Managing regulatory compliance

Investment management boutiques can achieve advantage in managing regulatory compliance

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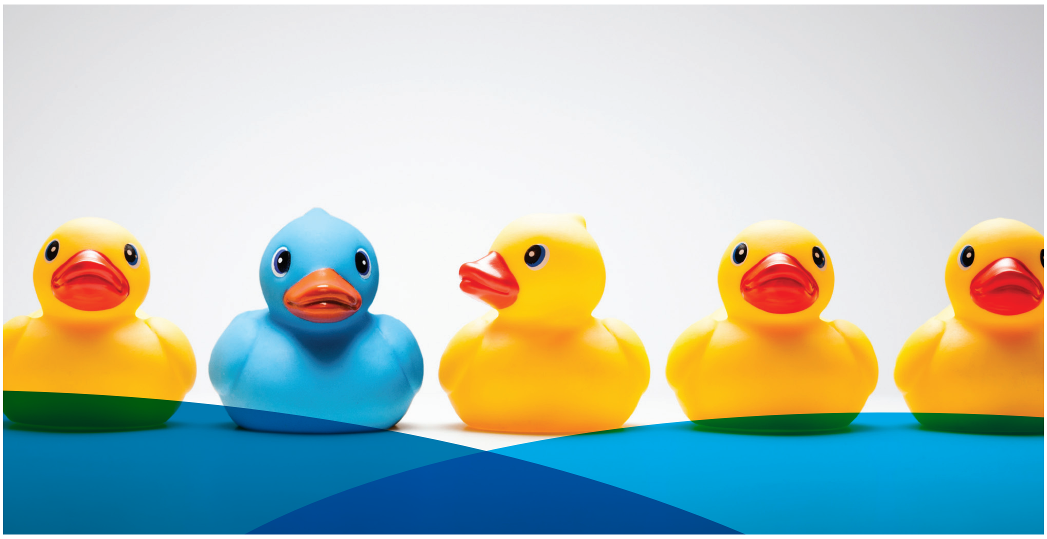

Introduction

I was asked to speak at the 2014 Fixed Income Future Leaders Conference. The topic was: "Are regulations pushing SMEs (small and medium-sized enterprises) out of the market? "

The idea that regulation is overwhelming for small businesses is a common theme that I have heard many times before. As I thought about what I might say at the conference, I reflected on our experience in Cameron Hume. Compared to my experience in much larger firms, we find it relatively easy and inexpensive to cope with regulatory change. I felt that people might find this counter-intuitive idea to be a more interesting theme for the conference.

Executive Summary

The UK financial services industry is regulated by both the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). There have recently been wide-ranging regulatory changes that have impacted the investment management sector and there are more to come, with particular impact for firms that, like us, trade in fixed income instruments and derivatives.

We are an investment management boutique operating in the UK market and regulated by the FCA. Our experience has been that, although the regulations can at times appear labyrinthine, the regulator has yet to ask us to do anything other than those things we believe a well-managed firm should be doing in any case. We are required to consider our capital, the quality of our people, our systems and controls. This is simply good management and governance and there is only a small overhead involved in documenting and reporting these considerations to the FCA.

The quality of regulation in the UK makes it an attractive place for us to be domiciled, and for our international clients to do business. Our clients not only expect us to be capable investment managers, have great people and robust operations, but also to be a well-managed and highly compliant business. It is important that we reassure our clients of our ability to maintain high standards of compliance.

From our experience of both large firms and boutiques, we have found that managing regulatory compliance is made easier for an investment management boutique by the combination of a simple business model and an appropriately designed operating model:

- Investment management boutiques have relatively simple business models that are less exposed to regulatory risk than businesses with more complex models.
- Investment management boutiques are more able to adopt new techniques and technologies that allow them to change more efficiently in response to regulatory demands.

1. Simpler investment management business models are less exposed to regulatory risk

All firms are not created equal in the eyes of the regulators. In the UK, The FCA classifies businesses on two scales. The conduct classification uses a measure of the firm's ability to impact the objectives of the FCA and the number of its retail customers. The prudential classification is based on assessments of the complexity of the business and the potential for failure of the business to have a material market impact.

Scale is clearly a factor in influencing conduct and prudential classifications. However other aspects of the business model influence regulatory risk directly. Complex business models that participate in multiple markets face greater regulatory scrutiny than simpler business models and therefore have a higher overhead associated with regulatory compliance. There is simply more regulation with which large and complex businesses must comply. The compliance functions in those businesses may also face greater difficulty in identifying non-compliant business activities sufficiently quickly to avoid reputational or financial consequences.

This is not to say that firms should choose their business models to avoid regulatory hazard, but rather to make the case that firms with simple business models ought to be less prone to inadvertent breaches of regulation.

1.1 Some regulated activities are riskier than others

The FCA grants permissions to firms to undertake activities that are regulated by the Financial Services and Markets Act 2000 (FSMA). Some regulated activities are riskier than others. For example permission to hold client money carries a risk that client money is inappropriately comingled with firm money or is incorrectly identified, and we have seen examples of firms fined for persistent failings to properly identify client money. Firms that have client money permissions are also subject to more rigorous capital resources requirements.

Permission to give financial advice and the consequent risk of mis-selling is another high risk activity and we have seen numerous examples of financial services firms being fined, or having to undertake expensive customer remediation exercises in respect of the mis-selling of financial products.

1.2 Regulators are more concerned with retail clients than they are with institutional clients

The regulators are generally more concerned with protecting retail clients than they are with protecting institutional clients. Institutional clients are regarded as sophisticated buyers of financial products with access to resources to help them to understand such products and to seek redress if needed. The regulations offer retail customers more protection than institutional clients, because retail customers are thought to lack these characteristics.

This means that business models that service retail clients have to compensate for their clients lack of sophistication and access to resources. The relevant regulations are intended to ensure that they do this, which means that business models that service retail clients have to deal with broader and more onerous regulations than those that service institutional clients.

1.3 More complex businesses need more complex regulation

We have seen that regulations apply differently to both different activities and customers. They also apply differently to different business models. Firms that have multiple product businesses in multiple markets are subject to more regulations and variations in regulations than "monoline" firms or firms with relatively simple business models.

We can see this in the different characteristics and trading arrangements of fixed income and equity instruments. The regulator recognises this and firms are required to specify the classes of assets that they require permission to use. Investment management boutiques typically focus on a single asset class, and can therefore focus on the relevant regulations for that asset class.

2. Investment management boutiques can adopt operating models that are easier to change to meet regulatory requirements

In larger businesses it is commonplace that the majority of strategic change capacity (project resources and budgets) is absorbed by the demand for changes arising from regulation. This has the effect of inhibiting those businesses from developing new products or undertaking other strategic projects to the benefit of their clients.

This is in part a result of the volume of regulatory change that has to be accommodated, but it is also a function of the operating models of these businesses. These tend to have developed over time in a patchwork fashion and are characterised by multiple sources of data, many computer applications and overlapping processes and functions. These are resistant to change, since even simple changes may have to be made many times and computer applications are often monolithic "legacy" systems that can only be changed after complex reprogramming and testing cycles. Operations are often in-house and therefore the responsibility and cost for making the change rests with the firm.

Investment management boutiques can have much simpler operating models and do not have legacy operations and systems. For example, we have had the opportunity to design our operations from scratch and in doing so have been able to take advantage of new outsourcing techniques and technologies. The costs and complexities of migrating away from legacy operations and systems can make accessing these techniques and technologies prohibitively expensive for established firms.

2.1 New operating models are easier to change

The pace at which new ways of doing things become available is always faster than that at which they can be implemented. Changing an operating model may involve:

- data migration;
- a lot of testing;
- de-commissioning costs;
- staff redundancy costs; and
- property disposal costs.

These costs are often prohibitive and undermine the business case for change. It is quite simply a case of "I wouldn't start from here". We were able to take immediate advantage of best practice techniques and technologies simply because we had no legacy operations to deal with.

For example, the market for outsourced investment operations is mature, with a good number of large and well established providers. A new investment management boutique can use that market to access scale, experience and expertise that would otherwise take years to build. As another example, the supply of hosting services for virtual private cloud computing has matured rapidly and provides access to highly resilient, scalable and secure IT services, in small units and at a low unit cost. Established firms with their own data centres find it difficult to match this flexibility and may struggle to make the business case to migrate to a new model.

2.2 Outsourced operations can provide access to scale and shared services

Outsourcing can provide access to scale and skills that would not otherwise be achievable, but it must be well managed to avoid loss of control and disappointed expectations. When we established Cameron Hume, we set out to manage our outsourced investment operations well. We started with a top-down design for our operating model that enabled us to specify the investment operations services that we needed. We prepared a request for proposal based on that design and used that to select an investment operations partner (Northern Trust). Our contractual and service management framework was based on the same operating model. This strong design integrity, coupled with good governance enables us to be confident that our investment operations partnership is delivering the services we need, to the right quality.

We have found that having a modern, well-managed outsourcing contract enables us to handle changing regulation far more efficiently and effectively than if we managed our investment operations in-house. Northern Trust undertakes regulatory changes on behalf of all clients and in our case the cost of these changes is included in our contract. This enables us to cope with demand for regulatory change, at speed and with scale, with little or no resource or cost impact on our business.

2.3 Scare skills can be acquired efficiently

Regulatory and compliance skills are in great demand and are likely to remain so. Small firms value generalists over specialists and so may lack individuals with deep knowledge of narrow regulatory topics.

We have found that specialist knowledge can be acquired efficiently from outside the firm. Northern Trust manage the impact of regulatory change on their business by constant scanning of the regulatory horizons and then share this experience with their clients via events and newsletters. There are also specialist regulatory and compliance consultants who provide expert advice and other support services such as compliance monitoring.

Investment management boutiques need not therefore be disadvantaged in accessing specialist regulatory and compliance skills, and can access those skills cost-effectively.

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