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Legacy Main Street Solution Proposed for Wall Street

Allan D. Grody and Timothy P. Smucker May 17, 2011

As required by the Dodd-Frank legislation, the US Treasury established the Office of Financial Research (OFR). This organization is focused on regulating financial infrastructure and imposing identification systems on corporations. The OFR must choose its approach by mid-July, so it’s about time to start figuring out how new regulations could affect your company.

Fixing the Identification Plumbing before the Next Financial Tsunami

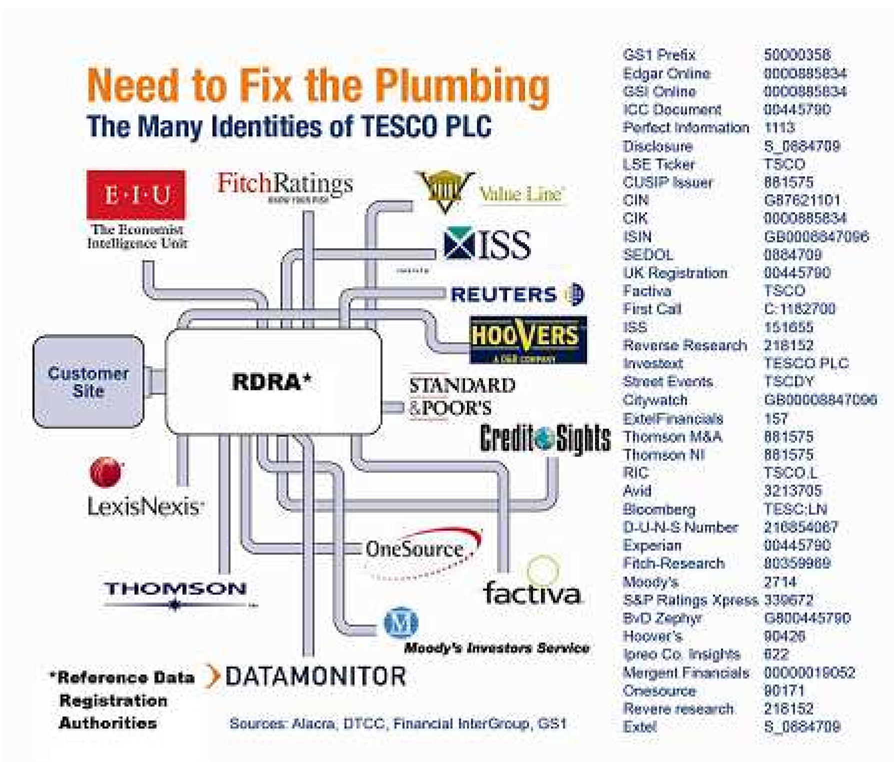
A little known, almost obscure provision in the Dodd-Frank legislation, the establishment of the Office of Financial Research (OFR) under the US Treasury is set to impose yet another identification system on corporations. Although many corporate executives might think it is just a financial institution’s issue, the OFR is set to have a profound effect on all businesses that originate and otherwise participate in financial markets.

After weathering the 2008 global financial crisis, many corporate CEOs realized that preventing another financial meltdown is as much their challenge as Wall Street’s. In this past crisis, corporations’ shareholders were disenfranchised, businesses couldn’t get loans from banks, public companies were neither able to raise capital nor issue commercial paper, and business users of hedging markets were asked to put up huge amounts of additional collateral or cash margin.

What became clear during and after the Lehman collapse, is that regulators had no way to assess overall financial system or counterparty risk. There was no universal identification system for the financial services industry and hence no overall visibility of financial participants and products.

This is quite amazing when you consider the information age we are in, the vast sums of money on the table and the fact that other global industries like retail, food, consumer, healthcare and manufacturing have been using unique manufacturer and product identifiers in barcodes for years.

Corporations are already familiar with obtaining multiple identifiers for listing its shares or contracts in the financial markets they trade in and having multiple tax identification numbers in all the tax jurisdictions of their business. But beyond this, unseen by a public company, is literally dozens of other identifiers within the infrastructure of the financial system. The constant mapping and matching failures caused by such multiple identifiers cascades into integration, aggregation and payment problems. Ultimately it manifests itself as higher risks and a lack of transparency. (See a partial list of identifiers for a single company below.)



Regulators are now focused on this core infrastructure problem. Their goal this time around is to establish a one-stop-shop identification system – a universal, unique, unambiguous structure that works for everyone, one that is being referred to as the legal entity identifier (LEI) by regulators. The LEI is a foundational aspect of the Dodd-Frank regulatory reform legislation. Standardized LEIs will allow regulators to gain visibility so they can aggregate risk information and monitor the contagion of systemic risk effectively, before the next global financial crisis occurs. Ancillary, but important benefits to financial industry members is the ability to reduce significant IT infrastructure costs and to be able to effectively monitor their own enterprise's risk. The universal benefit is transparency in financial dealings for all who participate in financial markets.

Supporting the LEI requirement is the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Commodity Futures Trading Commission (CFTC), the

Federal Deposit Insurance Corporation (FDIC), the Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC), and the US Treasury. They have developed guidelines detailing the best way the industry might create, develop, and maintain a global identification system for businesses participating in the financial markets. Globally regulators are also engaged and all are being encouraged to embrace the same global identification standard.

There are a few approaches to assigning an LEI. One suggested in the legislation itself and supported by industry trade associations is self-registration whereby corporations and others who participate in financial markets assign their own company identifiers under assignment rules administered by a global standards registration authority. This procedure resembles the process used in industries such as food, healthcare and consumer packaged goods, whereby manufacturers self-register their products and locations under a standard system administered by a global standards body, GS1.

Two million company identifiers and forty million unique, unambiguous and universal product codes now exist in the trade supply chain administered by GS1 under a similar self-registration model whereby local countries and corporations assume responsibility for identifying products at their origination. GS1, informed by a global alliance of financial market participants, is interested in doing the same in the financial supply chain. And it has both the framework in place and both the experience and understanding of how to implement this rather quickly, not the years anticipated by others.

Besides meeting the OFR's prerequisites of being an International Standards Organization (ISO) and an Internationally Recognized Standards-setting Body (IRSB), GS1 is a neutral not-for-profit, private member driven global federation of 1.5 million member companies. Overseeing standards and their global administration is all GS1 does. It is the largest global standards setter in the world – it has an established and accepted governance structure and implementation framework that works in both private and private-public business models in 150 countries. It has been in this business for 40 years and operates in 25 global industry sectors. GS1 wants to offer its best practices from the retail, healthcare, and consumer packaged goods industries and, in partnership with the financial industry, apply it to financial services.

There is a short runway left in which to discuss this issue and for the industry and regulators to reach a consensus on the best approach. Whatever the approach the OFR chooses for the global identification system – its timeline for a decision is mid-July – it's going to have significant ramifications for all financial market participants. And until some kind of approach is approved and implemented, we are still vulnerable. While financial institutions' profits may have returned to pre-crisis levels, the financial system is conceivably only one Lehman-like collapse away from another global crisis.

For the banks, it should be viewed as an opportunity to rebuild their trust with Main Street and with corporate America. The global identification system is going to be imposed regardless of whether the industry wants it or not.

And it's also in the interests of all corporations to play an active role in determining the best path forward, to not only reduce their company's own risk but also in preventing another financial crisis.

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