

Introduction

Regulatory pressure, decreasing margins and increasing costs in the securities industry are pushing funds actors to improve their middle and back-office systems. This is causing a clear shift towards further automation and standardisation, which is good news for the industry as greater automation goes hand-in-hand with improved cost efficiency. Communicating in a manual or semi-automated environment leads to significant operational risks caused by manual errors and lack of an audit trail. Another aspect of operational cost rises from having to maintain many different communication channels (fax, email, ftp, etc). Therefore it remains crucial to pursue the goal of more automation, and to decrease the level of manually processed orders.

During the spring and summer of 2014, SWIFT interviewed the heads of investment operations and fund distribution at six of the ten largest investment management firms to assess the current and future operational needs of the industry. These firms and their counterparts at more than 30 other fund management houses (encompassing the long-only, alternative only and both long-only and alternative sectors), completed a detailed questionnaire. By conducting this research SWIFT aims to capture and better understand the operational challenges facing this important sector, with a view to working together with the industry to find shared solutions.

In this paper we will deep dive into two particular areas covered by the research – funds automation and financial crime compliance. For the full research findings, please visit swift.com to find out more.

Standards and automation are needed to overcome fund distribution challenges

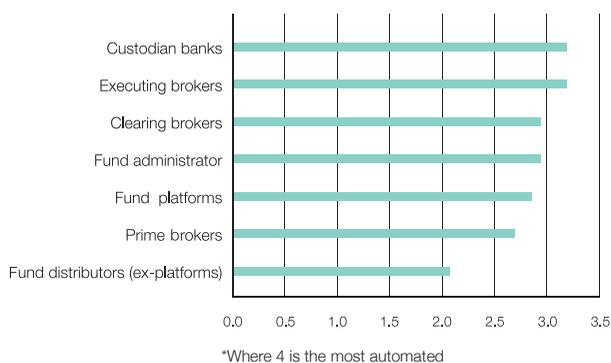
Processing large volumes depends on the automated exchange of standardised information

The main constraints on automation are linked to practice rather than technology. Constraints arise as a result of the availability and penetration of message standards in different asset classes, and the willingness and ability of counterparties within those asset classes to employ message standards. There is considerable variety in the degree of automation by counterparty and asset class.

Custodians are the most automated counterparties of investment managers

As Table 1 shows, the levels of automated exchange between investment managers and custodians are high, principally because they use standardised messages. This matters because, in addition to dealing with the custodians to their own funds, investment managers also have to interact with custodians appointed by their institutional clients. It is not unusual for a large investment manager to have contact with over 100 custodian banks.

Table 1: The most and least automated counterparties*

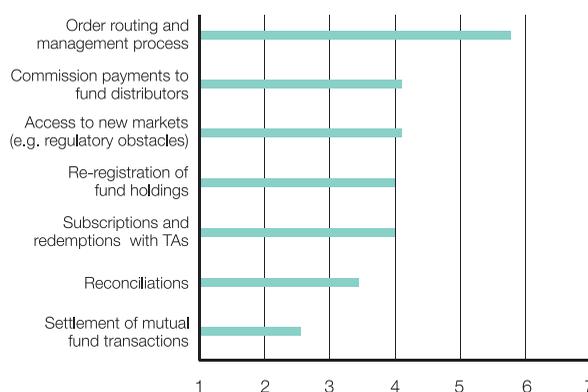


There is scope for increased standardisation and automation in dealings with transfer agents

As Table 2 shows, investment managers regard their exchanges of information with transfer agents – registration of changes of ownership of funds, and the processing and settlement of fund subscriptions and redemptions – as relatively inefficient and in need of automation. This reflects limited use of available message standards, and a continuing reliance on file transfers and fax. Even in the United States where a local message standard ostensibly prevails (FundSERV), a manager is dismayed by “how much flexibility there is in the interpretation of the technical standards.”

Table 2: The largest and smallest obstacles to efficiency in fund distribution*

*Where 7 is the biggest obstacle to efficiency.



There is limited pressure for standardisation in transfer agency

Investment managers and transfer agents have historically attached greater importance to accuracy rather than speed. “We prefer to get FTP files from transfer agents,” says a manager. “With low volume names, fax is probably better.” However, managers agree that a higher level of standardisation would nevertheless facilitate distribution in new markets.

Multiple order-routing networks hamper standardisation of exchanges with fund distributors

The proliferation of competing order-routing networks linking investment managers and their transfer agents with fund distributors, notably in Europe, has stifled the development of a single message standard in communications between fund distributors and investment managers and their transfer agents. As Table 2 shows, investment managers regard the current combination of networks using proprietary standards and different data templates as inefficient.

Banks are among the least automated of fund distributors

Banks dominate fund distribution in many countries, but are seen as resistant to standardisation of communication, especially if they are private, regional or local banks. “The problem tends to be a lot of smaller players who perhaps have not got the resources or the inclination,” explains a manager. “We, like a lot of other providers, are reviewing all those players. We are looking at options for them. Maybe, ultimately, we as an industry will say, ‘You need to deal with us through STP and, if you do not, we are not going to accept faxes.’”

The degree of automation varies widely between markets

One investment manager estimates that its communications with fund distributors are 100 percent automated in the United States (using FundSERV), where a dominant order-routing network (Fund/SERV) channels the subscriptions and redemptions into the National Securities Clearing Corporation (NSCC) as a settlement agent; 90 percent automated in the United Kingdom; 75 percent automated in Continental Europe; and 50 percent automated in Asia.

Fund distribution challenges are linked to investment operations but also have distinct characteristics

Investment managers divide post-trade investment operations from the operational support given to fund distribution. This division is somewhat artificial. A change in the settlement of fund transactions or the remuneration of fund distributors, for example, has knock-on effects on investment operations. The operational challenges facing fund distribution are nevertheless distinctive.

Investment managers face growing complexity in fund types and structures

Within the five broad categories of funds – equity, fixed income, money market, multi-asset and alternative – lies considerable variation. There are more than 78,000 separate mutual funds available round the world, employing a wide variety of vehicles (including UCITS, non-UCITS, OEICs, SICAVs, ‘40 Act funds, ETFs), share classes (Class A, Class B, Class C, income, accumulation class) and currencies (the biggest mutual fund markets encompass 33 currencies, necessitating the hedging of shares back to a base currency).

Global distribution requires global operational support

One investment manager says his firm has 700 funds distributed in 23 jurisdictions through 1,620 distributors, ranging from banks and private banks, through IFAs, to fund platforms and corporate treasurers. Each fund requires daily valuation and transfer agency services. The same manager has developed another 400 hedged share classes in its Luxembourg-domiciled fund range alone, because it is simpler to add a share class to accommodate investors in a new market than to launch a separate fund. The top priority of one manager surveyed is the “Globalisation of operational infrastructure to support the international growth of the firm”.

Distributing funds in new markets is operationally challenging

Three out of four of the mutual funds currently in existence are distributed in Europe or North America, but that proportion is down from four fifths five years ago. In other words, Africa, Asia, Latin America and the Middle East are of increasing importance. Funds distribution in these markets requires an understanding of local laws and regulations, the selection of existing or local transfer agents and fund accountants, building distribution networks in new markets, and selecting the appropriate fund vehicles. “Are we going to use international funds or local funds?” asks one manager. “The answer to that question will have an operational impact.”

Hedge funds are hard to support with conventional services

Distributors are selling more hedge funds, but they suffer from infrequent liquidity, insistence on signed applications to invest, and the limited use of standards by hedge fund managers. This makes hedge funds hard to support with conventional fund accounting, transfer agency and order-routing services. "It is very difficult to have T-minus settlement, which is what you are looking at with hedge funds with liquidity points months ahead," explains a manager. "How do you put that in your system?"

Fund platforms are displacing traditional transfer agencies

Fund platforms are undermining the economics of transfer agents, who collect a fee for processing subscriptions, redemptions and switches, by aggregating multiple orders into single buy and sell messages. "The fact that 70-80 percent of the business comes from platforms is more efficient for us, because they aggregate deals," explains a manager. "That is the problem for transfer agents. The more the platforms grow, the greater the reduction in the functions that transfer agents will ultimately perform. If you take that to its logical conclusion, the question is whether you end up with an industry hub." The most likely candidates to fulfil this role are central securities depositories (CSDs).

Disaggregating orders from fund platforms is an administrative burden

Investment managers report that, despite their ability to aggregate orders, fund platforms can impose additional manual work on fund managers in terms of calculating commission payments to distributors, because the underlying clients and distributors are difficult to disentangle in omnibus accounts. "You cannot see the assets that clients of distributors hold on the register, which creates the risk of over-paying commission," explains a manager. However, disentangling aggregated orders is relatively simple by comparison with maintaining individual accounts for every investor. Individual or segregated accounts may become more commonplace or replace the use of omnibus accounts in the funds and securities industries, due to the increasing focus on AML, KYC and other risk considerations.

Centralised settlement via CSDs is expected to replace settlement via transfer agents

Investment managers expect mutual fund order processing to evolve globally on the basis of a model operated by the National Securities Clearing Corporation (NSCC) in the United States, where subscriptions and redemptions are channeled through a single order-routing network (Fund/SERV) into a single settlement process (NSCC). The NSCC service is now extended to Latin America. In Europe, mutual fund trades are already settling in CSDs in France, Germany and the United Kingdom, and the CSD in Hong Kong is building a fund settlement "hub" for the use of transfer agents. "As an investment manager, we would definitely welcome delivery-versus-payment (DvP) in real-time in the mutual fund sector, since it would place mutual fund settlement on the same footing as securities settlement," says a manager.

Investment managers support the realignment of securities and fund settlement cycles in Europe

European securities markets moved to settlement on T+2 in October 2014, creating a mismatch with funds, which generally settle on T+3. This means subscriptions and redemptions to and from a fund are not aligned with purchases and sales of the underlying assets. As a result, portfolio managers are obliged to incur the cost of borrowing money or hedging the position in the futures markets. This additional cost has created a strong expectation that funds will shift to a T+2 settlement timetable in Europe. That will not happen until fund distributors can accommodate it, and investment managers are confident it will not hamper sales of European funds in time-zones such as Asia and Latin America.

Investment managers are concerned that CSD settlement will inhibit access to distribution data

Investment managers are concerned that settling mutual fund transactions in CSDs will make it more difficult to obtain accurate and timely distribution data, because this information is presently derived from transfer agents. One manager says his concern on this issue is borne out by experience of the French model of CSD settlement. "It is very difficult for investment managers to live with," says a manager. "We cannot see the distribution network except through the centralising agent [for subscription and redemption orders] and then with limits. We therefore have to work hard to discover who is buying our funds, and whether our marketing campaigns are working. This is expensive and opaque."

Access to timely distribution data is increasingly important to investment managers

Investment managers are increasingly interested in detailed fund distribution information from transfer agents, order-routing networks, and fund platforms, though they are struggling to integrate data from such disparate sources. The information is useful in determining which distributors are most effective and profitable to the firm, which products are selling well and which badly, and what new funds need to be developed. It is also useful to portfolio managers to position funds to cope with inflows and outflows of capital. “We are moving into serious statistical analysis of the behaviour of the distribution network,” says a manager. “It takes a lot of investment in technology, and is difficult to do if you are using a large network of transfer agents in different countries. You have to knit the different sources together.”

Investment managers have a responsibility to ensure that products are sold correctly via distributors

Investment managers are under an obligation to “treat customers fairly” (as the terminology of the United Kingdom regulator, the Financial Conduct Authority (FCA), puts it). This entails ensuring investors always buy funds appropriate to their needs, even if the sale is made by an independent distributor. “Regulators are increasingly asking investment managers to be responsible not only for the manufacturing side of the business but also for the context in which their products are being sold,” explains a manager. “We look at our distributors as being our customers. The regulatory view is that distributors are actually agents of the investment manager, and the investment manager therefore has a duty to ensure products are sold correctly, in the sense that suitability and appropriateness tests are met.”

Order-routing networks are considered inefficient

As the research showed, investment managers regard order-routing networks as inefficient because there are too many of them, at least in Europe. Unlike the United States, where a single network (Fund/SERV) dominates the routing of fund subscription and redemption orders from distributors to managers or their transfer agents, European fund orders are carried across a variety of domestic and cross-border networks, each of which operates according to proprietary standards. This means that managers and transfer agents face additional costs of maintaining multiple interfaces, many of which direct orders to proprietary settlement venues. “Competition has expanded the tool sets, and we have seen costs fall in this area for the first time,” says a manager. “But a unified, cheaper system would still be best, especially if organised regionally.”

Inefficiencies are also identified in the registration of purchases and changes of ownership of funds

As Table 2 shows, the registration and re-registration of ownership of shares or units in funds is considered to be among the least efficient aspects of fund distribution. Transfer agents who maintain the registers of owners frequently receive incomplete or unmatched instructions to transfer stock between accounts, and have to chase investment managers, distributors and investors. Managers would prefer it if both the senders and the recipients of messages about the transfer of shares in funds use a standard template, as proposed by the Findel Transfer Working Group.

Data sharing can be increasingly standardised

Investment managers share with fund distributors, fund platforms and data vendors sets of dynamic and static data needed to process fund transactions efficiently, including the standard codes that identify the fund, its manager, launch date, valuation timetable, and dividend dates. At present each service provider requests data in a bespoke rather than standard template, requiring investment managers to adapt their dynamic and static data to multiple templates. To remedy this inefficiency, managers favour centralising the data at a single repository in a single agreed format. “There is a role for someone to organise a standard template or create a utility,” says a manager.

The payment of commissions to fund distributors is inefficient

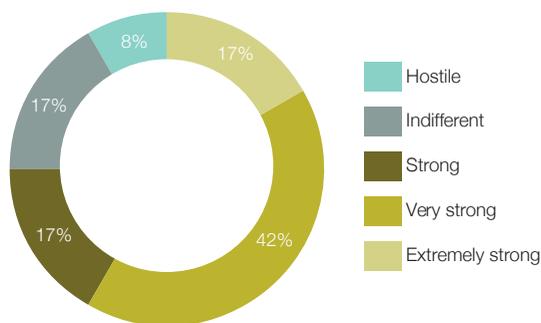
Payments to fund distributors are largely dictated by the transfer agents that record their activities. It is considered to be an inefficient process, because of the number and differences between the legal agreements drawn up between investment managers and distributors, and much of the work is completed by hand. Yet the sums at stake are significant. An initiative to increase automation and reduce the

risk of error by creating a standard commercial term sheet, known as the Dematerialised Mutual Fund Sales Agreement (DMFSA), has so far failed to win sufficient support from investment managers and distributors. “This is a very serious source of inefficiency across the global asset management industry,” according to one investment manager. “It is a wonder that it has remained neglected for so long.”

Better use of established messaging networks

Investment managers are clear that what they value most in a post-trade service provider is network effects: the value of the service stems from the access it offers to as many of their counterparties as possible. “We look at what has community,” explains a manager. “In general, that is where we go. It is community and standards that decide which services we use.” With over 6,000 securities participants in its global network of over 10,800 connections, SWIFT is ideally positioned to deliver this network effect in the post-trade arena. Half the investment managers in the surveyed group that have not outsourced post-trade communications to a global custodian send more than three quarters of their messages via SWIFT. Managers surveyed stated that they would welcome wider use of SWIFT messages in parts of the post-trade environment where they are available. There seems to be especially strong support from investment managers to find an industry standard for mutual fund distribution. Four potential approaches can be identified. First, automation of the inefficient fund registration and re-registration process (which SWIFT has already been working on through its membership of the Findel Transfer Working Group). Second, the capture, storage, standardisation and online distribution of mutual fund static and dynamic data. Third, the development of SWIFT messages to facilitate the settlement of mutual fund transactions in central securities depositories (CSDs). Fourth, SWIFT messaging services could potentially displace proprietary message standards, file transfers, emails and faxes throughout the post-trade area of the investment management industry. SWIFT has already built a strong market position in standardising and automating exchanges of information between investment managers and their transfer agents and fund distributors, Table 3 indicates that three out of four managers believe SWIFT should now build on this franchise.

Table 3: Support for SWIFT as the standard in mutual fund distribution



The Need for Financial Crime Compliance

Managers must check the integrity of investors

Fund managers are required to assess clients and counterparties to ensure they are not laundering money, breaching sanctions or handling investments from corrupt public officials (known as “politically exposed persons”). Since the passage of the PATRIOT Act in 2001, which included specific anti-money laundering (AML) provisions to prevent the financing of international terrorism, regulators have required financial institutions to follow detailed and evolving sets of Know Your Customer (KYC), AML and sanctions screening procedures.

Investors must also be checked for tax compliance

The Foreign Account Tax Compliance Act (FATCA), introduced by the United States government in 2010, has led to a requirement to check the tax compliance of clients as well. The principle behind FATCA is the sharing of information by national tax authorities, enforced by withholding income from recalcitrant individuals. It is now becoming the international norm. Member States of the Organisation for Economic Co-operation and Development (OECD) have agreed a package of measures labelled Treaty Relief and Compliance Enhancement (TRACE). The package is known colloquially as the “global FATCA.”

Workload is increased by jurisdictional variations in KYC and AML rules

These obligations towards clients are placing managers under pressure to perform and document detailed due diligence on investors, under the threat of fines for errors and omissions. They apply in multiple jurisdictions where managers are active, and each national regime has its own variations. As a result, one manager stated that “KYC and AML checks have now become a major obstacle to fund distribution, particularly in high risk markets, such as those in Asia.”

Managers seek comprehensive KYC and AML solutions

“Compliance with customer due diligence obligations such as KYC, AML, FATCA and TRACE has developed into probably one of the greatest challenges for fund managers, promoters, fund service companies, intermediaries, and investors,” said one manager surveyed. Managers are now looking for efficient global solutions, such as “golden sources” of reliable data, the establishment of one or more KYC, AML and sanctions screening utilities, and the issuance of digital “passports” to automate due diligence processes.

KYC, AML and sanctions screening data sources and procedures are fragmented and inefficient

Managers address investor due diligence by questioning and assessing institutional clients and fund distributors, and by outsourcing the assessment of retail investors to transfer agents. They have to use a variety of data sources, such as those provided by Markit, SWIFT, the Depository Trust and Clearing Corporation (DTCC) and WorldCheck. Credit rating agencies are used for retail clients.

Sources of KYC, AML and sanctions screening data are inadequate

Current sources of customer due diligence data are fragmented. In some cases, data is not readily available. Fund distributors, for example, have to be tested for AML, but, unlike banks, tend not to have information to hand. Likewise, tenants in commercial buildings owned by funds have to be vetted, which can pose difficulties in obtaining information at the local level.

Due diligence procedures strain relations with clients

Repetition of the due diligence process for the same client (by each and every manager, even when an existing client invests in another fund), can strain relations with investors. “It creates a lot of frustration,” says one manager. “Clients hate it, because we are making their lives complicated.”

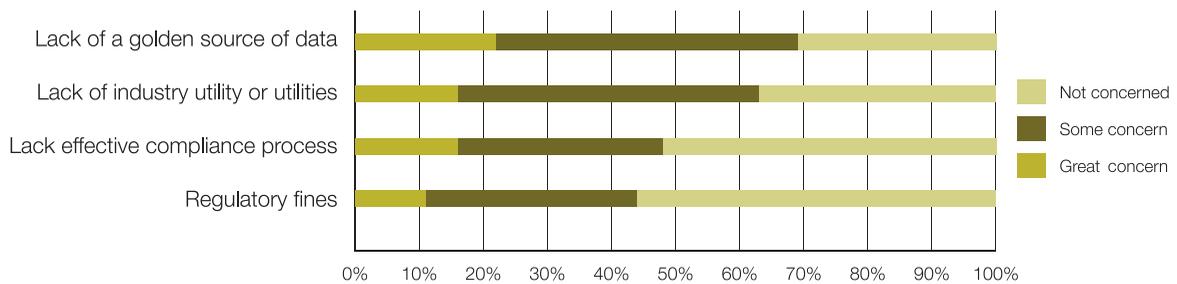
Significant interest in a ‘golden source’ of KYC and AML data

A majority of managers are interested in a golden source of KYC, AML and sanctions screening data, especially if the service can match internal standards. “Why we cannot, as an industry, make it easier somehow, through more collaboration and more centralisation of documentation in some form, or sharing of documentation, I do not know,” says a manager. “It is incredibly inefficient.”

Support for industry-wide utility solutions to address KYC, AML and sanctions screening

The survey results shows that a majority of managers favour the replacement of the current network of commercial service providers and data sources by one or more data utilities. “We would favour all firms placing all of their KYC data into a single data repository, to which all firms would have access via a user access protocol,” says one manager. “At the moment, KYC is eating a lot of time in manual processing and paper-based workflows.”

Table 4: Greatest concerns about KYC, AML and sanctions screening



Summary

It is clear that survey participants are facing operational challenges and are receptive to pragmatic industry-wide solutions. SWIFT is positioned at the heart of the industry - supporting capital markets since 1987 - and has a two-fold role. We provide the standards, solutions and post-trade processing services that enable securities institutions worldwide to connect and exchange financial information securely and reliably. We also act as the catalyst that brings the financial community together to work collaboratively to shape market practice, define standards and consider solutions to issues of mutual interest. With this in mind, we hope that this paper has highlighted some common operational challenges facing the industry and we look forward to discussing further some of the ways in which SWIFT is seeking to support the community with relevant solutions.



Empowering the Funds Industry through Automation

What is the current status of automation in the funds industry?

82%

of cross-border funds orders are now automated according to a standardisation survey by SWIFT and the European Fund and Asset Management Association (EFAMA)

5.6%

increase in ISO automation between 2012 and 2014, while manual processing decreased by 4.9%

SWIFT's unique position in financial services

10,800

institutions on SWIFT

100+

million funds messages sent annually over SWIFT

21%

increase in funds messages on SWIFT in 2014

200+

countries and territories where SWIFT is present

>2/3

of SWIFT funds messages are now migrated to MX (ISO 20022)

40

years of successfully serving the global financial community

How can SWIFT help funds participants?



Reducing Costs

Cost duplication eliminated by reducing the number of communication channels to bring all participants to the same level of automation and efficiency.



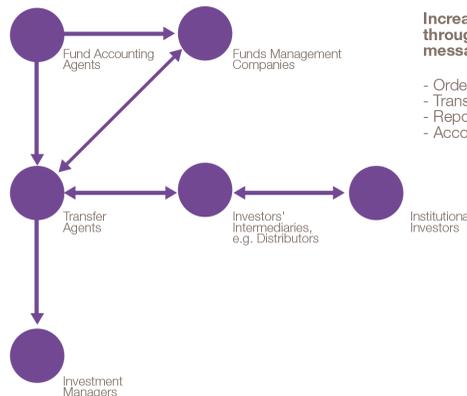
Increasing Transparency

Standardisation through one single channel by reducing manual processing and providing an audit trail for greater transparency.



Decreasing Operational Risks

SWIFT facilitates the establishment of better controls and audit trails through highly secure messaging, and financial crime compliance services



Increased efficiency through ISO 20022 messages for:

- Orders and confirmations
- Transfers and status
- Reporting and custody
- Account management

Core Messaging Platform and Standards

Connectivity solutions

Alliance Lite2

Alliance Access

Integration services

Business solutions

Financial crime compliance solutions (KYC Registry)

Reference data (SWIFTRef)

Standards/docs management portal (MyStandards)

Training, Consulting & Support services (ISO 20022 services)



Legal notices

About SWIFT

SWIFT is a member-owned cooperative that provides the communications platform, products and services to connect more than 10,800 financial institutions and corporations in more than 200 countries and territories. SWIFT enables its users to exchange automated, standardised financial information securely and reliably, thereby lowering costs, reducing operational risk and eliminating operational inefficiencies. SWIFT also brings the financial community together to work collaboratively to shape market practice, define standards and debate issues of mutual interest.

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