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# The globalization of oversight: a new standard

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**Across the globe, financial regulators are looking to institute policies designed to protect the best interests of investors. While some are certainly more vigorous in their reform efforts than others, the underlying message is the same – no one wants a repeat market disruption of similar magnitude to the 2008 financial crisis. Controls were immediately focused on crisis prevention specific to the liquidity failures that occurred, but over time the radar and scope of scrutiny has naturally broadened and progressed to review the operational inadequacies that allowed for such failure. The year 2013 saw substantial activity geared toward tightening controls surrounding the prevailing outsourced operations model in particular.**

Regulation, chartered with ensuring the appropriate oversight framework is in place, has become a common, international theme throughout the asset management industry. The list is long, but a handful of examples where financial regulators have issued mandates include:

- Canada's Securities Administrators (CSA) Memorandum of Understanding Effective Dec 3, 2013
- Singapore's Monetary Authority (MAS) June 2013 issuance of their Technology Risk Management Guidelines
- The UK's FCA recent publication of a follow on thematic review in November 2013
- Australia's Prudential Regulation Authority (APRA) Superannuation Prudential Standard SPS 231 came into force in July 2013

The growth rate in the outsourcing space in recent years offers explanation where, in the US alone, more than 90% of fund accounting, transfer agency & custody operations are already outsourced and middle office functions are trending in the same direction with an expected growth rate of 19%[1].

The bigger picture is that it does not matter whether regulation has been instituted by the US, our global counterparts, or not at all. The reality of the situation is that we, the investor, are all impacted by what happens globally. "The global mutual fund industry now has representation in 45 countries and manages nearly $27 trillion in assets tied to markets across the globe. Almost half those assets – more than $13 trillion worth – were managed by the roughly 7,600 mutual funds domiciled in the US. Many of those funds invest in foreign issuers listed in the US or they invest overseas."[2] The sizing actually goes far beyond that, since those statistics refer exclusively to mutual funds and don't include, for example, the SICAV funds out of Luxembourg, or UCITs funds across Europe and Asia. When an outsourcing provider makes an error, the impact often reaches across international borders.

There are no jurisdictional walls when it comes to the damaging effects of NAV errors and the impact they have on an asset manager and the global investor community they service. This realization and the global collaboration movement that is taking place to address it are creating a new, global standard for "best practice" with or without the existence of domestic or foreign regulatory policy. In our 2014 Survey of North American asset managers, Milestone Group found that when asset manager respondents were asked to select from five reasons that would cause them to increase the level of fund oversight at their firm, their most often chosen reasons were:

1. To protect their reputation (62%)

2. To protect the interests of their investors (50%)[3]

At last year's ICI General Membership meeting, SEC Chair Mary Jo White was quoted as saying "throughout the SEC, we are cooperating with our foreign counterparts in ways that unleash the fullest potential of our capital markets to drive economic growth and create jobs – and to do so in a way that does not lower the bar or relax the regulatory and oversight standards that protect investors and stabilize markets. What happens overseas matters here at home, and matters more every day. The fund industry knows this almost better than anyone. American investors and fund managers make decisions based on financial reporting standards developed and financial statements audited overseas."[4]

1. *Investment Management Outsourcing, Navigant Gibson Dunn, March 2012 Presentation, http://www.navigant.com/~/media/WWW/Site/Insights/Financial%20Services/FINAL_NCI_GDC_Presentation_030912.ashx/*
2. *ICI 2013 General Membership Meeting, Mary Jo White, SEC Chair, http://www.sec.gov/News/Speech/Detail/Speech/1365171515952*
3. *Outsourcing and Oversight – US Market Survey, Milestone Group, www.milestonegroup.com.au/.../outsourcing-oversight-us-market-survey/*
4. *ICI 2013 General Membership Meeting, Mary Jo White, SEC Chair, http://www.sec.gov/News/Speech/Detail/Speech/1365171515952*

White's point that we look globally when assessing what the required local standards should be is duly noted, but we also understand that regulations in many cases are merely the effects rather than the cause. They are established to protect the global investor and are usually implemented after the fact. They are the results of failed high risk management strategies and the damage some fund managers and their investors have already absorbed. If regulations do not exist, other effects will come into play as a means to reduce exposure and anticipate potential breaches. When it comes to oversight; fund managers will eventually self-regulate rather than expose themselves indefinitely. These are savvy businesses that understand putting the appropriate level of controls in place is a small price to pay by comparison to the potential losses incurred. They are taking the oversight of service provider calculations very seriously, realizing that there is an opportunity for strategic innovation here that will serve to add to investor confidence levels and act in support of their business growth objectives.

When it comes down to it, regulation has not been the primary driver of fund oversight in the US market to date. In fact, there has been some very recent criticism in the press that the SEC has not done more to pass new mandates in this area. The Morningstar Fund Research Group's Global Fund Investor Experience Report offers additional evidence with regard to unsatisfactory regulation, while receiving the highest overall investor experience scoring, the US received one of the lowest scorecards across 24 countries with regard to the topic of Regulation & Taxation. Reasons given for the low regulation score included:

- The existence of multiple regulators opposed to the desired best practice single independent regulator
- Conflicts between these regulators
- Delays in instituting regulation
- Existing regulations only partially addressing known problems[5]

The global standard that has emerged is a product of both international regulation that has investors' best interests in mind and a strong desire of prudent fund managers to steer clear of negative press. In the absence of a more formal standard, however, some firms will instinctually remain in a holding pattern awaiting further instruction, potentially to their detriment. Many firms are reluctant to be the first to implement new solutions, believing requirements will continue to be modified and early stagers will serve to create added confusion with models that do not yet hit the mark with what would be considered "best practice". Given what is at stake with oversight of third party service providers, however, the only action that truly puts firms at risk is inaction. Looking at the oversight of outsourced third party fund accounting and net asset valuation calculations specifically, no US regulation currently requires oversight, but asset managers have been placing growing focus on protecting their business regardless. The broader global market has already begun paving the way forward by creating a global best practices mold and many US Asset Managers are now following suit. There are five top checklist items that can help ensure success and future compliance, regardless of geographic location when assessing your oversight requirements and potential approaches:

- Risk Reduction & Improved Client Service (via automation) are the two most important success criteria to be met and will serve to protect reputation and support growth by increasing investor confidence
- Start Early with the end goal of consistent service level adherence and an improved relationship with the service provider
- Keep it Simple & Efficient to ensure the automation supports the underlying outsourced service model rather than duplicating efforts and adding unnecessary costs and infrastructure
- Remain Flexible to conform and adjust the model as business needs and regulatory requirements change
- Look Globally, collaborating with foreign counterparts to ensure current and future compliance needs are met, anticipating and factoring in existing opinions and mandates such as independent checks

Putting the growth and state of the US Outsourcing market together with the SEC's recent global focus and priorities, market participants can make the educated assumption that US regulation of outsourcing oversight is not far away. The global message has strengthened the requirement and oversight has become the new standard.

As firms review and identify their "at risk" outsourced operations, instituting the right level of control does not have to become a heavy cost burden of creating large infrastructure to support the oversight function. In fact, if done well, doing away with the still prevalent practice of using spreadsheets (68% of asset managers polled are still using some form of spreadsheets in tandem with other solutions to perform oversight)[6] should serve to ultimately save costs and increase margins. More importantly, automating as many of these traditionally manual processes as possible and creating an exception based analysis environment protects the asset managers and the investors they serve from the unnecessary damage of valuation error.

5. *Morningstar Fund Research, 2013 Global Fund Investor Experience Report, http://corporate.morningstar.com/US/documents/MethodologyDocuments/FactSheets/Global-Fund-Investor-Experience-Report-2013.pdf*

6. *Outsourcing and Oversight – US Market Survey, Milestone Group, www.milestonegroup.com.au/.../outsourcing-oversight-us-market-survey/*

## EXPERT DEBATE

# Analyzing how the complexity of an operation dictates the viability of an outsourcing model

**Moderator**

**Chido Tagarira**
*Senior Publisher, Clear Path Analysis*

**Panellists**

**Todd Healy**
*Vice President, Head of Investment Operations, BMO Asset Management Corporation*

**Tony da Silva**
*Vice President and Director, Wellington Management Portfolios Administration, and Investment Administration in Europe and Asia/Pac*

**Chido Tagarira: You already have an outsourcing strategy I believe?**

**Todd Healy:** Yes that is correct. However we are presently developing this further largely because our business has evolved through acquisitions. Consequently we've had to implement new systems and really assess our distribution and the extent to which our present operation models add leverage and reduce costs. Just like our competitors we have growth targets but I wouldn't say our resources are put out there, outsourced in a linear fashion. Just because we double our resources doesn't mean we double our operations team but rather we need to be assessing all pieces of the puzzle in order to identify where value can be added.

**Tony da Silva:** Our outsourcing strategy is centred on our operations and administration activities, and I would describe it as an integral component of our investment administration model. We have a long history of component-based outsourcing, and a significant percentage of our operations are outsourced to a variety of providers.

**Chido: What is your current appetite then for outsourcing, across both the front and back office functions?**

**Todd:** We have high expectations for growth in assets under management with new product wins and product launches which will subsequently increase our appetite for outsourcing opportunities. This is a real change in that as little as three years ago we were pretty adamant about doing everything ourselves. Today our need for scale and an expedite release of information with consistent data flowing out there as quickly possible, means that we're certainly willing to look at where, strategically, outsourcing makes sense.

**Chido: Is it the same at BMO Todd?**

**Todd:** It's slightly different in that the only piece we currently outsource is the administration, whereas middle to front office functionality resides completely within BMO.

**Chido: As an operation becomes more complex, are you likely to be increasingly for or against outsourcing?**

**Todd:** We would definitely look for outsourced opportunities as the business becomes more complex for a couple of different reasons. One of the main reasons is in relation to the speed to market in that when we launch a new product we don't always have the right expertise in-house to both speed up this process and deliver the appropriate risk aversion simultaneously. In that scenario we would definitely look to outsourcing first and foremost.

**Tony:** For us, it's not so much a question of for or against. Rather, we regard outsourcing as a management lever that we evaluate when addressing business drivers. We use outsourcing as a tool both to create scale in more commoditised activities and to deal with complexity and the speed to market issues that Todd highlighted.

**Chido: Do you feel a hybrid approach is more viable than total outsourcing?**

**Tony:** We prefer a hybrid approach — or component-based outsourcing, as we call it — because it allows us to evaluate our business circumstances and apply a best of breed solution. In many instances, we have worked closely with service providers as early adopters to jointly design solutions that best address our business requirements. We like this nimble, component approach as it allows us to retain a sense of control and integrate outsourcing risk and service level management into our overall operating platform.

**Chido: So you'd never seek to do a total outsourcing strategy with some of these functions?**

**Tony:** Total outsourcing hasn't been a viable alternative for us, and I don't expect it to be.

**Todd:** Absolutely I agree wholeheartedly with Tony. Total outsourcing might be a viable option for a small boutique firm who doesn't have a lot of the operational resources available to them. When you're dealing with a larger, complex function ultimately you need to strike a balance. What percentage of what functions fall within the hybrid outsourcing model will vary depending firm to firm, the complexity of their products and the markets in which they are distributing.

**Chido: Is that from a cost perspective do you think?**

**Todd:** From a cost and a skill perspective. Once you move into more complex products the question becomes whether or not you have access to the right resources internally. I'm based in Chicago and don't have a lot of expertise at my fingertips from local resources regarding UCITs funds, for example. We're definitely utilizing an outsource provider to assist with that administration piece because it's outside of our area of expertise. Of course we're fabulous at running strategies and picking the right type of securities needed to handle the buys and sells but for other administrative pieces it can be too costly to buy and build yourself, unless of course you are an extremely large asset manager.

**Chido: Is 'loss of control' a valid reason not to outsource and to what extent should managers look to re-define their due diligence processes in outsourcing agreements?**

**Tony:** Loss of control is a key consideration in any outsourcing decision. I believe that our component-based outsourcing approach actually improves operational risk management, in that we tap into the risk and control practices of organizations that perform these activities as a service. It also introduces additional layers of management oversight and controls that we perform. With our component-based model, each of our operational areas retains direct oversight of outsourced activities and keeps very close to the day to day operations. For instance, key risk measures and service levels are incorporated into our internal risk and management reporting.

In terms of defining the due diligence processes in any outsourcing agreements, it's important to take an institutional and component view of your outsourcing partners. It's also critical to bring together all of the disciplines required to perform due diligence on outsourcing, including information security, legal, compliance, physical security and financial experts.

**Chido: So there should be a companywide agreement in some of these processes?**

**Tony:** We view it as more of a hybrid approach, with a combination of companywide and component-specific reviews.

**Todd:** I would say it depends on what service you're considering outsourcing. If it is a proprietary trading mechanism I can certainly appreciate how loss of control could be a showstopper. However, for us that hasn't been the situation but rather as Tony stated, the point is that you need to spend time putting together your service level agreements. You need to really explore what is enforceable and run significant checks on your provider's disaster recovery and business continuity planning.

Another key component for us with regards the control and monitoring piece, is that at BMO we are required to run quarterly governance and therefore, need to attest to how the relationship is working. We do deep dive into what the relationship is and the state of that vendor because really that's what you're doing when looking at an outsource provider. It is responsibility for the vendor and the governance behind that relationship that really falls upon us within the business. We have to spend a great deal of time ensuring all service levels agreed upon are met. If an issue has occurred then certainly discussions will ensue and information security will come into question. It's not a case of handing over the keys and forgetting, even though there is a shift in workload there are still elements that we need to maintain within the business from an oversight deck to avoid a degradation in service.

> "... it's important to take an institutional and component view of your outsourcing partners."

**Tony:** I agree with Todd, but we also believe it is equally important to integrate your management of the service provider and any risk into your overall business management strategy. As previously noted, our key risk indicators and service level agreements are very much integrated into our risk, control and reporting processes.

**Todd:** Everybody needs to remember it's a partnership and that just as you select the outsource provider to perform a function they will equally require information from you. If you don't approach it in this dual way then of course, any outsourcing relationship will be tough and it is crucial that it fits within the business' overall strategy. If you adopt a hybrid approach then you may well be using multiple providers for different functions. You have built out your dependencies in multiple directions, which of course requires a fair amount of oversight.

**Chido: Thank you both Todd and Tony.**

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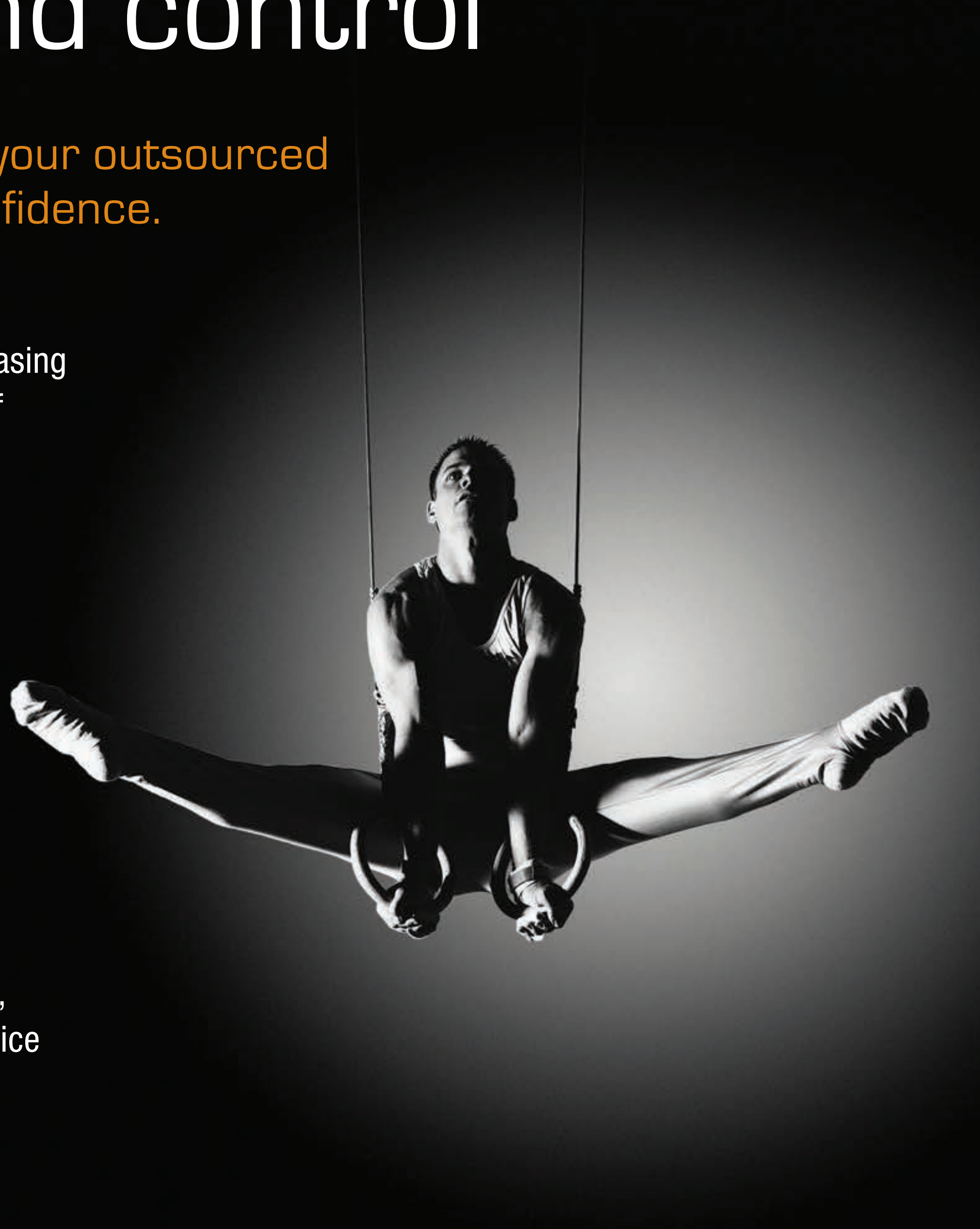

With regulators globally increasing their focus on the oversight of outsourced fund accounting, and with traditional practices no longer meeting their expectations, it's a strong case in point for balance.

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