

Compliance, like risk management, has traditionally been seen by buy-side firms as a somewhat onerous business process that at times curtails their portfolio managers' ability to generate returns. But this scenario has changed markedly over the past two years to the point that now investment managers see their compliance procedures as a way of winning new mandates. By **Victor Anderson**

From a compliance perspective, buy-side firms have to cope with something of a triple whammy: internally driven procedures of checks and balances for the fund's own staff; regulatory processes that must be negotiated and satisfied in order to appease regulatory bodies; and increasingly demanding investors, many of whom have different – and often pedantic – requirements. Of the three constituents, however, it's the investors who have the ability to literally transform buy-side firms' fortunes overnight through the award of new mandates, which, when one considers how tough the operating environment has become in the past 12 months as a result of shrinking asset bases brought about by poor performance and investor redemptions – is a pretty compelling driver.

Darren Johnson, head of investment operations and IT at Impax Asset Management, explains that for an industry that has seen its fair share of change as a consequence of the global recession, successfully addressing investors' compliance demands is an indirect (but effective) way of furthering the business. "Before we implemented Linedata

Compliance we had a compliance officer but we were pretty much paper-based and we only conducted post-trade compliance, and for us to win new mandates – especially out of the US – any RFP [request for proposal] that we filled out wanted to know about our compliance systems and our procedures," Johnson explains. "It gives us added credibility to have a good compliance system and it's certainly helped us win two significant mandates for the business."

Johnson's sentiments are closely echoed by those of Jeff Ng, vice-president at \$430 billion New York-based institutional asset manager Alliance Bernstein, a long-term LatentZero client having deployed the London-based vendor's compliance platform Sentinel back in 2002 to support its entire business – fixed income, equities, hedge funds, and commingled products. According to Ng, Alliance Bernstein's institutional clients are now far more likely to request the attendance of compliance personnel during on-site visits than they were a few years ago, a trend he attributes to the growing need for investors – not only institutional investors

but private investors too – to understand how their money is being managed and whether their compliance mandates are being met, and if so, how they are being monitored. "The trend is for institutional clients to be much more cognizant of their fund managers' compliance requirements," Ng explains. "Most of Alliance Bernstein's institutional clients



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are visited throughout the year, but often they also come to New York to see various groups – portfolio management and research for example – but now more often than not they ask for compliance to be part of the group they visit. More and more clients are making it a regular practice to understand how their assets are being compliance tested."

Historically speaking

Johnson's description of Impax's compliance procedures as "paper-

based" and "conducted only on a post-trade basis" prior to the Linedata Compliance implementation can be considered a proxy for a large number of buy-side firms reluctant to even contemplate costly and time-consuming implementations to support their compliance activities. This is the view of Bob Proctor, product manager for Linedata Compliance, who feels that, given the ongoing upheaval in the global financial services industry with corporate failures and bailouts, fraud, and



Salient points

- Investors exert significant influence on buy-side firms in their adoption of better compliance procedures and technologies
- Money managers are using their compliance infrastructures as a marketing tool to attract new capital, especially from institutional investors
- There is a marked trickle down effect from traditional investment managers to hedge funds when it comes to compliance systems and processes

a general lack of transparency, things simply have to change. "Historically a lot of the smaller shops and even some medium-sized firms have done compliance on Excel," Proctor says. "But the problem is that Excel represents a huge operational risk – it lacks the necessary checks and balances, doesn't ensure proper investor protection, and doesn't provide any kind of an audit trail to prove that the correct steps were taken."

Robin Strong, director of market strategy at Fidessa LatentZero, goes a step further than Proctor by suggesting that buy-side firms use their compliance processes and underlying technology as a marketing tool through which they not only allay prospective client fears, but also provide an additional incentive for the award of new mandates. "Some of the discussions I've had with clients since joining Fidessa LatentZero is that they are actually using the fact that they have strong compliance processes when they pitch for new business, even showing reports from Sentinel to prospective customers," Strong says.

Strong describes a scenario across the buy side where performance is no longer the be all and end all of investor focus, and is therefore not the sole consideration when awarding mandates – clearly performance is important, but in recent times that fixation has been tempered by demand for greater transparency into compli-

ance procedures and risk exposure. "In the old days, it was all about returns and fund performance, often at the expense of complete risk assessment, and this was one of the reasons why so many institutions invested in hedge funds," he says. "Now that investors are more sophisticated they require demonstrable business control."

Strong explains that it's not only traditional investment managers showing greater levels of interest in shoring up their compliance procedures and the underlying technology that allows them to automate a significant number of processes that fall under the compliance umbrella. "We signed one of the largest hedge funds in the UK market last year," he continues. "In addition to their hedge funds, they also run long-only portfolios with a mandatory requirement for compliance. That's where a compliance tool is not just about meeting the demands of various regulations – it must also deal with the exposures created by a diverse instrument base. We can process those exposures and net them off in various ways so that we can genuinely manage exposures in a way that is unique in the market."

Additional challenges

investor fears and landing new mandates on the back of tight compliance controls, it would be naive to assume that these are the only challenges facing buy-side compliance officers, as Ng explains: "The biggest challenges come about when innovation takes place in the marketplace," he says. "For example, a decade ago maybe a couple of hedge funds traded CDSs [credit default swaps] with some of the big investment banks – CDSs weren't mainstream yet, and twenty years ago there was nothing such as structured products. As new products are introduced to the market they place pressure on the technology vendors to build better analytics to support those instruments. Once you start doing any of the things that make trading more complex – trading interest rate swaps, currency hedging, basically anything involving derivatives – this leads to a tremendous amount of complexity when it comes to compliance."

This introduction of new instruments to the market is what keeps Ng up at night, especially when it comes to Alliance Bernstein's underlying technology and whether it has sufficient flexibility and extensibility to handle those products from a data perspective.

"More clients are now having their rules customised for their own specific concerns," Ng explains. "For example, in fixed income before the world went crazy and we had this credit implosion, clients would rarely ask if their structured product investments included sub-prime loans. Prior to the last two years, we never had questions like that, but in the last two years we've had more than a handful of clients asking those questions. Two things have happened in recent years: clients want more evidence about how their compliance is being handled; and their rules or constraints have become much more specific and complex." >

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