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2.1 INTERVIEW

Using technology for multi-jurisdictional regulatory compliance

Interviewer

David Grana,
Head of North American Media,
Clear Path Analysis

Interviewee

Lisa Shea,
Senior Product Manager,
Northern Trust

SUMMARY

- *Regulation is impacting various fund products globally*
- *Large asset managers are impacted by global regulations because they operate in multiple jurisdictions, in multiple fund wrappers, and in multiple products all around the world*
- *There is an increasing trend for asset managers to look towards their service providers for support in managing regulations*
- *The larger you become as an asset manager, the less likely it will be that you will have the ability to manage data and report to regulators without an efficient technology solution*

David Grana: What are some of the more recent regulatory changes in the financial sector that we've seen around the globe?

Lisa Shea: My particular area of focus is the U.S. market, and we have certainly seen a lot of global regulation and like-spirited regulations in different jurisdictions that are impacting various fund products around the globe.

In the U.S., what we have seen over the past couple of years is a move towards transparency. In particular, two of the most significant developments for registered mutual funds in the U.S. are Form N-PORT and Form N-CEN, which are part of the financial reporting modernization that the Securities and Exchange Commission (SEC) undertook. This was done with the objective to provide additional information to the regulators and the investors in the marketplace about the products in which they invest.

David: How common is it for financial services firms to have to comply with regulations across multiple jurisdictions?

Lisa: It is very common. When asset managers look at their distribution models, they are very likely to repackage their strategies into different wrappers for the jurisdictions where they want to sell their products. It is not uncommon to see a global asset manager with a similar strategy in a UCITS structure and a US 40 Act fund structure at the same time. You might see the same strategy in some form of private fund, like a collective investment trust or a limited partnership.

You do see large asset managers being impacted by global regulations because they operate in multiple jurisdictions, in multiple fund wrappers, and in multiple products all around the world. It is, therefore, very common for an asset manager to have to navigate this global regulatory landscape and understand the similarities and the differences of the rules that are impacting the products being managed.

David: Traditionally, how have financial services firms addressed this challenge?

Lisa: There is an increasing trend for asset managers to look towards their service providers for support in managing regulations. Not only from a knowledge and knowledge-share perspective, but also from a technological point of view.

The trend around the globe is to collect more and more data and information. This leads to an increasing need to bring all of it together, align it, and ensure that it is accurate, timely, and packaged appropriately for submission to the regulatory authorities.

> THERE IS AN INCREASING TREND FOR ASSET MANAGERS TO LOOK TOWARDS THEIR SERVICE PROVIDERS FOR SUPPORT IN MANAGING REGULATIONS

What we have is a convergence of the requirement to know the rules and understand the regulations, as well as to be able to translate the data into the right format for consumption by the regulators. There is a true convergence of regulatory expertise with data and technology savvy to be able to meet the necessary requirements.

David: How much energy and time is required to be able to meet these requirements without using high-end technology? And does this require a lot of human resource and capital in order to make it happen?

Lisa: If we use Form N_PORT as an example, extensive information about a fund portfolio must be documented and funds are required to prepare the form on a monthly basis. Up to this point, it has been a requirement that the form be added to the books and records for the funds. But coming up in April of 2019, it will be a requirement that it be filed with the SEC.

In larger fund families, there is a tight timeline to prepare month-end information and put it into the Form N-Port for completion. There is a 30-day window for this process, with reporting for each month end due 30 days following. For a large fund family with, say 45 funds, the amount of human capital that it takes to compile, validate and prepare that information in time to turn it around for regulatory filing is extensive. The larger you become as an asset manager, the less likely it will be that you will have the ability to do this without an efficient technology solution.

David: How onerous can non-compliance be for firms?

Lisa: Depending on which rule you are referencing, there could be fines, penalties and significant impacts for non-compliance.

David: How is technology helping to simplify this challenge?

Lisa: Having data in a format that is easy to extract and deliver is crucial, making the processes much more efficient and effective.

The data that sits underneath an asset manager's portfolio is needed for multiple purposes, such as for regulatory filings, activity monitoring, investor reporting and projections, and analysis. Having this data in a central location, with the ability to extract it, reformat it, and reuse it is a big step toward meeting your obligations.

The next piece to this is where you marry the human input with the data to understand what you are looking for, what you are trying to extract, and how you align the information that you have with the information that you need.

David: How have regulatory bodies embraced technology as a means of simplifying their processes?

Lisa: We have seen an increasing trend with regulators using technology not only to receive data, but to conduct analysis on it as well. The SEC has just finalized and released their 5-year strategic plan, and. one of their strategic imperatives is that they will be looking to use technology to analyze the data that they collect. They are committed to using technology to analyze this data across the industry and identify potential risk points. They are trying to understand the make-up of what is going on in the markets so that they can pinpoint areas of potential interest or potential risk. All of this goes towards their objective of protecting investors and mitigating risk in the markets.

David: What are some of the challenges with implementing high-tech solutions to existing methods of dealing with compliance?

Lisa: This is an environment where there is continued pressure to reduce the fees that the end investor is paying for a product, and the cost of compliance is a challenge. We have increasing costs to license or build software, where necessary, and to have the intellectual capital and talent to manage the data. All of these areas factor into overall costs. One of the things that regulators in the U.S. do within any rule proposal is have a cost-impact analysis. This shows what the costs of compliance are expected to be, which is then factored into the decision-making process.

Another challenge is bringing together two skillsets and pieces of knowledge. Historically, having compliance expertise was not a technical skill. You simply focused on the interpretations of the laws and rules. Whereas now, we have to marry that with operational and technology skills in order to be able to manage the data, process it, and prepare forms. Finding someone with the combined skills to bridge these two pieces is a real need in today's marketplace.

David: How cost-friendly are these technologies?

Lisa: The costs are going to vary, but you have to factor in all of the pieces that I mentioned. You need both the knowledge and the tools. The first decision you have to make is whether you are going to build or buy, and what the costs are for each solution. You then have to look at what your solution is. Will it be reliance on a service provider who is going to bring the right expertise, and can do so in a scalable way, or do you build it in-house and hire the right subject matter experts internally? You will see different approaches across the industry, depending on the size of the asset manager and their staff.

We have seen an increased move towards outsourcing functions, allowing managers to focus on the business of managing money. It allows them to partner with experts in the industry who can help them manage the data, and assist in the navigation of the regulatory compliance process effectively.

“WE HAVE SEEN AN INCREASED MOVE TOWARDS OUTSOURCING FUNCTIONS, ALLOWING MANAGERS TO FOCUS ON THE BUSINESS OF MANAGING MONEY”

David: Is this a one-platform or one-provider solution, or can you use multiple solutions and providers to make this happen?

Lisa: What we have seen is an increasing need to marry together a fund's investor data and investor-specific information with their portfolio data. These two pieces of information do not typically exist within the same system. This is where you can leverage service providers to bring this information together for you. The ability to synthesize the data, package it, and send it out the door is something that an outside provider can help you to manage.

David: Do you have any final thoughts on this topic?

Lisa: When you consider companies with a global footprint, another benefit that a service provider may offer is that they have the ability to align, compare, and contrast the rules and regulations to understand the points of intersection and the points of divergence. The ability to bring these together is very important because it helps us to more effectively communicate with our clients to help them understand how to find the efficiency in their processes and put together a package that is conscious of the globe, but locally compliant.

David: Thank you for sharing your thoughts on this subject.

3.3 INTERVIEW

The benefits and drawbacks of buying versus building versus outsourcing

Interviewer

David Grana,
Head of North American Media, Clear Path Analysis

Interviewees

Paul Williams,
North American Head of IOO Product and Strategy, Northern Trust

Marc Mallett,
SVP, Director of Strategy, Americas-Asset Servicing, Northern Trust

SUMMARY

- *The three main themes in business process evaluation are: consolidation, simplification, and outsourcing.*
- *By outsourcing, a firm is obtaining an increase in expertise, skill, capabilities and, most significantly, agility*
- *Firms should assess if a particular process or function is a source of competitive differentiation*
- *Robotics and automation are most commonly employed today as tools to remove latency and reduce operational risk*
- *An outsource provider is going to have a greater economy of scale to deliver robust solutions at a fair price*

David Grana: What are the key factors financial services firms should consider when evaluating whether a business processing requirement can best be addressed by buying, building or outsourcing?

Paul Williams: It starts with understanding the business problem at hand and how the desired outcome sits in the context of the business' strategy. Keeping this perspective can be helpful in determining what the right solution is going to be.

The decision to build is typically driven by one of two conditions being present: either there is no existing solution available that meets the need, or the business wants to retain the maximum amount of control over the technological solution. In either one of these cases, there is a premium on having that top shelf expertise, and this usually comes at a premium cost. The business case behind the build decision has to take into consideration that value proposition; not just to build, but to sustain it over time.

The decision to buy is notionally more straightforward as a matter of integration, training and support. It is generally not going to have a transformational effect on a business; it is more of a tool to deliver a specific outcome. Purchased technology also has the benefit of having a higher likelihood that there is an established user community to lean on and the associated market availability of personnel who may already be well trained in the platform. However, pre-packaged solutions are limited in flexibility and agility, and may not address the strategic growth needs of the business.

Outsourcing decisions are inherently transformational to a business. It is about moving functions away from what is being performed in-house, with an inevitable effect on people, process, and technology. These decisions can be very effective if they are done in alignment with the business strategy, and are a powerful way for the businesses to execute their own strategies. By outsourcing, a firm is obtaining an increase in expertise, skill, capabilities and, most significantly, agility.

A firm's growth strategy can include things such as new facilities, equipment, technology, and personnel, all of which can require significant capital outlays. In the context of an investment management shop, these are traditionally fixed costs against a variable, returns-driven revenue model. Outsourcing provides a more unitized cost structure that is better aligned to revenues, increasing cost control. Outsourcing also provides a manager with the immediate capability to offer new products and asset classes with operational experience and capabilities at hand.

> “OUTSOURCING DECISIONS ARE INHERENTLY TRANSFORMATIONAL TO A BUSINESS”

The larger, broad-based financial services providers can deliver additional benefit to outsourcing clients by connecting them with expertise in related services on a cross-sell or ad-hoc advisory basis.

David: Are there types of costs where they are more pay as you go and are based more on usage rather than a fixed fee, especially with outsourcing?

Paul: That is a common commercial structure in an outsourcing deal – and also a compelling attraction. It is about controlling your costs and matching the trajectory of your costs more tightly to that of your revenues.

Marc Mallett: When a firm is doing an assessment of these three options, I would typically ask them a series of questions. One is whether a particular process or function is a source of competitive differentiation. Is it something they feel that if they did it well, would actually allow them to outperform their competitors?

A follow-up would be whether they can afford to be a market leader in this process or function. They may well believe that it provides a level of competitive differentiation, but they may not be able to afford to deliver a solution that is better than what their competitors or the market-at-large can do.

I would also find out what the opportunity cost is in addressing this particular process or function. It is very much like a decision tree. When determining whether to build or buy, you have to look internally to determine whether you have the human capital and real capital to put towards something like this in order to become a market leader.

This is where the turn towards outsourcing typically shows its value. You can lean on someone who is already a market leader in a particular function or process. This allows you to invest your capital in areas where you feel you can truly differentiate yourself.

David: How are financial services firms tackling the technology issue to ensure that systems are talking to one another, that there is not duplicity, and that they are not running on too many systems that are difficult to manage?

Marc: There are three themes that we see firms looking at: consolidation, simplification, and outsourcing. Some of this does depend on where firms are in their growth lifecycle, and how they have gotten there.

If you take a firm that has grown through acquisition – by acquiring different capabilities in different parts of the world - in all likelihood, these acquisitions came with people, processes, and technology. And they are likely disparate, with different systems running on different operating models in various parts of the world. One of the first things that needs to be done is to look across those acquisitions to find areas to consolidate and simplify from a people, process, and technology perspective.

Rather than building or buying multiple solutions for different product lines and geographies, a firm can hone in to find where they can create leverage and simplification. For international companies, rather than trying to develop their own global operating model, they can lean on outsourcing providers who already have a global presence and infrastructure. This means that they can start to take a look at the areas where there may be specific requirements that they may not want to have to deal with in-house.

Again, it all comes back to finding where you can consolidate, simplify, and outsource to gain as much leverage as possible as you continue to grow your business.

Paul: There is some tension in the financial service market at the moment. Firms and stakeholders are leaning away from the traditional model in which everyone houses their own data, even if it is the same data. This model requires constant reconciliation from system to system to ensure that data sets match. In this model, all parties tacitly agree to bear the reconciliation cost burden.

There are several firms looking at ways to establish a kind of middle ground, where a single entity acts as the source of shared common data. In principle this does away with the need to reconcile altogether. This is similar to the principle in a blockchain solution but it does not necessarily require a blockchain architecture.

Obviously, there are legacy systems with connectivity and processes that have to be considered for this to become a reality. There is tremendous inertia to overcome, but this is certainly a theme that we are seeing more broadly in the market.

An important, and somewhat understated, consideration in this paradigm to achieve a single hosted view of data is around the security and safe keeping of a firm's "precious data", which is considered a real asset to the firm. The increasingly public profile of cyberattacks and ransomware puts a heavier emphasis on every firm's controls to ensure that their data is safe.

David: What role are AI, robotics and automation playing as financial services firms endeavour to modernize their technology platforms? What do companies need to consider when deciding to buy, build, or outsource AI and automation?

Paul: Robotics and automation are most commonly employed today as tools to remove latency and reduce operational risk. We all agree on what needs to be done; it is about how to do it as quickly, efficiently, and with the highest quality possible.

Operational processing is a good example. Technology has been steadily put to use to automate more and more market operations, and I expect that this will continue to be the case as robotics and other technologies continue to advance.

In this context, whether a firm should adapt automation or robotics is more of a straightforward, cost benefit exercise. However it is important to remember that automation, for its own sake, is not the answer.

Firms may be enamoured at the prospect of implementing robotic processing and automation, but may not fully understand the costs to implement and sustain it.

When we start talking about machine learning and AI, this opens a new and exciting front beyond the traditional de-risking and streamlining of rigorous processes. This is where you start to have technological tools that allow you to deal with the expanding universe of data to give yourself new and actionable insights.

For instance, a firm might have a sporadic and seemingly random issue and they don't really understand what the cause is. By the time anyone gets around to digging into it, there are new fires to fight.

The new generation of big data and machine learning is giving operations management the ability to look at massive universes of data and identify possible correlations that can then be investigated on a much more targeted basis. The prospect of being able to find the needle in the haystack can be a very compelling consideration for an operations manager, because they know the very real costs of these issues. However, they lack the ability or the tools to find the cause and take action to resolve it.

Marc: As an industry, we are bringing to bear a lot of compelling new tools around AI, robotics and machine learning. But what many firms haven't yet resolved is identifying good quality data upon which to apply these new technologies.

Ensuring you have good quality data, consistency, and timeliness is vital to ensure that firms aren't automating on the back of incorrect or stale data. If you don't ensure that the data is of high quality you could automate yourself into an error, which erodes internal and external confidence in new technology solutions.

David: As investment in more complex assets, such as private assets, continues to grow, and financial services companies must collect, process and report information that is simply not pulled from an exchange, are new systems able to address this growing trend? What is the best solution (buy, build, outsource) to managing information for these asset classes?

Marc: Outsourcing for all firms, in particular mid-size firms, who are looking to launch or extend their line-up of alternative assets, is likely to be the best option.

It can be very costly and challenging to identify and hire the necessary human capital to design, build, and implement most technology solutions. This also comes with a pretty significant lead time. Bringing in the right people to determine what the best options are is, in all likelihood, going to take longer than your investment teams and clients will want to wait in order to get these new products to market.

Outsource providers are having to address the need for scale, better data collection, automation, and quality control of that data for many clients. For firms who are looking to get into this space, leaning on a service provider is going to deliver the best time to market and, ultimately, the best outcome.

David: How would you suggest financial services firms best support their efforts to remain competitive through new client acquisition or delving into new products?

Marc: It is not enough to just deliver investment performance and product diversity. Firms are getting into new and more complex asset classes, based on the demands from their clients and the market at large.

What they have to consider is whether they have the human capital, knowledge, and experience to do this in a timely fashion. This is where outsourcing can play a role in accelerating time to market, and improving the outcome from a near and long-term perspective.

Paul mentioned the point of having a more predictable view on costs on an ongoing basis so that you can right size what you are comfortable spending in a new product area, rather than having to make massive capital investments to bring in people and technology. If you can engage with a partner who has made these investments already, you can, in all likelihood, get to market putting far less capital to work.

David: Regulatory and compliance requirements continue to become more complex and costly, are financial services firms better served by keeping these systems and processes in-house or working with a service provider?

Marc: There are a number of compelling reasons that support the decision by a growing number of financial service firms to outsource more of their regulatory and compliance functions.

Outsource firms are addressing these issues for their clients already and these are not services or capabilities that are necessarily going to add value to a firm's end clients. After all, firms have limited real and human capital and have to make decisions on where best to deploy them. Scale really starts to happen for firms who have over $500 billion dollars in assets under management. For anyone below that, they have the same regulatory burdens as their much larger peers, but their pockets aren't as deep. Being able to lean on service providers who are operating in all of these jurisdictions today and have put the investment into people, processes, and technology makes much more sense than trying to tackle it on their own.

Paul: An investment management firm may or may not have what I call a "high delta strategic growth plan". But every firm in this space is facing a high delta regulatory landscape. The buy and build solutions are going to be inherently challenged to keep pace - firms who go down this path can discover higher than expected costs in updating and revising those in-house technological solutions. An outsource provider owns this burden and is going to have a greater economy scale to deliver these robust solutions at a fair price.

David: Thank you for sharing your thoughts on this topic.

> "THERE ARE A NUMBER OF COMPELLING REASONS THAT SUPPORT THE DECISION BY A GROWING NUMBER OF FINANCIAL SERVICE FIRMS TO OUTSOURCE MORE OF THEIR REGULATORY AND COMPLIANCE FUNCTIONS"

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