Mastering the distribution chain and related operational challenges

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The success of the UCITS product, which has become a worldwide, widely recognised brand, is a result of its high quality, strong investor protection and clear regulatory structuring. These features paved the way for UCITS funds to be distributed globally. The recently implemented AIFMD follows on from this and lays the groundwork for alternative vehicles and their cross-border distribution.

There is no doubt that one of the key elements of successful distribution is having a solid distribution network. The dependency of asset management firms on these counterparties is considerable since they are the main channel through which the target investors can be reached. Hence, the initial selection of distributors and the ongoing monitoring of their activities is of vital importance.

Furthermore, the risks associated with distribution in conjunction with applicable regulatory requirements and oversight of delegated functions cannot be neglected, and it is worthwhile to have a closer look at these challenges and the means required to address them.

This article focuses on the due diligence aspects of distribution and the diligence required of distribution delegates.

The burden of oversight

Typically, distribution oversight is associated with Anti-Money Laundering (AML) and Counter Terrorism Financing (CTF) requirements for end investors, while monitoring the counterparties bridging the gap between the investment fund and the end investor is often neglected, if not forgotten. It is important, therefore, to put in place adequate measures to ensure distribution does indeed enable commercial success, while at the same time managing its risks.

CSSF circular 12/546 of 24 October 2012 is very clear about the obligation a management company (or a self-managed SICAV) has to monitor its delegates on an ongoing basis, including the distribution network. Moreover, it also stipulates that management companies must actually have a deep understanding on how and by whom their funds are being sold.

This sounds easier than it is. In many cases, management companies appoint or act as a global distributor, who then in turn appoints sub-distributors. However, the management company's monitoring does not stop at the global distributor level.

Roles and responsibilities for the due diligence of sub-distributors can certainly be entrusted to the global distributor. But are these requirements clear, and does the management company ensure they are actually applied if the global distribution function is delegated? How does, for example, a management company make sure that throughout the distribution chain, the distribution licenses given to a particular fund are actually complied with? Can it really be sure that an Alternative Investment Fund not registered for sale to retail investors in France, for example, is definitely not sold to retail investors in France?

In fact, distribution and related due diligence tasks are much more of an operational challenge than a legal or compliance issue. The latter two set the rules and guiding principles, but taking the step down to the machine room actually shows how risks are managed and the workload optimised.

As a matter of fact, the fund distribution model and the wide variety of actors it involves both have a considerable impact on distribution, irrespective of whether we are looking at an asset manager selling its own products to the market, or a Registrar and Transfer Agent that handles daily transactions of shares and units of investment funds.

How to address the operational challenges

'Know and monitor your delegates' is a leading theme that is at the core of management company activities and at the top of regulators' agenda. As the distribution network grows and becomes more geographically spread, companies are facing multiple challenges to effectively monitor all the entities.

We will consider the following holistic four-layer approach to mastering operational specificities, embracing delegates' cultural specificities and ensuring compliance with local and global rules and regulations in order to meet the expected service level requirements.

Distribution dynamics and associated risks

COUNTERPARTY RISK

- Financial soundness
- Ownership structure
- License type
- Market share and book of business
- Quality of service

COUNTRY & REGULATORY RISK

- Political stability
- Supervisory quality
- Economic and business environment
- Local marketing rules

DISTRIBUTION CHANNEL RISK

- Product misselling
- AML and CTF policies
- Infrastructure stability
- Remuneration policies
- Client classification & data protection

REPUTATIONAL RISK

- Brand perception
- Market position
- Regulatory fines

The four dimensions address different dimensions of distribution, and management companies' risk appetite and monitoring requirements shall be defined separately for each layer.

From concept to implementation

Conducting initial and ongoing due diligence on a large number of distributors can be a time-consuming administrative task. One can estimate that, on average, a full-time employee can cover the due diligence of 200 distributors throughout the year, and reports progress and issues to the conducting officers.

Our experience clearly shows that due diligence has a lot of room for optimisation. Many management companies do not actually apply a risk-based approach to due diligence, nor do they set priorities as for the extent of the due diligence. Just sending out the full due diligence questionnaire again to distributors might seem like the best way, but does this make sense in all cases, and who evaluates the responses afterwards?

Does it make sense to treat a large EU banking group in the same way as a small distributor in a non-equivalent country?

These examples seem easy and straightforward on the surface. In reality, however, we observe quite the opposite.

Conducting risk-based and 'smart' due diligence saves on workload, manages risks, and spares precious resources by 50% (on average), and the benefits do not stop there.

Many organisations do not set clear rules on who—and which function—actually owns distribution. The more parties and responsibilities are involved, the more coordination is needed (and the weaker the actual monitoring task over the distribution network usually becomes).

We have shown in the preceding graph a four-dimensional approach to distribution. But do asset managers and asset servicers actually face the same types of operational challenges in relation to distribution? To a large extent they do, by being complementary and leaving some ground for synergies, especially in larger groups that combine both service types under a single, corporate roof.

Asset managers and asset servicers: key priorities to keep distribution under control

Asset managers	Asset servicers
Risk Intelligent approach for selecting and monitoring distributors	Strong compliance monitoring process for distributors and investor instructions
Clear governance encompassing the distribution process and the network of distributors, as well as distributor selection and monitoring (incl. sub-delegates)	Focused relationship management and communication platform with key actors within the distribution chain
Complete service documentation governing each distributor relationship	Operational documents defining the roles and responsibilities, as well as relevant KPIs
Definition of scope of distributor marketing activities (website content, distributor's marketing materials, promotion of asset manager's brand name)	Proper identification of underlying investors and leveraging on initial controls performed by the distributor
Clear and up-to-date distribution matrix	Clear overview of the asset manager's counterparties
Know your distributor: document gathering, handling, storing and maintenance	
Capacity planning of resources dedicated to monitoring distribution	

Consider revisiting your operating model

The use of automated solutions and shared resources dedicated to the due diligence process may significantly reduce the costs of due diligence on third parties and increase efficiency. We believe the time has come to bring this activity to a global level within organisations and look for opportunities to optimise tasks.

Capacity planning combined with a pragmatic approach and the right tools will ease the burden imposed on asset management companies and asset servicers. Further consolidation of the process within larger groups by building up a centre of expertise supported by an adequate data management system can maximise the positive results while keeping costs low.

It is only a matter of time before we see specialised entities emerging, providing due diligence services that allow for complete and large-scale outsourcing of the process. The ultimate responsibility for any delegated activities, however, will always remain with the management company.

Distribution and the related monitoring processes, networks and delegates require more attention, and although they do receive it, this is not always in an optimal and optimised way. Distribution due diligence is not only a synonym of AML and CTF obligations even though it is often perceived as such.

It is time to embrace distribution and its complexities and turn them into an advantage. Hence, defining a robust, flexible and efficient process will help to leverage distribution, while ensuring the necessary compliance with the regulatory environment.