

## **WHITE PAPER**

KEEPING THE BALANCE OF  
FRONT OFFICE CONTROL:  
TORN BETWEEN COMPLIANCE  
AND EFFICIENCY?



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## Asset Management: positioned for growth, but are there risks on the road to recovery?

Demand for asset management services is being driven up by a number of trends in economic growth, savings rates and investment diversification. Rising savings rates in the UK and North America as well as continued economic growth in the Asia-Pacific region provide a positive backdrop for increased demand for asset management in these markets. And, in a low yield environment, pension plans in both America and Europe are diversifying their assets and investment strategies.

Overall, asset owners such as insurance firms and pension plans are increasingly looking to outsource their asset management to avoid dealing with the complexities of regulation, the costs of operational outlay and the overhead of maintaining the headcount for savvy investment teams and the administrative teams that support them.

As they are replacing large holdings of domestic equities and mainstream bonds - often managed by one or two firms - with overseas assets and alternative investment strategies, we are seeing a trend for firms to prosper if they:

- Offer a highly differentiated service and product to attract new investments; or,
- Are able to provide access to global expertise and economies of scale, which allow the profitable provision of mainstream benchmark-driven investments.

All this bodes well for asset managers of all sizes, as they see demand for asset management services increasing and going global. In particular, growing wealth across Asia and the Middle East is boosting demand from wealthy individuals and sovereign wealth funds.

## Risks ahead: Front Office controls

Renewed growth has led to the discovery of a latent problem that may yet hinder asset managers' ability to profit from a recovery in investor demand and renewed appetite for making investments.

**Rising volumes and additional operational and regulatory complexity can expose weaknesses in key processes and controls, such as in the handling of client monies, valuation of client assets and the management of liquidity.**

Recent years have witnessed an increase in the controls-related market practices for the front office. Considerable work has been undertaken to improve internal controls and practices. This can be seen, for example, in the complex investment strategies offered by some managers to retail investors via the UCITS (Undertakings for Collective Investment in Transferable Securities) fund format.

**Regardless of investment philosophy and strategy, regulatory scrutiny and high-profile failures of management oversight are putting pressure on COOs and CEOs to ensure they have full rigour and control of their front and middle office processes.**

Asset managers who widen their range of investment techniques and instruments or significantly grow their assets need to be able to demonstrate adequate expertise, appropriate operating processes and proper risk controls.



Complex operating systems provide the backbone of the asset management industry and it is encouraging to see the UK industry's systems appeared to operate well during the crisis. **Ensuring systems and controls operate effectively remains a key priority for the FSA and we have identified a number of areas where systems may be less effective than we wish them to be.**

([http://www.fsa.gov.uk/pubs/plan/sdg\\_am.pdf](http://www.fsa.gov.uk/pubs/plan/sdg_am.pdf), p.9)



Fundamentally, they need to ensure that their firms possess the requisite systems, IT, controls and capital to manage the investment strategies offered to their clients.

## Out of control, out of oversight: a study of regulatory fines and reputational damage

Systems and controls failings revealed serious weaknesses over recent years in several firms' procedures, management systems and internal controls. The recent trading scandals to befall UBS and JP Morgan were not isolated cases and show parallels with the €4.9bn hit taken at Société Générale in 2008 and Barings prior to that.

Despite cutting-edge technology being available to curb breaches of trading limits and extensive monitoring employed by many buy-side and sell-side institutions, the balance of front office efficiency and control is often tipped in favour of profit. Let's find out what happens when the balance of front office control is tipped too far in the pursuit of efficiency:

**DEUTSCHE SECURITIES ASIA (Hong Kong):** In December 2012, the Securities and Futures Commission (SFC) reprimanded Deutsche Securities Asia Limited and fined it HK\$2,500,000 for regulatory breaches and internal control failings relating to position limit failures.



The SFC considers the failings of Deutsche Securities Asia more serious because it had already been told by an independent reviewer in 2007 that its real time monitoring system for position limits could not capture proprietary trades executed via external brokers.

**GOLDMAN SACHS (USA):** In December 2012, the U.S. Commodity Futures Trading Commission (CFTC) ordered Goldman Sachs to pay \$1.5m for supervision failures related to ensuring that certain aspects of its risk management, compliance and supervision programs comported with its obligations to supervise diligently its business as a Commission registrant.



Specifically, in violation of Commission Regulation 166.3, the firm failed to have policies or procedures reasonably designed to detect and prevent the manual entry of fabricated futures trades into its front office systems, which aggregated manually entered and electronically executed trades in the same product.

**MARTIN CURRIE (USA and UK):** In May 2012, the FSA fined Martin Currie £3.5m for failing to manage a conflict of interest between two of its clients. At the time this was the largest fine ever imposed by the FSA in a conflict of interest case. In addition to the FSA's fine, the US Securities and Exchanges Commission (SEC) also fined Martin Currie, imposing a penalty of US\$8.3m (c. £5.1m).



The FSA found that many of Martin Currie's failings resulted from weaknesses in its systems and controls around unlisted investments. In particular, the firms lacked adequate oversight of the fund managers advising both Fund A and Fund B.

**PSG ASSET MANAGEMENT (South Africa):** In April 2013, the Financial Services Board's Enforcement Committee imposed a penalty of R250,000 on PSG for failure to comply with section 26(2) of the Long-term Insurance Act of 1998. The section states that no person shall acquire more than 25% of the shares in a long-term insurer without the approval of the Registrar.



During the period February 1 2011 to March 1 2012, PSG Asset Management acquired 100% shareholding in PSG Asset Management Life Limited without prior approval.

**SAVOY INVESTMENT MANAGEMENT (UK):** In November 2012, wealth management firm Ashcourt Rowan was ordered to pay a £412,000 fine by the FSA over investment suitability failures relating to its Savoy Investment Management business.



The FSA says Savoy allowed its investment managers a high degree of discretion to advise clients, had limited front office controls and its other processes failed to ensure the suitability of its advice and portfolio management.

## Front Office compliance: keeping the balance

When the balance is tipped in favour of efficiency, short-term increases in profit margins and headline figures are likely to please P&L owners and clients.

Yet the regulatory fines and the reputational damage and loss of investor confidence far outweigh any initial monetary benefit over the longer term.

Firms are beginning to understand that robust investment management systems to monitor trades, compliance and execution are not a 'nice to have', they are a necessity.

There is a concern that some systems and procedures to control the holding of client money and assets still fall short of regulatory requirements:

Sometimes because procedures are ignored in favour of profit, or because the firm has been reluctant to invest in infrastructure, although its investments have far outgrown the scope of the current technology in place.

## MANY SHADES OF MARKET ABUSE

Market abuse comes in a variety of hues, from the outright prohibited to the frowned upon:

From 'Front Running' (The unethical practice of a broker trading an equity based on information from the analyst department before their clients have been given the information), to

'Painting the Tape' (A form of market manipulation whereby market players attempt to influence the price of a security by buying and/or selling it among themselves so as to create the appearance of substantial trading activity in the security), and

'Marking the Close' (attempting to influence the closing price of a stock by executing purchase or sale orders at or near the close of the market), to

'Banging the Close' whereby a trader buys or sells a large number of futures contracts during the closing period of a futures contract (i.e. the period during which the futures settlement price is determined) in order to benefit an even larger position in an option, swap, or other derivative that is cash settled based on the futures settlement price on that day.

## Protecting clients' assets

Regulators consider the protection of client money and assets to be fundamental in sustaining consumer confidence, and the UK's FSA, for example, set out detailed rules in the Client Assets Sourcebook (CASS). This means ensuring that clients' money and assets are safe, and remain safe even if a firm, such as an asset manager, becomes insolvent. Regulators and clients alike are concerned that some firms' controls over client money and assets do not always achieve the appropriate level of protection.

A particular risk are systems integration projects following mergers and general system upgrades, as firms may lose complete and accurate records of client cash holdings, resulting in client assets becoming co-mingled with firms' assets.

Controls over segregated accounts appear to be insufficient in some firms, and inappropriate claims over client money may be made. This is a particular problem in firms that engage in contingent liability transactions (e.g. Contracts for Difference (CFDs) and spread betting products).

**TAKE-AWAY:** Consider allocating client money to sub-pools with its own distinctive parameters set by type of client and/or type of business, for example by separating retail and non-retail investor money. The principle should be that in the event of insolvency or abuse, clients will have recourse to a specific pool containing their money.

## Valuation of assets

Fund valuations are a specific concern for regulators - the systems and procedures used to value client assets perform a critical role in areas like the calculation of performance and asset managers' fees, as well as the setting of prices at which investors transact.

Robust and reliable valuations of assets are an essential part of the management of clients' portfolios and collective investment schemes. Failure to value assets correctly can result in litigation or reputational damage to firms and reduce consumer confidence in asset management products.

**TAKE-AWAY:** Ensure that your firm's investment management system will automatically calculate fees (e.g. management fee, administration fee, etc.) and automatically accrual on the valuation until it has been paid. This process needs to be automated and auditable. Make sure your performance calculations are GIPS (Global Investment Performance Standards) compliant. Dividend income received on investments will also need to be taken into account when performance is calculated.

## Staying ahead of regulation: MiFID's systems and controls implications for asset managers

Asset managers will principally be affected by a number of proposals aimed at enhancing investor protection, increased transparency and transaction reporting obligations.

**Regulators on the front foot:** A consultation paper issued by the Committee of European Securities Regulators (CESR), a forerunner of the new European Securities and Markets Authority (ESMA) that forms part of the European System of Financial Supervision, clarified that the effect of both MiFID Article 21 and Level 2 Article 45 is to require that firms establish and implement a process for complying with the best execution standard. This includes firms who execute client orders and portfolio managers as well as receivers and transmitters.

For each class of instrument the process must include information on the venues where a firm may direct client orders and the factors affecting this choice. Firms must disclose appropriate information about the execution process to their clients. They must also monitor and review the effectiveness of their execution process and correct any deficiencies. For those firms who execute client orders, Article 21 imposes additional requirements that do not normally apply to portfolio managers or receivers and transmitters.

## "Asset managers lagging on MiFID II preparations", says PwC study

According to a recent survey by PricewaterhouseCoopers (PwC) asset managers - including hedge funds - appear to be lagging behind broker dealers, retail banks and private banks in their preparations for MiFID II.

While the survey released in September 2012 found that 79% of asset managers had raised - or at least intend to raise - internal awareness about MiFID II's technical requirements, very few had initiated any plans for further analyses on what it will mean commercially and operationally for their businesses. (See: <http://old.cooconnect.com/archives/4649>).

**"The lack of preparation to date among asset managers is down to several factors," stated Munib Ali, director at PwC in the wake of the organisation's findings. "Managers are already facing a barrage of regulation including AIFMD, FATCA and UCITS IV and to date have put most of their resources into ensuring they will be compliant with those rules rather than MiFID II," he added.**

"These rules, unlike MiFID II have clearer or earlier deadlines, hence why managers are devoting more resources to them. Regulators hope to implement MiFID II from 2014 but realistically we think it could be as late as 2015," the PwC executive noted.

**TAKE-AWAY:** Ensure your technology infrastructure is prepared to deal not only with the current regulatory regime, but is also adaptable enough to support future requirements and turn compliance into a competitive advantage. This is achieved by being ready to support imminent and longer-term best practice as well as regulatory requirements at an increased level of complexity and for rising investment volumes.

## Front office efficiency: keeping the balance

Equilibrium of front office efficiency and control is important to avoid risks and losses. But the ultimate raison d'être of portfolio managers and traders alike is to make money. How can front-office staff be effectively supported in this quest whilst keeping regulators at bay and books in order?

## Chasing alpha with your hands tied behind your back

The truth is that inefficient and uncompetitive investment processes are not driven by burdensome regulation and excessive investor due diligence requirements, but by outdated and old-fashioned processes and systems. Middle and back office staff may not be motivated to improve the processes that keep them in work, and senior executives will typically only see a rationale for making changes and replacing systems if there are significant operational changes, such as winning a large mandate or making an acquisition.

As a result, it is the front office 'rain makers' who suffer the inefficiencies of pre-trade and post-trade compliance, telephone dealing and time-consuming manual reconciliation from spreadsheets and terminals to trading systems and ledgers.

At the same time, their investors will expect them to supply customized reports taking into account their risk profiles, investment strategy and trading restrictions, while the executive layer expects ad-hoc as well as monthly reporting for management purposes.

Naturally, client services and marketing take care of formatting such reports. Yet how often do portfolio managers check these PDFs only to find that numbers have been swapped, performance figures copied in the wrong place and benchmarks taken from other fund factsheets?

As a matter of fact, operational inefficiency creates operational and reputation risk and wastes the time of highly skilled staff and thus the money of investors. With the additional 'best execution' requirements of MiFID, the record-keeping needs necessitated by KYC requirements and the equity markets finally on the move up, **this is the worst time for portfolio managers to be mired down with reconciliation, reporting and rebalancing.**

With one integrated portfolio management system in place, all these actions can be processed straight through at the click of a button. After all, if your investment strategy is paying off and you are signing up new clients, the last thing you want to tell them is that their mandate will take a week to implement and that you are struggling to meet their requests for well-defined, transparent reporting, performance updates, monthly 'risk reports' and periodic management calls. And, many investors now require position-level transparency from their fund managers both before and after they invest.

**TAKE-AWAY:** Put in place a system for monitoring of trading, but ensure there is automated Straight-Through-Processing (STP) of trades. Make sure the same investment management system and process is used across business lines and offices. This will not only make portfolio managers more efficient, it will also make it easy to resolve trade queries, calculate daily P&L, produce consistent reports and demonstrate to clients and regulators alike that your firm has good management oversight and a robust infrastructure that supports your growth strategy.

## Trust, execution, control: a recipe for growth

Executive staff at asset managers must have supervisory oversight of system capabilities, business processes, financial transactions, risk evaluation methodology, trade booking data as well as books and records. Critically they must also be able to communicate these complex concepts and processes to various stakeholders including their existing clients, potential investors and regulators.

Having robust investment management can help executive officers not only oversee front-office investment execution but support the enforcement too of best practices and efficient controls across the front office. Systems and controls not only need to be in place to execute and monitor trading, but also to effectively support the front office.

As the UK FSA has highlighted with regard to one financial firm:



It is no excuse that some of Martin Currie's failings resulted from the actions of individual fund managers. **The primary responsibility for ensuring compliance with a firm's regulatory obligations rests with the firm, and senior management must ensure that there are adequate systems and controls in place** to manage conflicts and to oversee the actions of employees. The action taken by both ourselves and the SEC should leave firms in no doubt about the serious consequences of this type of failure.

(May 2012)



It is often said that trust is the hardest thing to gain but the easiest to lose. The fund management industry has experienced the truth of this statement over the past few years. Clearly, rebuilding investor confidence shaken by such events is key to long-term growth and prosperity for asset managers and their clients. As such transparent, documented and well-supervised investment processes and systems can go a long way to ensuring a firm's high standing and reputation

remains that way with investors. And, when it comes to keeping the balance of front office efficiency and control, the guiding ethos should be:

## 'TRUST IS GOOD, BUT EFFICIENT EXECUTION AND CONTROL ARE BETTER'.

### Checklist: Front Office efficiency and control

#### Efficiency

- ✓ Is your investment management system still able to cope with the complexity and volume of your investments?
- ✓ Can you provide your investors with written notifications of significant events such as investor redemptions, management selling shares etc.?
- ✓ Can you show and tell? If clients or regulators ask for a walk-through of the full lifecycle of a trade, would your portfolio manager have to show them Microsoft Excel spreadsheets and Access databases?
- ✓ Do your portfolio managers need to produce and/or check fund factsheets? Consider providing your investors with a secure web portal where they can access such information and the latest customized reports. An automated batch process can help with version control and avoid manual input errors.

#### Control

- ✓ Back up: Should files or transaction records be altered, deleted or otherwise lost, can they be recovered?
- ✓ Performance: Where are historical portfolio Net Asset Values (NAVs) from inception stored? This is important if regulators or potential investors question your firm's marketing material.
- ✓ Are your systems SAS-70/ISAE-3402 certified? Adhering to these auditing standards is now expected by investors.
- ✓ Do you have a single, reliable 'Source of Truth' for that calculates, monitors and tracks trades, compliance, performance, valuations and execution venues?

If you would like to find out more about enabling your front office staff to generate alpha while satisfying your duty to exercise adequate management control, you may be interested in taking a look at the following investment management solutions:

#### Asset Arena 360

Core investment technology across front and middle office functions for boutique asset managers. Available both on a Software-as-a-Service or installed basis, Asset Arena 360 helps boutique asset managers improve portfolio insight and operational efficiency and deliver customized and clear client investment reports.

From portfolio management, compliance, order management, risk management, trade execution and performance attribution to client servicing, Asset Arena 360 helps boutique asset managers grow client assets.

Learn more about SunGard's Asset Arena 360, visit [www.sungard.com/assetarena360](http://www.sungard.com/assetarena360)

#### Asset Arena Manager

Industrial-strength investment management system for large, complex global asset managers. Available both on a Software-as-a-Service or installed basis, Asset Arena Manager helps the world's leading asset managers structure their front and middle office investment processes so that portfolio managers can focus on investment decisions and performance instead of processes and procedures.

From portfolio management, compliance, order management, trade execution and performance attribution to client servicing, Asset Arena Manager helps asset managers focus on their core business activity.

Learn more about SunGard's Asset Arena Manager, visit [www.sungard.com/assetarenamanager](http://www.sungard.com/assetarenamanager)

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## About SunGard Asset Management

SunGard's asset management solutions help institutional investors, hedge funds, private equity firms, fund administrators, and securities transfer agents improve both investment decision-making and operational efficiency, while managing risk and increasing transparency. SunGard's solutions support every stage of the investment process, from research and portfolio management, to valuation, risk, compliance, investment accounting, transfer agency and client reporting.

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 For more information, please visit:  
[www.sungard.com/assetmanagement](http://www.sungard.com/assetmanagement)

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## About SunGard

SunGard is one of the world's leading software and technology services companies. SunGard has more than 17,000 employees and serves approximately 25,000 customers in more than 70 countries. SunGard provides software and processing solutions for financial services, education and the public sector. SunGard also provides disaster recovery services, managed IT services, information availability consulting services and business continuity management software. With annual revenue of over \$4 billion, SunGard is the largest privately held software and services company and was ranked 480 on the Fortune 500 in 2012. For more information, please visit [www.sungard.com](http://www.sungard.com).

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