0%	12,5%
No	33,3%	58,3%	58,3%	75,0%	75,0%	91,7%	100,0%	87,5%
<b>DOMESTIC INTERMEDIARIES</b>								
Yes	40,0%	15,0%	20,0%	10,0%	20,0%	10,0%	10,0%	11,1%
No	60,0%	85,0%	80,0%	90,0%	80,0%	90,0%	90,0%	88,9%
<b>OTHER INTERMEDIARIES</b>								
Yes	69,2%	30,8%	46,2%	23,1%	38,5%	7,7%	7,7%	0,0%
No	30,8%	69,2%	53,8%	76,9%	61,5%	92,3%	92,3%	100,0%
<b>BANKS</b>								
Yes	36,8%	21,1%	15,8%	10,5%	10,5%	10,5%	5,3%	16,7%
No	63,2%	78,9%	84,2%	89,5%	89,5%	89,5%	94,7%	83,3%

With reference to the institutional nature of the intermediary, the degree of progress of the measuring process of Compliance risk seems to be larger among SIMs and SGRs, since 38% of the cases estimated an expected loss of non-compliance compared to the 10% of banks. This advantage, in terms of risk management could depend on:

- a) less complexity of the processes to be mapped for intermediaries that are not banks;
- b) greater difficulty to be compliant to the banking regulation since they can be considered multi-organizations.

**b) Mitigation of compliance risk.** The second phase of risk management is control and mitigation. The participants were asked which instruments reduced the risk by using internal controls. The majority of the sample (82,9%) affirmed not to have undertaken any mitigating activity yet. The positive answers show that the following means were used:

- a) code of conduct;
- b) controls in the investments and the communication with reference to the market abuse phenomena and insider trading of the employees;
- c) protocol of autonomy;
- d) compliance manual for each business line;
- e) ethical code.

With reference to the code of conduct, this was adopted by 94% of the participants taking part the survey. Among these: international intermediaries: 100%; domestic intermediaries: 89.5%; non-bank intermediaries: 100%; banks: 89.5%. When the analysis was carried out on each business line (Table 2), few cases were found.

Table 2. Adoption of the code of conduct by business line

	in general	retail banking	private banking	asset management	investment banking	other
<b>TOTAL</b>						
Yes	93.5%	9.4%	15.6%	25.0%	15.6%	100.0%
No	6.5%	90.6%	84.4%	75.0%	84.4%	0.0%
<b>INTERNATIONAL</b>						
Yes	100.0%	8.3%	16.7%	41.7%	25.0%	100.0%
No	0.0%	91.7%	83.3%	58.3%	75.0%	0.0%
<b>DOMESTIC</b>						
Yes	89.5%	10.0%	15.0%	15.0%	10.0%	100.0%
No	10.5%	90.0%	85.0%	85.0%	90.0%	0.0%
<b>NON-BANK INTERMEDIARIES</b>						
Yes	100.0%	0.0%	0.0%	30.8%	0.0%	100.0%
No	0.0%	100.0%	100.0%	69.2%	100.0%	0.0%
<b>BANK INTERMEDIARIES</b>						
Yes	89.5%	15.8%	26.3%	21.1%	26.3%	100.0%
No	10.5%	84.2%	73.7%	78.9%	73.7%	0.0%

Asset management is the business line with the largest concentration of *ad hoc* codes (25%), while retail banking only used it 9.4% of the time. In comparison, international intermediaries paid greater attention to the codes, with the exception of retail banking. The comparison between bank and non-bank intermediaries (Table 2) shows how the latter are clearly more oriented to the introduction of the code within asset management, while about one out of four banks calibrated the contents of the code of conduct to business lines. Lastly, none of the participants seemed to have created any risk transfer solutions either of the financial (derivatives) or insurance type, coherently that compliance hedges company's reputation.

#### 4. Method of interaction of the Compliance function inside and outside the structure

The various methods of interaction of the compliance function inside and outside the structure were examined with reference to four areas: a) the internal and external means of communication used by the compliance function; b) the contributions that the compliance function can bring to the innovation processes in the investment services; c) the mechanisms and connecting processes between the compliance function and the system of values of firms, as well as between the Compliance function and the system of incentives; d) the degree of the present involvement of the Compliance function during the implementation of the MiFID directive.

**a) Internal and external communication systems.** Due to the nature of the Compliance function, which has to pro-act and manage the non-conformity risks with all the "rules of the game", both internal and external, its ability to communicate, especially within the structure, is very important. If this is not present, then there is no

use for the Compliance function. Sharing the “rules of the game” goes through communication processes that need a wide range of means of communication.

With reference to the *internal communication instruments*, according to the research, those that are of great importance to the Compliance function are: reunions, intranet and email. There is a slightly higher preference expressed for the first of these in terms of media (7.68 is the reunions score and 7.26 internet and email score on a scale of 10). The need to use both is therefore apparent: reunions, as a means to have a rich and personal means of communication that has a high potential for communication exchange, aimed at a restricted number of people, is very expensive in terms of time and resources; intranet and email, that use the technology which enables the spread of a vast range of information, with less potential of communication diversity, but more affordable means to reach the entire staff of the company. The exclusivity of reunions is effective when those who receive the message are a restricted group within the company (this is when the term “exclusive” was used) and it is very reasonable that it be used in the implementation phase of the projects. However, for messages that concern and have to be spread throughout the company, as is the principle of conformity to the rules of the game, it is indispensable to use those means of communication that can reach all those to whom it is addressed.<sup>7</sup> Always referring to the nature of compliance, it is not surprising to find that circulars are considered another relevant means of communication, since they are often a useful instrument for the interpretation of internal and external rules, giving specific references to efficiency. Communicating via training courses aimed at compliance topics is preferred by those operators who work internationally. This sort of communication, together with the participation of the Compliance function to the general training of the bank, is instead preferred by operators who have a diversified bank activity compared to other intermediaries.<sup>8</sup> The combination of these two descriptions leads one to believe that as the complexity of the company increases (international coverage and presence of different activities in the bank sphere) so will awareness to the importance of training, making it possible to transmit the culture of compliance, as less “exclusive” compared to reunions, but just as rich from the communication point of view. The internal code of conduct is less important as a means of communication for the compliance function. The scarce interest can be explained by the fact that in many cases the Compliance function begins after having set out the code, hence, because there was no input from the function it was not interpreted as an important internal communication tool for the prevention and management of the conformity principle. On this topic, in preventive terms, one could instead exploit the connection between the compliance function and the content of the internal code of conduct, which the function itself helps to spread and also supports its correct interpretation.

With regards to the *external communication instruments* used in order to have a dialogue with the external institutional players, and more in general with the public, the survey showed the importance that is given to the following instruments: Annual Report; Code of Conduct; documents on the web; presence at conferences. On

average, there is a higher preference of attendance at conferences and communication via documents posted on the web. There are even certain important differences based on the task and typology of the intermediary. The opportunity of comparison that occurs at conferences and the compliance principles visibility by the Code of Conduct are the ways in which the intermediaries' attention is more focused, especially for the international ones. Moreover, compared to all the mentioned means of communication, the tension of communicating with the outside is on average higher for banks compared to the other financial intermediaries.

**b) Contribution of the Compliance function to innovation.** The dialogue between the Compliance function and other company units facilitate not only the spread of the culture of conformity, but can also generate opportunities for innovation. On comparing different company viewpoints, solutions can arise that assist working by the rules of the game. In particular, with reference to investments, an operator who took part in the survey stated: *“it is in this phase of understanding and applying the MiFID Directive that the risks and opportunities for the intermediary are decided. The correct implementation of the regulation, hence compliance to it can be decisive of the positive effects and innovations to working and business”*. 66% of those who answered shared this view (this is to say 23 of 35 of those who replied), mainly with a domestic background and diversified bank operations (if one interprets it like this, the approvals rise respectively to 72.7% and 76.2% of those who replied). The first delineation, concerning domestic or international operations, can be due to the geographic location of the Compliance functions with regards to the positioning of other functions of the company. This is to say, that the participations of the Compliance function to the process of innovation of the product or of the process in the area of investments is made easier by the proximity, even logistically, of the company functions that are involved in the process. This situation occurs more frequently for those operators who work domestically and consequently with opportunities for exchanges and comparisons that are made easier because of the logistic proximity. The second difference, between banks and other intermediaries, is based once again on the perception of a greater “necessity for activism” from the Compliance function to complex and diversified situations such as banks that work in a highly regulated environment. This understanding, on behalf of the operators, is an indication of the condition of the bank, the most regulated financial intermediary in the financial system. Due to this, the process of innovation in the bank cannot be split from the dialectic confrontation, with external and internal rules of the game (the latter are self-determined by the bank, in order to maintain control over the company processes, as required - even imperatively - by the regulations of the sector). For the bank, the legislation is an important financial innovation input process that leads to providing special attention to the role given to the Compliance function, especially in this implementation and/or reorganization phase of the function.

In the absence of an authentic motivation to innovate, “compliant” with the new rules of the game, the propelling push of legislation can become an innovative

“elusive”<sup>9</sup> process. This would mean losing the opportunity of making all the players advance to new and higher quality standards for the service rendered to the clients. The participation of the Compliance function to the innovation processes reduces the risk of tax evasion and can contribute to accelerating and improving the reference standards of the innovative process.

***c) Connection between the Compliance function, the system of company values and that of incentives.*** For those companies that are subject to legislation, such as the firms in this survey, namely banks and investment companies, the search for innovative solutions cannot lead one to work outside the external and internal rules of the game. In particular, in the area of the investment services, the activity of the financial intermediary aims at savings, a “good” that is protected by the Italian constitution (art. 5). The principle of investor protection is reaffirmed at the European level in the MiFID European Directive which foresees the need for an intermediary behavioural standard in order to guarantee differentiated levels of protection, according to the investment service nature and the investor typology. The call for a written contract (compulsory for all investment services except in the case of investment consultancy) arises because of the need to clarify the rules of the game that characterize the intermediary financial-investor connection. The respect for the rules of the game is among the essential principles for the existence of the financial intermediary. Because they are qualified to act on behalf of the investors, who in turn contribute with their accumulation process and investment choices to the development of the economic system, and because financial firms are prone to regulations, compliance to these rules must be part of their genetic make-up. This statement leads to two distinct points. The first is that when the Compliance function is coupled to that of the company’s value system, it gains visibility. The second is that when in a company the effective mechanisms or processes link the principle of conformity to the internal and external conventions of the system of incentives<sup>10</sup>, it gains concreteness.

The survey showed the presence or absence of these connections and suggests the following combinations:

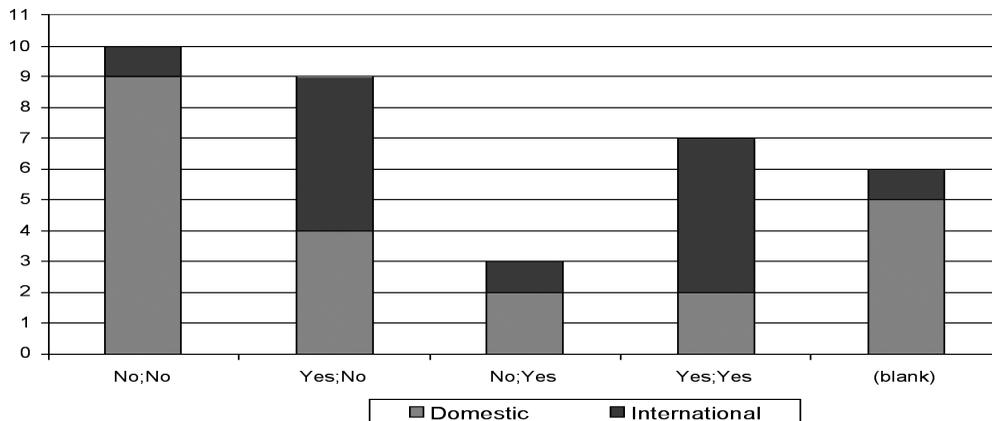
- Absence of a connection either with a system of values or one providing incentives (no; no);
- Presence of a connection with the system of values, absence of a connection with the system providing incentives (yes; no);
- Absence of a connection with a system of values, presence of a connection with the system providing incentives (no; yes);
- Presence of a connection both with the system of values, and with the one providing incentives (yes; yes).

The “virtuous” situation, this is to say presence of a connection at both levels of the system of values and one providing incentives, characterized only 7 cases of the 35 surveyed and essentially with an international operability (Graph 2). At the opposite end, the absence of both connections was the reply of 10 operators, essentially with

domestic operability. In 9 cases, the connection was present for the system of values, but not of providing incentives, while in another 3 cases the situation was the opposite, this is to say the connection was present exclusively for the system providing incentives. When present, for the connection with the system of values, those who replied explicitly recalled the Ethical Code and the Codes of Conduct or reminded about the conformity principle that is part of the company’s mission.

With regards to the connection with the system providing incentives, in certain cases what was stated was that: *“The collaborators are evaluated also on acceptance to the rules and this has an impact of the variable part of the income”*. The same concept was expressed when stating the following: *“Respect for the regulations is evaluated quantitatively so as to have an effect on the variable part of the income”*. In certain cases, the connection was the result of a process that had recently evolved: *“From 2007, elements of compliance have been inserted into the system of objectives”*. In others still, the “pervading” element of the connection between the compliance function and the awareness of the system providing incentives was: *“The compliance function is involved in the design of the system providing the incentives. It verifies that the budgets do not have objectives which could lead to non-compliant behaviour. It has promoted the introduction in the budgets of qualitative indicators”*.

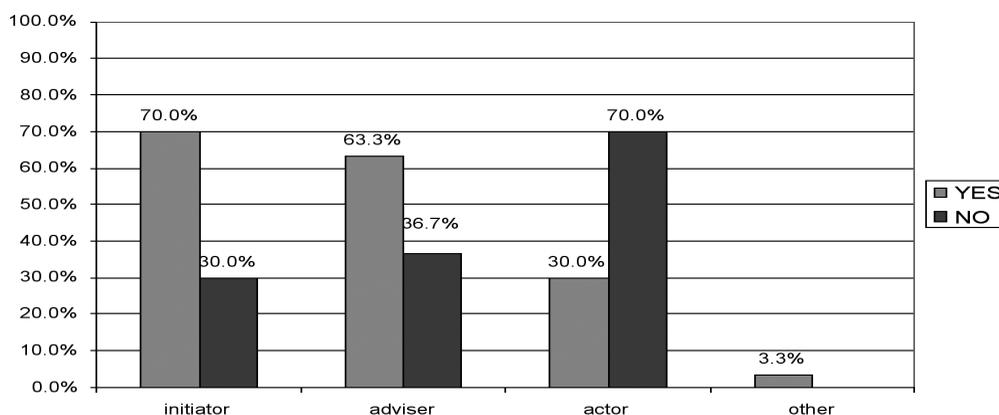
Graph 2. Link: Compliance function – System of values promoted by the bank – Incentive system



**d) Level of involvement of the Compliance function to complying to the MiFID Directive.** Due to the area of the survey, limited to the investigation of the procedures of prevention and control of Compliance risk and to how the investment services have evolved, the aim of this research was to explicitly assess the involvement of the Compliance function in the internal processes of the company in terms of complying to the MiFID Directive. The results are a reflection of the net interpretation that the role is one of propulsion and consultancy and becomes less relevant during the

carrying out phase (Graph 3). The propulsive push, which is pertinent to the properties of the function of Compliance, is especially present in the Compliance function of international firms, while for the domestic ones the internal consulting approach is preferred. On this, there is probably a learning curve of the potentials that are intrinsic to the role of the Compliance function that still have to be achieved by some of the domestic situations. In particular, what comes out is the “distance in perception” of the involvement of the Compliance function in the process at point relative to drafting the suitability and appropriateness test; this is to say, the support to the suitability and appropriateness evaluation tests as expected by the MiFID Directive. The evaluation of suitability is foreseen for high added value services, such as investments advisory and portfolio management.

*Graph 3. Degree of involvement of the Compliance function in the internal business processes of complying with MiFID*



### **Conclusions**

As synthesis of the research, we can affirm that in fact “*Compliance starts at the top*”, at the macro level in the majority of situations, the compliance role is given to someone within the Board of Directors or this person reports directly to the Board, without formal filters from the General Manager, but, at the micro level, the function must have adequate resources, both qualitative and quantitative, in order to carry out its tasks in an effective and fast way, and the research shows a warning signal: the Compliance function does not generally have an independent budget. This is very much so for domestic and non-banking intermediaries.

The activity of compliance requires diverse skills, partly complementary, necessary if one is to sustain a commitment which is foreseen to grow in the next three years.

This seems necessary to be able to face the known challenges presented by the laws and the growing competition arising in the area of savings investment services internationally. The function of compliance, in terms of experience gained, assignments carried out and areas of involvement, seems at present more developed in firms working internationally. The greater attention given to training by these is a clear signal of the importance of establishing a culture on compliance, based not only on knowing the rules, but also on a strong and widespread sense of moral duty.

The role of compliance requires that, because of the diversified tasks and contents, there be adequate staff in terms of both quality and quantity. Personnel management must make use of its entire means, and the best possible ways, to ensure that know-how, competence and skills in compliance rise, in particular for domestic firms and those working in large and medium-sized holding banks.

Also the use of dedicated IT applications appears scarce. The investments channelled to IT resources do not seem adequate for the challenges awaiting the Compliance function in the near future. It would seem that most of the representatives of this function, who answered, were not able on their own to provide an estimate on the size and the type of IT investments necessary.

The majority of firms have used not used articulated model, neither qualitative nor quantitative, to measure risk compliance. This is exactly the opposite when looking at the other part of the sample, namely the international firms compared to the domestic ones. The domestic firms who have mapped out the conformity risks are still a minority when compared to their international counterpart. The discrepancy between the international and the domestic sample increases with reference to the degree of exposure, the probability of it occurring and the impact or severity.

The dialogue between compliance and the other company functions not only supports the spread of the conformity culture, but can also generate an opportunity for innovation. On comparing the different viewpoints of the companies, it is possible for new solutions to arise which facilitate the efficiency of playing by the rules. The majority of the companies that were object of this study fall within this category.

The low estimated importance of their role in the prevailing domestic setting is transversal to all MiFID implementation processes. This is particularly true for the "level of awareness" which can be seen between in the involvement of the Compliance function of international intermediaries and that of domestic ones when creating an appropriateness and suitability test. This is also the case for the two subgroups, namely banks and financial intermediaries, but in the former the Compliance function shows a greater degree of involvement.

Respect for the rules of the compliance game is part of the crucial ethics of financial intermediaries. They are qualified to act on behalf of the money savers who contribute with their accumulation process and resulting investment choices to the development of the economic system and because financial firms are prone to regulations, compliance to these rules must be part of their genetic make-up. This statement leads to two distinct points. The first is that when the function of compliance

is coupled to the company's value system it gains visibility. The second is that when in a company the effective mechanisms or processes link the principle of conformity to the internal and external conventions to the system of incentives, it gains concreteness. The "virtuous" situation of a connection between the value system and that of incentives was seen in only the minority of the probed sample.

### Notes

<sup>1</sup> *Compliance and the Compliance Function in Banks*, Basel Committee, April 2005 (Consultative Document January 2004).

<sup>2</sup> The European "rules of the game" for investment services have been significantly modified following the enforcement of their discipline, the investment activity contained within the Directive 2004/39/CE (MiFID Directive) and the connected Directive 2006/73/CE.

<sup>3</sup> As defined by the Directive 2004/39/CE: 1) reception and transmission of order in relation of one or more financial instruments; 2) execution of orders on behalf of clients; 3) dealing on own account; 4) portfolio management; 5) investment advice; 6) underwriting of financial instruments and or placing of financial instruments on a firm commitment basis; 7) placing of financial instruments without a firm commitment basis; 8) operation of Multilateral Trading Facilities.

<sup>4</sup> The researchers wish to thanks all the 35 financial companies who made possible the research. The implementation of the on-line release of the questionnaire has been possible thanks to the first step of the process generated through some very useful meetings with very professional compliance officer. The collection of data occurred via a questionnaire designed and elaborated by a group of researchers of the Research Division of SDA Bocconi School of Management. Data collection stopped in July 2007 and started in November 2006. The questionnaire was created based on observations which arose from a pilot phase of the research, carried out from January to February 2007. The research activity has been carried out with the support of HP and SIA-SSB.

<sup>5</sup> *The joint Regulations of Bank of Italy-Consob, acknowledged by MiFiD, establishes that the intermediaries set up and maintain permanent positions, that are effective and independent of controls on conformity to the laws, and in line with the proportionality principle, risk management of the firm and internal audits.* Title I, Chapt. III, art. 12, Bank of Italy-Consob Regulation.

<sup>6</sup> Cf. Basel Committee on Banking Supervision, *Compliance and Compliance Function in Banks*, April 2005.

<sup>7</sup> "Compliance should be part of the culture of the organisation; it is not just the responsibility of specialist compliance staff", in Basel Committee on Banking Supervision, *Compliance and Compliance Function in Banks*, April 2005.

<sup>8</sup> Moreover, this information is also within the *Surveillance Norms for Compliance*, Bank of Italy, August 2006: "It is part of the Compliance function ... collaboration in training staff in order to avoid the risk of non conformity through knowledge of those regulations that are applicable to activities carried out to favour the spread of the company culture based on honesty, correctness and respect for and abiding to the laws".

<sup>9</sup> This point of view is highlighted by E. Kane. He describes the regulation-innovation-re-regulation dialectic, in the context by which the legislation instead of carrying out a braking action, has a propulsive one for a financial innovative process that is "elusive", in other words, that "dodges" the rules of the

game. See: E. Kane, "Policy Implication of structural Change in Financial Markets", in *American Economic Review*, May, 1983.

<sup>10</sup> In the *Normativa di vigilanza in materia di conformità alle norme (compliance)*, Banca d'Italia, August 2006 this is what is written on the subject: "Another key area, where the compliance function is to build an important reference point for the top organs is the verification of coherence of the awarding system (staff retribution and incentives in particular) with the aim of respecting the laws, the statute, and possible ethical codes or other standards of conduct that apply to banks".