

Leveraging Technology to Ensure Compliance and Operational Excellence

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At Finnovative Inc., our strategic consulting efforts allow us to assist many firms of different profiles and sizes that share many of the same business headaches that arise in the industry. In an effort to assist our clients and others, we have instituted the Finnovative Knowledge Series as a method for sharing our insights into many of the hot-button topics facing firms in the investment management industry.

In a recent Webinar, we detailed recommendations for leveraging technology to ensure compliance and operational excellence. We began with a broad examination of the many pressures an investment management firm faces in today's business environment. We detailed both the internal and external forces that impact a firm's decision to allocate capital to address operations and technology issues, and provided insight into best practices. We thought it important to share these ideas.

Investment management firms today face an increasingly complex mix of internal and external pressures on their bottom line profitability. Impacts of globalization and competition bring firms to face rapidly developing issues related to the dictates of their clients, their regulators, and their management control structure.

Each one of these external drivers may have an immediate and serious impact on one or more business units, including operations, sales & marketing, portfolio management & research, finance, legal, human resources and information technology.

Pragmatism tells us that most firms are in a position to deal with external agents of change only reactively: that is, issues beyond our control must be addressed in concert with the rest of the industry. Simply put, staying in line with industry practices is a cost of doing business. On the other hand, firms can certainly manage the internal pressures that affect their bottom line. The key to doing so is through the execution of best practices that have the mandate and visible support of the firm's leadership.

Consider the internal needs of a typical investment firm's business units:

- The CFO is looking to increase operating margins and productivity to support change, growth, and customer service.
- The Chief Compliance Officer dictates an ever vigilant approach to risk management, regulatory, and customer-driven adherence with business rules and securities regulations, maintenance of a viable audit trail, and frequent employee training.
- Traders demand better execution quality, more access to liquidity via algorithmic trading platforms, dark pools, and faster trading systems.

- Research teams constantly seek access to larger amounts of market and reference data, more sophisticated modeling tools, more comprehensive analytics and reporting tools, and an ever increasing universe of coverage.

All of the above are achievable. But at what cost and how?

Our extensive experience with clients has taught us that for leveraging technology to ensure compliance and operational excellence, employ the following Five Best Practices:

1. Take an integrated approach

The reality of today's business environment is driven by the evolution of technology and the globalization of world markets and economic competition. These external realities drive an internal model in which key operating areas highly interdependent on each other.

Any technology, process, or operational initiative a firm undertakes to improve an area is sure to have some impact on other units upstream or downstream; therefore, taking an integrated approach for key initiatives is critical to achieving cost effective efficiency gains. Consider for example, if an investment firm looks to revamp its client reporting processes, it cannot ignore the portfolio accounting system and other data sources that feed into this reporting process.

From our experience, investment management firm staffs, including relatively smaller firms, tend to work in their own silos. During our engagements with them, we have found ourselves to be the "glue" between these groups. We take on the role of 'honest-broker' and work to break down the "walls". As we make communication/information sharing more open, business groups begin to more fully appreciate each other and the pain points each faces. This creates a very supportive environment within which new initiatives can be approached more productively.

Practical take-away: When starting a new major initiative, look at data, compliance, risks, technology, resistance, and costs for all impacted areas. We have seen too many cases when some of these key components were ignored and as a result projects have either not been completed or not been successful.

2. Identify the right technology

Do not take a "time-freeze" approach. Always anticipate future changes to the business model and scalability. This is not simple to do as technology and business requirements change each day – what an understatement now! But an approach that begins with foresight of anticipating change is one that will prove more successful. To do this, firms must be aware of what is likely to change within their basic business model and how today's potential solutions can expand to solve tomorrow's projected problems. We have seen a number of firms shut themselves out from changes because they chose a solution that works well only for today's problems instead of anticipating how to improve today's processes AND choose a solution that is positioned to support new processes required to remain competitive.

Practical take-away: by taking a time-freeze approach, you are likely to end up with an inadequate solution; you need to look at the projected key changes in business direction, to effectively evaluate all the solutions.

Here's an example of a client engagement we've undertaken that highlights this approach:

A \$1 billion AUM firm faced with selecting a new portfolio accounting platform approached us seeking advice on an appropriate solution. Their challenge was to identify a solution that would reduce processing risk and improve efficiency. They were focused on solving an immediate pain point and had not considered the value of long term product scalability.

We drove a discussion of internal process interdependencies and focused the client on future projections and business drivers to better understand how the initiative would impact the enterprise.

The solution: We undertook an independent study of solutions in the marketplace and recommended one that was a mix of outsourced and owned models. This model offered the flexibility of addressing today's issues cost effectively while positioning the process for future scalability.

By selecting the "right mix" of technology, the firm was not only able to forego hiring more internal resources to eliminate reporting errors but also set itself up for changes in business direction and for expected growth. Finding the optimum solution also allowed the client to "go live" sooner rather than later.

3. Time your decisions optimally

As with just about every aspect of business, timing is everything. It creates a perception that is largely based on the unpredictable reality of the larger market. In New York, buying an umbrella on a sunny day may seem silly until you realize that street vendors raise their prices for umbrellas by 40% on rainy days. Getting out of mortgage backed securities in 2006 makes one look very prescient today.

While a firm can place great emphasis on its decision-making processes, the biggest unknown intangible to any technology investment is timing your decision to commit to a purchase. In an industry as dynamic as investment management, products and services come to market with great frequency.

Finding the one that best suits your needs for immediate impact and long term cost efficiency can take time. But indecision generally proves more costly.

When the firm has determined the optimum solution, it must move forward on the acquisition before inertia can impede the process. Delays in acquisition and deployment inevitably lead to prolonged inefficiencies, re-work, and a general drain on resources. The sooner a technology solution can be implemented the sooner a firm will realize operational efficiencies and begin to enjoy long term returns on their investment.

Practical take-away: Always look to make your own opportunities. The media that cover our industry inundate us with articles about imminent decline in technology expenditures by investment management firms. A probable statement for sure, but what better purchasing environment could a firm seek – one in which vendors are starved for business and willing to cut fees substantially to sustain themselves. We call it 'buy-time for the buy-side'.

4. Decide to buy or outsource

This is really an exercise in the cost benefit analysis of a given business function. Our industry has shifted dramatically in the past decade to a philosophy of outsourcing non-core functions to service providers who can perform these tasks efficiently. The commoditization of middle and back office services is having a profound impact on the basic model of investment management firms. We see today that the typical small start-up firm, within just a few years of operation, will be faced with a decision to support continued growth by outsourcing functionality or by increasing head count and expanding the technology platform. This is a trend which we believe to be irreversible.

All participants in this industry must understand their own firms will eventually face such a decision. The decision itself is fraught with a very simple risk. Outsourcing by its nature involves a voluntary ceding of control over a firm's business functions to an outside service provider. The risk that the service provider will fail to meet performance expectations can directly threaten a firm's relationship with its clients and regulators. To protect itself from such threats a firm must approach the decision to outsource in a very methodical manner.

A firm must first decide if an outsourcing decision will result in staff changes/reductions and how such will be handled. Significant fact finding and reference checking must be made of any prospective partner service providers. The expectations of both firms must be clearly understood and agreed upon in documented service level agreements. Consideration should be given to incentives and disincentives as a method of ensuring service levels. Finally, a plan for unwinding an outsourcing arrangement in a controlled manner must be detailed before entering into any contractual agreements. Prudent risk management means that a firm needs to know how quickly it can get out of a decision that may have gone wrong no matter how well intentioned both sides were at the outset.

Practical take-way: Outsourcing does not imply an elimination of risk. Outsourcing implies managing risk through an optimal mix of skills and resources. Buying requires a large initial capital outlay and rigid cost structure but provides you with total control. Outsourcing will yield some control to partners but provides flexibility in cost management. Focusing on core competency and cost justification will guide the decision making process here.

5. Facilitate the implementation

The implementation of best practices will succeed only if the firm's leadership takes an active role in supporting them. While this may be the simplest best practice to explain, it is often the toughest practice to adhere. A firm's leadership has many varied responsibilities and demands on its time. However, the fairly uncomplicated process of communicating, demonstrating, and reiterating the idea that the firm will approach its leveraging of technology in a disciplined manner will create an environment of collaboration throughout the enterprise; be it a ten person firm or a firm of several hundred. As has been said before, a few minutes of time or a few words of explanation can go a long way to achieving success.

Practical take-away: While undertaking a new project, involve all stakeholders AND affected staff members early on. Seek their inputs, explain the potential benefits, and create a sense of ownership. Involvement from financial sponsors, operations staff, technology, and compliance staff is essential for a successful buy-in of a new initiative.

To learn more about our experience with clients who have implemented these best practices, please call us at 650-393-5666 ext 107 or email thall@finnovative.net. Finnovative specializes in helping you with our expert level knowledge in buy-side technology, operations, and compliance issues.