Investment Compliance Monitoring Survey

Moving forward with a sharper focus
Contents

1 Introduction
3 Specific findings, with implications and insights
9 Emerging issues
11 Conclusion
12 Contacts
Introduction

Changing the lens: An underappreciated strategic consideration

Investment compliance monitoring (ICM) is among the most important risk mitigation activities undertaken by investment management companies. The risks presented by breaches of investment restrictions, which include risks to reputation, can be significant. In addition, ICM costs — and payouts for breaches — can erode organizational profitability.

As investment managers focus on the battle for business and the pursuit of higher returns, critical components of effective ICM may be overlooked or underappreciated. Yet as with worn brakes or faulty wiring, hidden defects in portfolio compliance monitoring¹ can undermine performance or lead to breakdowns. This is especially true in the current industry environment of increasing competition, cost pressures, and regulator and investor scrutiny.

Regarding the latter, regulators and investors want to understand investment managers’ ICM capabilities and their management of the risks of noncompliance with investment restrictions. In addition, investor expectations for accommodation of, and compliance with, restrictions are rising as developments in information technology (IT) continue to raise expectations in many areas of business, including financial controls and reporting.

To manage ICM costs and address these concerns and expectations, investment managers should enhance ICM efficiency and mitigate the risk exposure of compliance breaches by committing an appropriate level of resources to ICM, properly structuring ICM processes, defining clear roles and responsibilities, and developing the required data and supporting technology.

These are the insights drawn from Deloitte’s Investment Compliance Monitoring Survey,² conducted in 2013.

This survey assessed current ICM practices at a range of investment managers and found that many could potentially benefit by strengthening their ICM processes and practices in the following ways:

- **Improve request for proposal (RFP) responses:** Forty percent of survey participants lack a standard workflow or set of actions for responding to RFPs, and only 16 percent use an automated tool in preparing responses to RFPs; 58 percent involve the ICM function in the RFP process — but not to a significant extent.

- **Enhance client on-boarding:** Nearly one quarter of survey participants — 23 percent — lack a standard workflow or set of actions for on-boarding clients.

- **Standardize handling of interpretive issues:** Sixty-eight percent of participants do not have procedures for identifying and resolving organization-wide interpretive issues, and 54 percent lack such procedures for contract-specific issues; this makes handling of interpretive issues a common pain point.

- **Enhance breach management:** Sixteen percent of survey participants reported an annual average of more than 75 breaches over the past three years; 42 percent of survey participants indicated that they do not have a specific team dedicated to post-trade compliance.

- **Address data limitations:** Sixty-three percent of survey participants do not regularly perform data assessments, 48 percent do not maintain a data dictionary, and 46 percent attribute more than half of their manual rules to data limitations.

- **Assess ICM-related IT capabilities:** Forty-four percent of survey participants with an automated ICM system have had their system in place for nearly a decade.

- **Understand ICM costs:** Eighty percent of participants indicated that they do not determine the costs associated with monitoring atypical investment restrictions.

¹ For purposes of this survey, the terms “investment compliance” and “portfolio compliance” are used synonymously.

² For purposes of this survey report, percentages may not equal 100% due to rounding.

These issues, and those covered in the remainder of this executive summary, are interrelated. The survey found that processes for ICM and related activities are often in need of enhancement or missing — with similar deficiencies in supporting data and systems. This may reflect a lack of appropriate priority on ICM, as well as competition for internal resources. However, considering ICM a side-issue or treating it as an afterthought may generate inefficiencies, costs and breaches of investment restrictions and may lead to financial and reputational risks.

In addition, shortcomings in ICM processes often indicate potential issues in other organizational areas, such as data management, trade processing, client communications, and financial controls. ICM also represents a critical control for investment managers and a point of coverage in regulatory exams, client due diligence, and control attestation reports such as the Statement on Standards for Attestation Engagements and the Service Organization Controls Report. The level of investment in ICM personnel, processes, and technology should thus not be considered merely on the basis of payouts for breaches incurred or avoided, but also with full consideration of the impact of ICM on marketing, client relations, regulatory compliance, and risk management efforts.

Periodically analyzing ICM requirements and understanding the related costs, benefits, and risks; involving ICM in the RFP and on-boarding processes; and automating ICM to the greatest practical extent generates cost savings, improves controls and risk management, and positions the organization to readily address regulatory and investor concerns.

Based on the findings of this survey (see sidebar for survey background) and extensive related experience in the field, Deloitte has further suggestions — as well as additional insight on what investment managers are now doing to monitor compliance with investment restrictions.

About Deloitte’s ICM survey

Like its predecessor in 2010, Deloitte’s second ICM survey assesses portfolio compliance monitoring practices in the investment management industry. This survey was conducted in the first half of 2013 with chief compliance officers (CCOs) or their equivalents at 26 investment management organizations.

Survey participants represented a diverse range of organizations, collectively holding more than $10 trillion in assets under management (AUM). Nearly one-third held over $500 billion in AUM, and nearly one-third held under $100 billion. Midsized organizations (with $100 billion to $500 billion in AUM) comprised 38 percent of the participants.

Mutual funds were the most popular product offered, and the majority of organizations offered institutional accounts. Equity and fixed-income investments made up the highest share of holdings, although money market investments, derivatives, and commodities were also represented.

This executive summary provides specific survey findings along with implications and insights drawn from the findings in light of Deloitte’s experience in assisting investment management organizations in achieving, sustaining, and monitoring investment compliance.

AUM of survey participants

<table>
<thead>
<tr>
<th>AUM Range</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; $500 Billion</td>
<td>23%</td>
</tr>
<tr>
<td>$101 to $500 Billion</td>
<td>38%</td>
</tr>
<tr>
<td>&lt; $100 Billion</td>
<td>31%</td>
</tr>
</tbody>
</table>

3 Although the 2013 survey is similar to the 2010 survey, given differences in the samples the findings from each survey are presented in separate documents.
Specific findings, with implications and insights

Improve RFP responses
Institutional investors want greater visibility into organizations’ ICM capabilities and are asking direct questions about those capabilities in their RFPs. Questions may focus on ICM processes, systems and controls, types of restrictions that can be monitored, and the organization and structure of the ICM team, among other items. For some investment managers, this trend may indicate a need for more detail and disclosure during the RFP process to correctly and completely portray ICM capabilities for potential clients.

As noted in the introduction, 58 percent of survey participants do involve the portfolio compliance function in the RFP process, but not to a significant extent. In addition, 40 percent of participants have no standardized workflow or set of action steps to facilitate responding to RFPs (see Figure 1). Only 16 percent use an automated tool while 44 percent use a manual checklist to facilitate responding to RFPs.

Implications and insights
During business development, investment managers may agree to monitor investment restrictions that the ICM team cannot monitor with existing data and systems, setting the stage for potentially costly and ineffective manual monitoring. Involving ICM in the RFP process can help companies to avoid or address this issue and correctly portray capabilities.

Information provided about ICM policies and capabilities in response to RFPs should be current, complete, and accurate. Yet not all investment managers view involvement in RFPs as a responsibility of the ICM team, although that involvement is one reliable way to improve ICM information in RFP responses.

Organizations should use efficient workflow tools to incorporate input from the ICM team, and other relevant parties, into RFP responses. To the extent that RFP engines are utilized, investment managers should conduct periodic reviews of those engines to ascertain whether they reflect ICM capabilities as well as past responses and outcomes.

Figure 1: Is there a standardized workflow or set of action steps to facilitate responding to RFP?

- No, there is no standardized workflow or set of action steps: 40.0%
- Yes, a manual checklist is used: 44.0%
- Yes, an automated tool is used: 16.0%
Enhance client on-boarding

While nearly 23 percent of survey participants indicated that they do not use a standardized set of actions or workflow for on-boarding, 80 percent involve their ICM team to a “significant” extent in client on-boarding. This reflects widespread recognition of the value of the ICM team’s familiarity with system capabilities, experience in resolving issues, and understanding of automated and manual processes.

However, while the ICM team generally manages investment guidelines and decides which restrictions can be addressed manually, relationship managers usually lead contract negotiations and own the documentation during on-boarding.

Standardization of on-boarding can assist organizations in clarifying ICM (and other) procedures and practices while supporting their implementation. Toward that end, almost 9 in 10 survey participants (87 percent) use at least one template in on-boarding (see Figure 2). Separately, however, 38 percent of participants indicated that not all templates in their organization allow automated monitoring within the ICM system.

Figure 2: How many different templates does your organization use in contract negotiations?

- 0: 12.5%
- 1 to 5: 45.8%
- 6 to 20: 33.3%
- 21 to 50: 8.3%

Implications and insights

Investment managers should understand the issues and risks involved in accepting investment restrictions that the organization is not equipped to monitor. These issues and risks include:
- Increased costs to develop or purchase technology to permit automated monitoring of complex guidelines
- Increased costs in resources to develop and implement efficient manual monitoring
- Potential breaches of restrictions that cannot be adequately monitored manually or via automation

Leading industry practices for mitigating ICM risks typically include involving the portfolio compliance monitoring function in the contract negotiation process (for example, by requiring ICM personnel to review and approve guidelines prior to acceptance), creating a standardized workflow for on-boarding and, perhaps, leveraging standard rule templates.

In addition, an organization can make deviations from rule and reporting templates the exception and hold business development personnel accountable for deviations. A clear picture of the costs associated with monitoring atypical investment restrictions may enable investment managers to justify greater standardization in the on-boarding process and to lower the associated risks.

Finally, maintaining on-boarding process controls can help the organization to ascertain whether investment restrictions are coded in accordance with client mandates. These controls may include:
- Using executed contract documentation for rule coding
- Establishing a standardized workflow for client and account on-boarding
- Blocking trades until an account is fully coded in an automated ICM system
Standardize handling of interpretive issues

Discrepancies in how terms related to investment restrictions are interpreted in the organization and in contracts can lead to inadvertent breaches and preferential treatment of some portfolios. Effective management of interpretive issues calls for a consistent approach to identification, investigation, resolution, and corrective action. However, such an approach is often missing.

Deloitte’s survey found that 68 percent of participants do not have specific procedures for identifying and resolving organization-wide interpretive issues (see Figure 3), and 54 percent lack procedures for identifying and resolving contract-specific interpretive issues (see Figure 4). The remaining participants — 32 percent and 46 percent, respectively — indicated that they do have such procedures. The majority of survey participants that have such procedures involve cross-functional personnel in the interpretive issues resolution process; however, only 12 percent of survey participants have a committee charged with approving global (organization-wide) interpretive issues resolutions.

Implications and insights

There should be standard, organization-wide methods of addressing absent or ambiguous definitions of terms in investment management agreements. Leading practices include establishing a cross-functional steering committee or management committee to review and approve organization-wide interpretive corrective actions. This step facilitates the gathering of input from relevant functions as well as consistent resolution of interpretative issues across the organization.

Additional steps to improve interpretive issues resolution could include:
• Establishing centralized tracking of interpretive issues (via an issue log or tracking tool) to promote consistency in resolution activities
• Disseminating interpretive resolution outcomes widely to reduce inefficiencies
• Using investment contract templates, vetted by stakeholders, to determine that interpretive terms have been well defined and restrictions can be monitored by the ICM team
• Leveraging the annual account review process to gain consistency in defining interpretive issues
• Documenting policies and procedures for interpretive issues investigation and resolution

As investment management organizations continue to implement global structures and systems, they should consider extending and reconciling definitions of interpretive issues across jurisdictions. This represents another step toward consistency and clarity in the handling of interpretive issues.

Figure 3: Are there specific procedures for the identification and resolution of the global interpretive issues (i.e., those issues that are applicable across the organization and not to one particular account/contract)?

| Yes | 32.0% |
| No  | 68.0% |

Figure 4: Are there specific procedures for the identification and resolution of contract-specific interpretive issues (i.e., those issues that are applicable to one specific account/contract)?

| Yes  | 45.8% |
| No   | 54.2% |
Enhance breach management

A total of 36 percent of survey participants reported an annual average of 16–50 breaches requiring payouts in the past three years, and 16 percent reported an annual average of more than 75 such breaches (see Figure 5). The average payout per breach was $10,000 or less for 62 percent of the participants and over $50,000 per breach for 17 percent of respondents. While 44 percent of respondents reported experiencing fewer than 15 breaches annually over the past three years, 20 percent — or one in five — reported more than 50 breaches per year.

The authority of appropriate business functions to validate, override, and resolve exceptions remains a critical ICM issue. Addressing this issue calls for balancing the oversight of trading activities with appropriate segregation of duties while allowing potential trade exceptions to be efficiently validated. In a separate question, 42 percent of survey participants indicated that they do not have a specific team dedicated to post-trade compliance. Validation occurs at T+1 (the day after the day of the trade) at 36 percent of survey participants’ organizations.

Figure 5: Approximately how many valid portfolio compliance breaches did your organization identify per year on average over the past three years?

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5</td>
<td>8.0%</td>
</tr>
<tr>
<td>5 to 15</td>
<td>36.0%</td>
</tr>
<tr>
<td>16 to 30</td>
<td>20.0%</td>
</tr>
<tr>
<td>31 to 50</td>
<td>16.0%</td>
</tr>
<tr>
<td>51 to 75</td>
<td>4.0%</td>
</tr>
<tr>
<td>More than 75</td>
<td>16.0%</td>
</tr>
</tbody>
</table>

Implications and insights

Breach management stands among the critical components of investment compliance, and appropriate related controls are essential. These controls include those required to:

• Prevent breaches from occurring
• Identify potential breaches
• Validate true breaches
• Escalate valid breaches for client reporting and, if required, payout
• Perform root-cause analysis to locate and resolve issues generating breaches

The potential financial and reputational damages surrounding inadequate breach management can undermine investment management organizations, which should therefore consider incorporating the following into their breach management procedures:

• Performing root-cause analysis on valid breaches to determine and resolve issues that contributed to a breach occurring
• Conducting forensic tests to identify patterns in validated breaches, such as data issues, rogue traders, and control failures
• Identifying and resolving the cause of recurring false alerts in automated ICM systems to reduce the time and resources devoted to dealing with them

Given increasing regulatory oversight, proactive breach-prevention measures may benefit investment management organizations by keeping the focus on continual improvement of the investment compliance process.
Address data limitations

Standardizing processes such as on-boarding clients, coding investment restrictions, and detecting breaches call for rich data and IT support. Although some 88 percent of survey participants have personnel assigned to maintaining data quality and availability for the data used in automated ICM systems, several needs persist:

• Forty-eight percent indicated that they do not maintain a data dictionary
• Forty-six percent indicated that they do not have formal policies and procedures for rule testing
• Forty-six percent indicated that more than half their manual rules were attributable to data limitations (see Figure 6)
• Fifty-two percent indicated that they do not perform a secondary review of manual monitoring procedures to facilitate proper execution and monitoring

That said, a total of 92 percent of survey participants do perform assessments of data quality and availability, with heavy reliance on third-party vendors to provide data feeds.

Figure 6: What percentage of your existing manual rules is based on data limitations within the automated ICM system (i.e., unavailable data, data inconsistencies, data inaccuracies, etc.)?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 10%</td>
<td>20.8%</td>
</tr>
<tr>
<td>11 to 20%</td>
<td>12.5%</td>
</tr>
<tr>
<td>21 to 30%</td>
<td>8.3%</td>
</tr>
<tr>
<td>31 to 50%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Greater than 50%</td>
<td>45.8%</td>
</tr>
</tbody>
</table>

Implications and insights

Ample data can generate efficiencies in rule monitoring by reducing the number of manual monitoring procedures performed and providing or enhancing the ability to perform forensic trend analysis. Data and technology support are also, of course, essential to management, client, and regulatory investment compliance reporting.

Investment management organizations that have not done so may do well to consider:

• Creating and maintaining a data dictionary for the ICM system
• Assigning a dedicated resource to maintain data quality and availability in the ICM system
• Reviewing data alerts periodically to determine potential areas for future data enhancements
• Establishing workflows for ICM to raise data issues to IT (or other responsible group) for timely resolution
• Developing protocols for prioritizing ICM data issues for resolution

These efforts can enhance the data available for coding and implementing investment restrictions and help in assessing and addressing risks associated with the use of data and technology. The costs of manual and hybrid rules increase the overall cost of investment compliance, and they are not always factored into client and product profitability analytics.
Assess ICM-related IT capabilities

Over the last several years, we have observed that investment management organizations have restrained their technology budgets. Forty-four percent of survey participants with an automated ICM system have been using the same one for nearly a decade (see Figure 7). However, investment managers are reconsidering their budgets and strategically evaluating ICM technology. Among participants with a proprietary system, 43 percent have at some point considered switching to a third-party system but have chosen to stay with their proprietary technology.

Figure 7: If an automated ICM system is in place, how long has the system been used?

Implications and insights

When assessing the alignment between strategic objectives and their technology, or deciding whether to build or buy ICM technology, organizations should generally weigh three specific considerations:

- Long-term and short-term costs
- Availability of personnel with the knowledge to use and maintain the technology
- Ability to customize the system and integrate it with existing processes and IT
Emerging issues

In addition to the preceding findings regarding common, core ICM issues, the following areas arose as emerging areas of concern.

Data assessments
Given the ever-increasing dependency of the investment management business on various data sources, periodic assessments of data availability and quality could be potentially valuable. Yet 63 percent of survey participants indicated they do not regularly perform assessments of data, and eight percent indicated that they have never assessed their data to see if additional data should be acquired (see Figure 8).

Figure 8: Does your organization perform assessments of data quality and availability to determine whether additional data should be acquired to enable, or enhanced to facilitate, the automation of certain investment restrictions?

What to do?
Investment management organizations should conduct periodic assessments of data quality and data availability to determine whether existing data is correct and complete and whether additional data should be acquired to enable or enhance automation of certain investment restrictions. Developing and maintaining a data dictionary could be another potentially worthwhile step to consider.
ICM and system connectivity

While trade order management systems (OMS) are generally well-linked with an organization’s ICM system, lack of connectivity between OMS and execution management systems (EMS) can generate issues. Lack of such connectivity may increase the risk that portfolio trades may be executed with entities restricted by the investment management agreement or industry regulations. The latter particularly impacts derivatives trades as they relate to approved counterparties and counterparty rating restrictions.

With respect to EMS, of the two-thirds of survey participants who use execution networks, 50 percent have a compliance check for approved brokers after execution but before the trade is allocated and sent to accounting, a total of 36 percent check in another timeframe, and 14 percent indicated that they do not check at all (see Figure 9).

Figure 9: With respect to the use of execution networks, at what point does the compliance check for approved brokers take place?

What to do?

Investment managers should consider whether they have the ability to monitor guidelines throughout the trading life cycle. EMS often do not feature or enable the same level of ICM connectivity as OMS. This can make monitoring certain restrictions, such as counterparty ratings on derivative trades, more complex. When possible, an organization may consider enhancing their EMS to allow prohibitions to be entered on each trade during the execution phase to prevent utilization of prohibited counterparties.

Investment management organizations should also be aware of gaps or breakdowns in ICM capabilities during the trade execution phase and of potential breaches, including inadvertent dealings with a prohibited broker/dealer.
Making ICM a priority may pay dividends
ICM stands among the linchpin issues of investment management, both stemming from and reflecting the organization’s commitment to operational excellence. This is not, however, the pursuit of operational excellence for its own sake, but rather for market positioning, portfolio and product profitability, and financial and reputational risk management.

Making ICM a priority not only assists investment management organizations in the pursuit of those goals, but also potentially enhances capabilities in functions such as sales and marketing, client communications, data and IT management, regulatory compliance, financial and security controls, and profitability analysis.

Pressures in the industry will continue to mount, particularly competitive and cost pressures, and increasing complexity will be the order of the day. Improved ICM capabilities, and the direct and ancillary benefits they provide, will assist investment management organizations in addressing those pressures and complexities. These considerations are crucial for organizations that are underresourced in ICM and for those working with new or more complex asset classes, such as derivatives.

Improvement can be realized by involving ICM teams more in RFP and client on-boarding processes, providing data and systems support of ICM, and standardizing handling of interpretive issues and breach management. Investments in ICM may be clearly justified by more explicitly tracking the costs of manual and hybrid monitoring as well as the costs — and risks — associated with breaches of investment restrictions.

Based on this survey, the foregoing analysis and insights, and Deloitte’s experience in the field, overall final suggestions could be for investment management executives to:

1. Assess current ICM capabilities, manual and hybrid controls, and history of breaches
2. Calculate ICM costs, including the cost of manual controls, and the average and total amounts of breach payouts for the past three to five years
3. Understand the risks associated with past and potential breaches of investment restrictions, including financial, regulatory, legal, and reputational risks
4. Decide which aspects of the ICM program could most benefit from improvement and develop a plan to achieve and measure those improvements
5. Participate in research geared toward identifying and promulgating leading ICM practices at investment management organizations

Conclusion
We thank the following Deloitte professionals for their contributions to this report:

- **Sean Cunniff**, Research Leader, Deloitte Services LP
- **Derek Hodgdon**, Senior Manager, Deloitte & Touche LLP
- **Lynette DeWitt**, Manager, Deloitte Services LP
- **Adia Finn**, Manager, Deloitte & Touche LLP
- **Antonio Crombie**, Senior Consultant, Deloitte & Touche LLP
About the Deloitte Center for Regulatory Strategies

The Deloitte Center for Regulatory Strategies provides valuable insight to help organizations in the financial services, health care, life sciences, and energy industries keep abreast of emerging regulatory and compliance requirements, regulatory implementation leading practices, and other regulatory trends. Home to a team of experienced executives, former regulators, and Deloitte professionals with extensive experience solving complex regulatory issues, the Center exists to bring relevant information and specialized perspectives to our clients through a range of media including thought leadership, research, forums, webcasts, and events.

www.deloitte.com/us/centerregulatorystrategies

This document contains general information only and is based on the experiences and research of Deloitte practitioners. Deloitte is not, by means of this document, rendering business, financial, investment, or other professional advice or services. This document is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this presentation. The survey information was taken “as is” from the survey participants and was not validated or audited by Deloitte.

Copyright © 2014 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited