A Confluence Whitepaper

Responding to Regulatory Change with Agility and Control

Partnering for Success in the Asset Management Back Office

Executive Summary

As the world's financial markets continue to fluctuate and powerhouse economies struggle, financial services companies across the globe are grappling with the economic challenges facing them — and, as if the global crisis were not enough, additional impact is added due to the continuing complex global financial services regulatory changes and the reporting they require. These new regulations are coming at an unprecedented pace, and financial institutions are under great pressure to not only understand and track the changes, but to also evaluate and implement regulatory compliance software solutions. Risk-aware institutions must be willing to invest in people and technology to help mitigate future risk.

Companies relying only on their internal IT and compliance departments can experience negative results as well, not only from a cost and resource perspective, but also from a compliance point of view as they struggle to understand the technical requirements around the data and how it should be managed. As a greater number of third-party technology solutions have emerged to solve the market need, asset managers are asking the obvious question: Why should we build products and services from scratch that have already been proven in the marketplace?

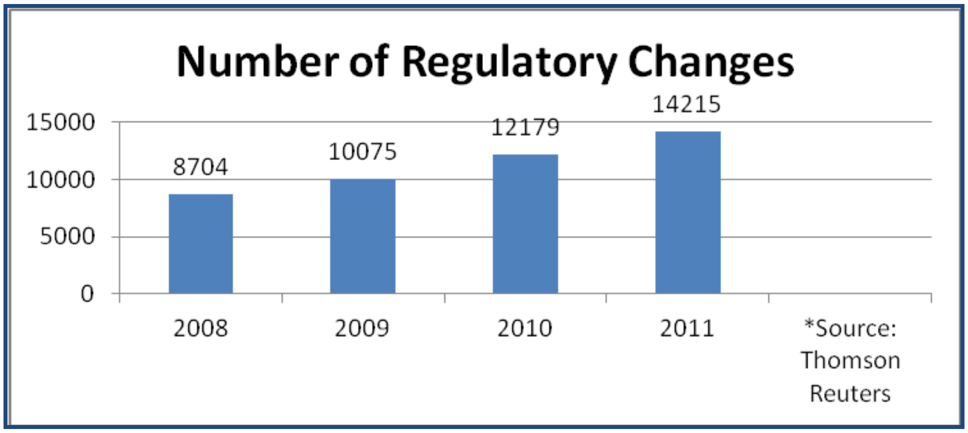
Choosing the right technology is critical to managing the complexity of regulatory compliance and ultimately driving down both risk and cost. But finding the right technology solution isn't enough. Asset managers need a trusted technology partner that can bring both the software solution and a myriad of intangible benefits to the table, including extensive industry experience and access to the shared knowledge of a strong client base.

To understand why having the right technology partner is such a key factor in the overall success of regulatory reporting implementations, it is important to grasp the breadth of changes financial services organisations are facing. This paper will examine not only the sheer number of regulations financial services companies are facing, as well as their associated costs, but also the potential magnitude and impact of acting too hastily or without agility. Technology partners can guide organisations through the sea of change and ultimately help them meet the escalating regulatory compliance reporting challenges.

Regulatory Changes Quantified

Thomson Reuters recently conducted a historical analysis of the vast sea of regulation facing businesses across the globe. Their analysis, which took a look at the number of regulatory changes over a four-year period, showed a steady increase year over year. The regulatory changes introduced in 2011 were almost double those seen in 2008.

"Our analysis illustrates the magnitude of the challenge facing businesses globally and the need for them to keep abreast of what is going on in each and every new market in which they operate," said Scott McCleskey, global head of financial services regulation, Thomson Reuters GRC. "This growth in activity also has an effect on the level of compliance spending, which is bound to rise, leaving less to lend, invest, and do the other core activities which will be necessary to revive the global economy.”[i]



Asset management is feeling the impact of the acceleration of regulatory change. In a recent webinar hosted by Confluence, Charles Muller, Partner at KPMG, Luxembourg, spoke to the magnitude of proposed changes facing the industry through 2019 — including the specific financial services regulations listed below that are targeted for 2012 and 2013.

2012

- **UCITS ETFs/Structured UCITS**
- **UCITS V**
- **Packaged Retail Investment Products (PRIPS)**
- **Short selling and credit default swaps**
- **Investor Compensation Scheme Directive (ICSD)**
- **Credit Rating Agencies**
- **Dodd-Frank Act**

2013

- **AIFMD**
- **EMIR/OTC Derivatives**
- **MiFID II**
- **Market Abuse Directive II**
- **Transparency Directive review**
- **Solvency II**
- **Capital Requirements (CRD IV)**
- **Securities Law Directive (SLD)**
- **FATCA**
- **EU Corporate Governance**
- **UCITS VI and Shadow Banking**
- **Central Securities Depositories**
- **EU Transaction Tax**

As the list of new regulations set to impact the fund industry continues to grow, industry executives are feeling the pressure. Eighty-five percent of investment management professionals at the Investit Intelligence Conference in September of 2012 said that ‘Regulatory Change Projects’ were at the top of their agenda for 2013. Respondents from 24 global investment management firms were then asked which regulatory activities are causing their firm the most concern; the top five were: Alternative Investment Fund Managers Directive (53%); Dodd-Frank Act (51%); Foreign Account Tax Compliance Act (43%); Solvency II (38%); Retail Distribution Review (32%). Four of the top five are slated to go live in the next year. [ii] Clearly, investment management firms need to find ways to comply without jeopardizing their core business.

The Staggering Cost of Regulation Compliance

Even more staggering than the number of new financial regulations is the cost associated with them. These costs include the direct costs of implementing compliance initiatives, the indirect costs associated with delaying a compliance decision and the opportunity costs that arise when compliance mandates take precedence over other strategic initiatives.

In a recent study, JWG, a European think tank focused on financial services regulation, has shown that the financial services industry has assigned €33.3 billion of 'change the bank' budget to improve their prudential regulatory reporting capabilities by 2015. JWG predicts that without fundamental policy reorientation in the EU, total costs of reporting, taking into account forthcoming regulatory initiatives such as CRD IV, RRPs and Solvency II, will approach €50 billion – about half of Greece's first EU bailout. Better regulation, according to the research, could save the industry €24 billion in implementation costs during a period when it is desperately needed to stimulate economic growth.[iii]

To further drill down into the cost of regulatory compliance, consider these two specific examples and their implied global compliance costs – FATCA and AIFMD.

The Foreign Account Tax Compliance Act (FATCA) is a significant piece of legislation that will impact many U.S. and non-U.S. entities, both financial and non-financial. Under FATCA provisions, foreign financial institutions (FFIs) are expected to sign an agreement with the U.S. Internal Revenue Service (IRS) identifying any U.S. person accounts and to report certain information on an annual basis. In addition, both U.S. financial institutions and FFIs will be required to report details to the IRS regarding substantial U.S. owners of non-financial foreign entities (NFFEs) unless under an intergovernmental agreement (IGA) is signed. It is estimated that FATCA will cost $100 million per financial institution or $8 billion across the industry.[iv]

The Alternative Investment Fund Managers Directive (AIFMD) is a proposed European Union law which will put hedge funds and private equity funds under the supervision of an EU regulatory body. These kinds of business vehicles have not been subject to the same rules to protect the investing public as mutual and pension funds. AIFMD is estimated to cost €6 billion across the depositories affected.[v]

The costs detailed above make an assumption that organisations comply in a timely manner. For those organisations that fail to take action in a timely and prescribed manner, the impact and cost of regulatory reporting implementation can further increase. These indirect costs can stem from delays in responding to regulation mandates as well as from the impact of changes made to regulations already on the books.

Traditionally, fund promoters are slow to respond to regulatory mandates. That complacency ultimately results in higher costs of implementation as the legal compliance date of a regulation draws closer. Rushing too quickly into a solution, however, can leave compliance teams with unnecessary rework as the regulations shift and change. At the same time, extremely slow response and implementation can present more risk and associated costs as regulation timelines are jeopardised and even missed.

A timely example of the continuous change in regulations to the fund industry is that of Key Investor Information Document (KIID) and the impending Packaged Retail Investment Products (PRIPS). The cost of KIID to the European industry has resulted in an approximate spend of €1 billion.[vi] No sooner have asset managers wrapped up their KIID projects than new proposals in Brussels have raised the need to further expand the document to cover other products caught under the scope of PRIPS – which is expected to add an additional €350 to €550 million to the industry cost.[vii]

Regulatory compliance impacts more than just risk and cost. There are also opportunity costs. In a recent survey published by *Money Management Executive* in November 2012, fund firm executives said regulatory compliance is of greatest concern and priority.

- Forty-five percent of respondents said because the outcomes affect their firms' bottom line performances.
- Another 38% said it affected their firms' ability to grow.
- Additionally, 36% said it affected their ability to innovate.[viii]

While the costs for regulatory reporting industry-wide continue to climb, individual firms can manage the associated costs and risks through careful planning and implementation of solutions. In addition to having the right internal teams in place, following a defined process, including industry best practices, will ensure a firm's ability to meet the regulatory reporting challenges with success.

Partnering to Benefit from Best Practices

According to the *Money Management Executive* survey mentioned before, almost two-thirds of respondents indicated that their firms now employ a dedicated chief compliance officer. Another 36% have chief risk officers. However, simply having these roles in place does not mean success. In fact, in a study by Thomson Reuters, *The Cost of Compliance Survey 2012,* even organisations that have compliance officers in place are feeling the pressure. The time required of them to not only manage the compliance projects and teams but to interact with regulators is increasing. Almost 70 percent of respondents expect the time they spend liaising and communicating with regulators and exchanges to increase.[ix]

The ability to follow best practices and implement the right measures and solutions requires a clear roadmap and a dedication not only to the individual organisation, but to the industry as a whole. It is important to the financial services industry for asset managers to remain engaged in regulation. The good news is that firms do not have to go it alone. The right technology partner can augment an organisations' time and resources, ultimately providing even more impact.

To successfully tackle global regulatory reporting issues, technology partners can help organisations' regulatory teams to follow the steps defined below.

- Analyze new regulations, legislation and impending legal updates and their impact.
- Track the progress, continued adoption and changing shape of regulations.
- Influence and steer the industry to ensure that the impact is fully appreciated and understood.
- Lobby and participate in working groups with both the regulators and industry bodies to ensure there is an understanding of the reality regarding the cost versus the benefit of any new or changing regulation.
- Implement regulation compliance and reporting in an organised and structured manner with clear rollout plans and checkpoints.

Companies that have compliance officers and teams in place and follow the tactics outlined above, with a trusted technology partner, are best poised for success. If regulation is not going away and firms' ability to meet performance goals, grow their business and innovate is on the line, then finding the best ways to meet regulatory reporting challenges is imperative — and embracing the right technology partner can keep regulatory-savvy firms ahead of the ever evolving regulations.

How Agility Determines the Build vs. Buy Decision

Often, the first response IT has to any solution request is "we can build it". That goes hand in hand with the old adage of "Just because you can do something, doesn't mean you should". Large service providers and fund administrators probably *could* build a regulatory reporting solution. But should they? Will the project come in on-time and on-budget? Will their solution have longevity? Will it produce the intended results? Will long-term maintenance costs outweigh any initial cost savings of an internal build? Can IT respond with agility?

PricewaterhouseCooper found that during build or buy evaluation, it's critical to thoroughly understand total costs during the software lifecycle – typically seven or eight years. Analyzing the entire lifecycle rather than only considering upfront costs is vital because 70 percent of software costs occur after implementation. A detailed examination of ongoing in-house maintenance often suggests that buying a market solution is more cost effective.[x]

Finding the right technology partner for regulatory reporting is of the utmost importance to a fund company's ability to manage compliance risk and the associated costs. Software vendors with a proven track record of developing the right applications, implementing with best practices and supporting the client at the highest levels provide the most agile response to regulatory reporting challenges.

Consider the following factors when determining whether a vendor's business goals align with those of your organisation:

- Do they specialise in fund administration?
- Does their client list include companies of similar size and structure as yours?
- Do they have a proven track record in delivering expected results?
- Do they stay abreast of global regulatory trends?
- Do they maintain key partnerships with audit firms?
- Do they have other fund administration automation products to meet future needs?
- Does their product development process involve open communication with clients on the enhancement and release roadmaps?
- Are they respected in the industry as thought leaders?

What do technology partners bring to the table?

1. Solid understanding of market and regulation requirements
2. Thought leadership
3. Strong client base with shared user groups and forums
4. Forward looking
5. Both proactive and reactive
6. Validation of solution through consultants and auditors
7. Data collection
8. Augmentation of data
9. Report creation

Gaining the ability to respond to regulatory challenges with agility and control is a paramount factor when choosing a software vendor partner. Strategic alignment of the software vendor and the fund administrator is of utmost importance when defining overall project goals and objectives. Building a long-term partnership rather than simply purchasing a point solution will enable success in both immediate compliance needs and in the evolution of solutions for regulations still being developed.

Confluence: A Trusted Technology Partner

As the industry's global leader in investment data management and automation, Confluence has earned a reputation as a trusted technology partner to some of the world's leading asset managers and their service providers. Technology is our business, our only business. We consider building client loyalty to be a strategic imperative. We understand the fund administration business and we are committed to keeping ahead of statutory and regulatory developments in the markets we serve. Our goal is to anticipate challenges and provide solutions before they become problems for our clients. And, we believe that it is our job to be industry experts and to keep our stakeholders educated on important trends and regulatory developments.

Confluence believes our clients are our greatest asset. As a result, we take building client loyalty very seriously and look to take advantage of every interaction with our clients as an opportunity to earn their trust and endorsement. In fact, we have embraced the Net Promoter Score (NPS) as an operational discipline and client loyalty metric. NPS is determined by our clients' answer to the following question: How likely are you to recommend Confluence to a colleague or friend? The score is calculated by the following equation: NPS = % Promoters minus % Detractors. Promoters respond to the question with a 9-10, Passives respond with a 7-8 and Detractors respond with a 1-6. We are proud to say that in 2012 our NPS rose to the world-class level +41%. According to Net Promoter, leading business-to-consumer software companies score in the 35% to 40% range, while average companies score only 5% to 10%.

We also pride ourselves on our knowledgeable team and their depth of industry knowledge. For example, unlike many of our peers that hire product managers solely on their IT expertise, Confluence product managers are hired for both their asset management industry expertise and their technology savvy. The vast experience they bring from their backgrounds working for large service providers is invaluable in understanding how our clients work and the reality of how the influx of regulations impacts their businesses on a daily basis. Confluence product managers also maintain deep relationships with global audit firms who provide analysis and feedback of our best practices. The depth of our regulatory compliance experience allows us to adeptly guide clients through the regulatory maze and plan to comply with reporting requirements in a timely, logical and cost-effective manner.

Our product managers stay abreast of what is happening in the global marketplace. For more than 20 years we have been solving tough statutory and regulatory challenges – After-Tax Performance Calculations, FAS 157, OFI-1, global IFRS and GAAP convergence, Form N-MFP money market reform reporting and N-SAR XML reporting to name a few. We take pride in our role as an industry expert and believe it is our responsibility to educate the market. That's why we publish informational whitepapers on various topics and produce webinars that focus on key issues facing fund administrators. For example, we frequently bring experts from well-known audit and consulting firms together with our product managers to deliver webinars focused on global regulatory challenges. Past speakers have included industry experts from leading authorities such as KPMG, ManagementPlus, PwC, Deloitte and Rothstein Kass.

We invite fund sponsors and service providers that are looking for a trusted solutions partner to leverage Confluence's reputation for client loyalty, our understanding of the fund administration business, and our commitment to staying abreast of key industry issues and solving tough challenges.

Conclusion

As more and more regulations are introduced to the global fund industry, organisations need a prescribed path to respond with the necessary agility. Building an internal point solution for every report required is neither scalable nor cost-effective. Finding a partner who can navigate the regulation onslaught and provide the best practices for compliance and solution implementation is imperative. Risk-aware institutions understand that reacting too slowly or hastily both have dramatic consequences. A software vendor with a proven approach can pave the way for regulatory reporting success so that fund administrators can get back to their core business of providing service excellence to their customers.

Relying on in-house IT teams to build multiple custom solutions is fraught with unforeseen costs and developmental pitfalls. The right response to agile regulatory reporting does exist. Remember the benefits that technology vendors can offer and follow the steps laid out in this paper to form a long-term strategic alliance.

About the Author

Melvin Jayawardana, a Confluence Product Manager, leads our global initiative to further expand our statutory and regulatory reporting platform globally.

Melvin has over 18 years of financial services experience gained with leading financial institutions in both the United Kingdom and Luxembourg. Prior to joining Confluence, Melvin served as a Senior Vice President with JP Morgan in Luxembourg as part of the EMEA product management team. In addition, Melvin spent 16 years with State Street in London, Edinburgh and Luxembourg where he held several senior operational roles leading multi-regional teams in post-trade compliance, statutory and regulatory reporting and fund services operations.

About Confluence

Founded in 1991, Confluence is a global leader in fund administration automation. Confluence helps investment management companies gain unprecedented control by automating every step of the fund administration process — including the collection, creation, confirmation and delivery of investment product data — while maintaining control of the process. Results are lower costs, reduced risk, decreased reporting turnaround times and the scalability to automate more processes without additional resources. Confluence solutions are used by 40 percent of the leading global investment managers, and more than 60 percent of U.S. mutual funds.

Headquartered in Pittsburgh, PA, Confluence serves the international fund industry with key locations in San Francisco, London and Luxembourg. For more information, visit www.confluence.com or email info@confluence.com.

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