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LAW

REGULATIONS

COMPLIANCE

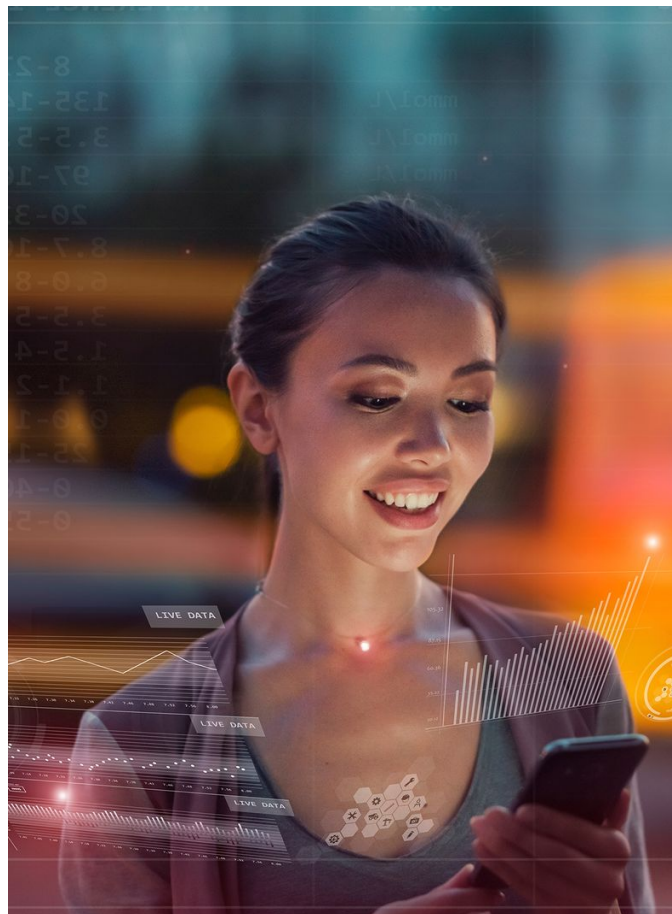
STANDARDS

POLICIES

**Future-proofing
your investment
compliance**

Changes in investment compliance beget opportunity

Seismic change is afoot given the significant uplift in SEC proposed rules reinforcing investor protection and demands for transparency from asset managers. Meanwhile shifting demographic trends and geopolitics, plus a focus on launching sustainable products, will all put significant pressure on compliance programs and the systems that support them. But get investment compliance right, and there's a big opportunity to gain competitive advantage.



Key takeaways

- There has been a pronounced increase in the volume and speed of proposed rules being released by the Securities and Exchange Commission (SEC). As the primary regulator of the investment management industry, this should put investment compliance programs on alert.
- Having an outdated compliance system doesn't just increase financial and regulatory risk. It reduces efficiency and limits the adaptability needed to pursue forward-looking business growth opportunities (think cryptocurrency).
- But entering new markets and offering new products increases complexity in compliance system usage and regulations. And regardless of the lack of regulatory standards, as with Crypto and ESG, investors are insisting on greater transparency.
- Automation has a central role to play - creating more robust and forward-thinking investment compliance programs and processes, reducing human error, and freeing up staff to work on higher-value issues.
- The right expertise, program approach and technology systems will reduce compliance risk and inefficiencies. They will also help companies enter new markets, improve time to market for automated compliance monitoring of new products and effectively position them for growth.



Investment compliance as it's always been done is no longer enough

Investment management has always been subject to stringent compliance rules, regulations, and policies. But the notion of simply “doing” or “managing” investment compliance in the same way it’s always been done is quickly becoming outmoded. The SEC is set to introduce more rules at a faster pace. Meanwhile, compliance challenges posed by the global legislative agenda, Paris Climate Accord and shifting geopolitics abound.

Today, investment compliance is a moving target. It is about dealing with changing conditions and expanding into more of a multidisciplinary function across the investment process. And while an outdated compliance system poses risks, getting investment compliance right begets the opportunity to create a competitive edge – through an ability to easily add new product types and highlight transparent communications to stakeholders. The shifting societal focus towards more sustainable practices is just one example of what’s driving the products of tomorrow – namely Environmental, Social and Governance (ESG) – and forcing investment offerings to stay competitive.

In this short paper, we look at the regulation and industry developments impacting investment compliance. We consider how the growing staffing gaps increase the challenge of applying compliance expertise to new requirements. And we discuss the role technology must play in being positioned to tackle these challenges head-on.



Regulation and industry shifts call for review of the status quo

The rapid evolution of compliance regulation is already underway. We have seen a pronounced increase in the speed of proposed regulations being released by the SEC and relevant European Union regulators over the past year. The SEC's changes are so significant they are being released in waves – with the most cursory of glances showing 22 new proposals consisting of almost 4,000 pages in the year to March 2022. Many of these regulatory developments focus on bringing transparency to the industry, with the ultimate intention of protecting the individual investor.

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Digital assets investing is one area coming under the spotlight. The fact that they stealthily entered the market through to the domain of the retail investor and retirement accounts is quite extraordinary. Until now, there have been no new regulations targeting these digital assets specifically. But regulators, such as the Commodities Futures Trading Commission, are taking a much more active interest. The SEC is also significantly expanding its Crypto Assets and Cyber Unit and has already conducted 1 legal battles against crypto creators and platforms. In one high-profile debate, Grayscale Investments is going head-to-head with the SEC after the regulator initially rejected Grayscale's application for a spot bitcoin exchange-traded fund (ETF) product. This seems indicative of more to come and furthers the call for adaptability in investment compliance.2

Organizations would be right to acknowledge that a strategy to future-proof investment compliance programs – in terms of both systems and expertise – is critical to enabling growth.

Keeping ahead of these changes will be one thing. But a more future-proof approach to investment compliance is likely to need an honest reappraisal of existing systems and processes for many organizations.

A more complex marketplace requires a fresh perspective on compliance

Shifting workforce and investor demographics, along with a focus on climate change, are just two macro areas driving industry change. In response, most asset managers are growing and adapting their lines of business. However, entering new markets and offering new products brings with it additional regulations to contend with. As an example, compliance systems will have to be able to evaluate risks stemming from non-compliance with core ESG regulations. In one of the first US cases in May 2022, BNY Mellon was penalized for greenwashing – in other words, misstating ESG considerations in its products. **3** Such demands broaden the types of investment compliance lenses required to assess new requirements and to efficiently monitor and maintain compliance.

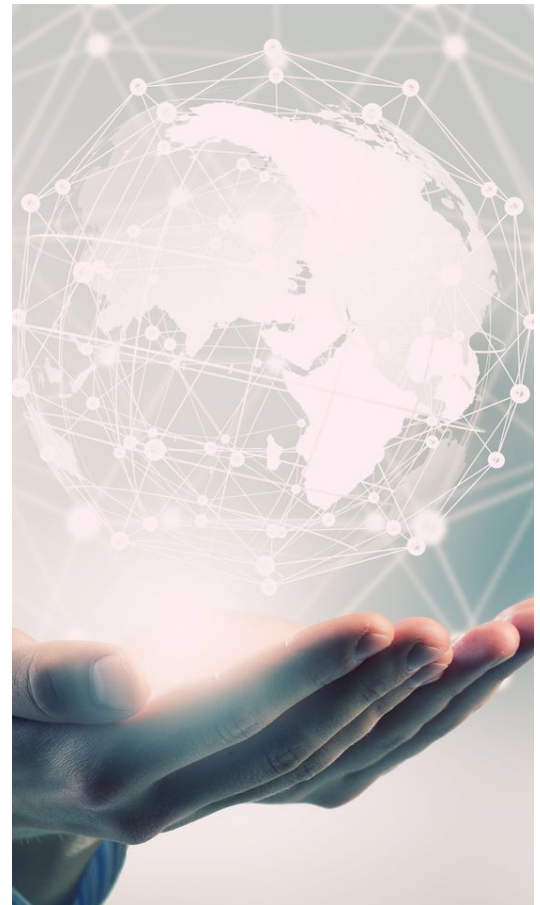
Often the new requirements do not fit into existing testing models, leaving investment compliance teams to cobble together interim solutions, which have often simply involved excel spreadsheets. Adding manual processes to this “system” only exchanges one problem with another. Thus, it is a zero-sum gain whereby inefficient interim compliance solutions often fail to improve or keep pace, exposing asset managers to even greater risk as time goes on.

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Regulators worldwide are turning hot on ESG practices

Consider the forthcoming SEC developments across the burgeoning ESG space alone. Asset managers and advisors are facing mounting demands from regulators around transparency. In April last year, the SEC issued a Risk Alert reviewing ESG-related practices and criticizing asset managers for inadequate controls and monitoring, and proxy voting. **4** Misleading ESG marketing claims and product labelling was also high on the agenda. And crucially, the regulator pinpointed insufficient ESG knowledge and experience within compliance functions.

The SEC has started laying out future best practices, especially regarding transparent disclosure around ESG investing approaches and products. In its May 2022 meeting, the Commission voted to approve two proposals which would crack down on misleading ESG labels. These practices include explanations of the ESG frameworks, policies and methodologies used to evaluate investments – and the knowledge expected of ESG within the compliance team. There’s no escaping the fact that all this requires hard work. The developments increase the pressure on compliance teams to keep up both operationally and in terms of efficiency.





Asset managers ignore the unambiguous signs of change at their peril

Even if asset managers have processes in place, there is little in the way of precedent or accepted standards – meaning that such processes may lack the necessary rigor to produce a consistent audit trail. At worst, a process might be little more than lip-service.

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Transparency calls for client-facing documentation and disclosures that clearly articulate how ESG factors are incorporated in investment decisions. It also calls for evidence of the fund manager's adherence to a consistent and transparent methodology.

In Europe, regulatory impetus is meeting the cultural shift toward sustainable investment products. Here, an embedded sustainable investment ethos is evident in investment and legislative circles. The EU's Sustainable Finance Disclosure Regulation (SFDR) which took effect in 2021 has an impact on all asset managers producing ESG products. ⁵This global regulatory focus is clearly not going away, and North American asset managers and fund administrators ignore the unambiguous signposts at their peril.

Of course, the expanding risks of fines, regulatory exposure and reputational damage associated with compliance breaches are forcing many to act. Many asset managers and fund administrators are already reading the cues and taking decisive action to modernize internal operations. But the proposed SEC changes and new asset class requirements have certainly raised larger questions around existing compliance programs; are current systems capable of handling a



Gaps in expertise add to the investment compliance challenge

Many firms are not set up to handle an increasing compliance burden, especially given fast-evolving regulation and shifting societal trends. This can be attributed to numerous factors, including a system with a lack of automation and flexible testing capabilities. But voids in staff expertise also play a big role. Here, talent gaps add to the challenge of applying compliance expertise to these new requirements.

Business and technical expertise in investment management can be hard to find and keep, and investment compliance is no different. This problem raises questions around whether to build internally from scratch, hire technology from a vendor or outsource to a third party. Many teams have built manual processes for compliance testing outside of their core monitoring program, even for extremely complex matters. Depending on a bespoke manual process outside of core technology not only generates added staffing costs but comes with significant inherent risks.

An outdated system can become cluttered with erroneous alerts and increase superfluous noise - the result being incomplete testing and unidentified breaches that compound financial liability.

A strategy to future-proof compliance is crucial for growth

We only need to think about the implications of fast-moving sanctions against Russia. This challenges a firm's investment compliance staff and systems to be adept.

There is also the matter of shifting geopolitics. Having the expertise to stay abreast of evolving governmental sanctions could prove critical. We only need to think about the implications of fast-moving sanctions against Russia. These don't follow the normal regulatory authority rulemaking process that plays out over several months or longer, with early warning signs enabling firms to assess the impact. Governments propagate sanctions swiftly and often with a directive of immediate compliance. This challenges a firm's investment compliance staff and systems to be adept. It is a scenario that could be managed with ease given the right know-how and with a disciplined approach to onboarding data – including alternative data sets and enabling screening of underlying exposure across the investment universe. If either is underserved, scenarios such as this will highlight weaknesses that need to be addressed.

There's no escaping the fact that creating solid programs and processes – even as organizations seek to automate – means finding the right expertise and technical skills. Compliance directors are often confronted with the need to acquire and retain the necessary resources for automated compliance testing and monitoring as the business and industry change. Organizations would be right to acknowledge that a strategy to future-proof investment compliance programs – in terms of both systems and expertise – is critical to supporting growth.

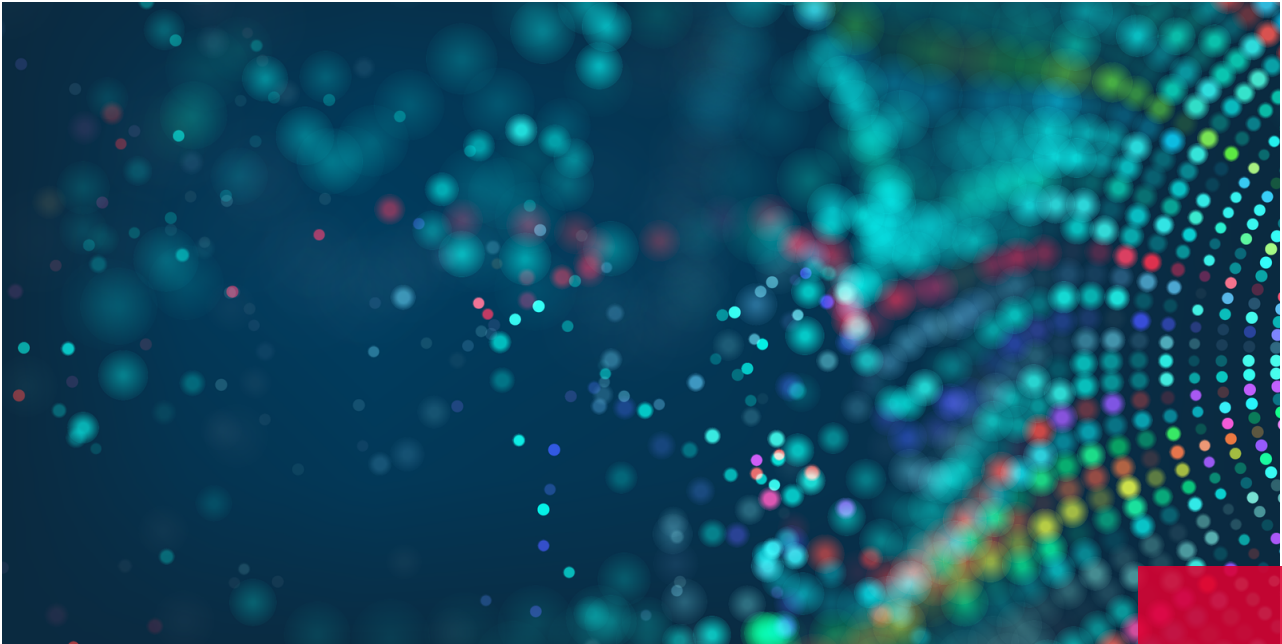


Robust, flexible technology and data are keys to adaptability

Making do with existing processes poses numerous investment compliance risks. An outdated system can become cluttered with erroneous alerts and increase superfluous noise - the result being incomplete testing and unidentified breaches that compound financial liability. Erroneous alerts could also indicate a compliance system is not set up correctly. In the worst-case scenario, this could mean missing actual compliance breaches. And with volatile markets and big price swings, a small correction in the morning can become an issue of much greater magnitude in the afternoon. Here, the damage can be both financial and reputational.

Poor data – in terms of access, integration, and comprehensive visibility - is often to blame. This could range from a misplaced decimal point in pricing to stale or missing data. And any weakness typically puts a strain on staffing resources as people are needed to sift through and decipher what went wrong. This triage process can also extend the time it takes an organization to identify 'true' compliance breaches and take corrective action.

The damage of making do with existing processes can be both financial and reputational. Poor data – in terms of access, integration, and comprehensive visibility - is often to blame.



Flexible systems consuming data with ease promote competitive edge

However, with the right technology solution in place, a firm can not only address its investment compliance challenges – it can also take advantage of new opportunities. Data has become a clear point of differentiation across the investment lifecycle; it is what provides competitive edge for both asset managers and advisors alike.

Gaining this positioning calls on system adaptability to easily consume new data sets without a hiccup. As businesses grow and become more complex, the need for diverse and disparate data sets also increases. An investment compliance system has to be malleable enough to consume new data seamlessly. And these types of innovations then enable compliance teams to view such data more holistically, which results in improved compliance monitoring and service levels.

Applying data analytics to investment compliance challenges

Another approach that more firms are taking to boost compliance performance and efficiency is to apply machine learning analytics to their automated programs. The right technology combined with good quality data enables efficient compliance monitoring with every rule and regulation. But the human side remains critical in reviewing the output. It requires taking the necessary actions and collaborating internally – say with portfolio managers and with legal teams around interpretation. This is the crux of the 'daily compliance' process for many firms.

To improve the process and outcomes, firms are applying machine learning models to identify patterns or trends. With sufficient historical data analyzed, teams can access predictive analytics insights to understand a course of action to resolve potential breaches. Taking it a step further, the analytics can automate the escalation process and work with the compliance outputs to propose necessary actions – which the user need only approve for the action to take effect. This not only reduces the workload on compliance officers; it also instills a matter of consistency and operational order.

Client Compliance Challenge A

Lack of rule testing automation increases risk

- As part of client investment policy implementation, a mid-sized wealth manager is required to regularly test portfolio concentration rules against certain benchmarks. The in-house process initially works well when the benchmark data upload is automated. The problem develops when this breaks down and can no longer be automatically loaded, and the testing reverts to a manual approach.
- This raises inefficiency and significantly increases risks – all of which could be mitigated by a more robust, fully automated vendor solution.

Compliance systems also need to be flexible enough to isolate the data required for any given rule. Rules get created and maintained, a record kept of every clean run and every compliance failure and the results analyzed for recurring breaches that could be avoided. Once that is done, the results must be reportable. This includes key metrics to demonstrate that a portfolio is adhering to the client's guidelines – such as average portfolio scores, percentage of a portfolio without sufficient data (a "conviction" score) and details of any breaches. When it comes to these metrics, less is definitely not more.

A compliance system "health check" seems an imperative

Given this growing need to adapt, a "health check" on system efficiency seems sensible and even imperative. It will demonstrate whether you are using your existing investment compliance system correctly and – more importantly – if it is capable of the functionality to manage new products and requirements.

Questions to ask – are data processes optimized? How close is the compliance program to being 100% automated? Are all results 100% accurate? And crucially, can the existing compliance process, workflows and system capabilities evolve to support business growth?

Client Compliance Challenge B

Manual processing of key regulatory test weighs on efficiency

- A large institutional fund manager handles its 'Regular g' testing through a manual, internal process. This requires reams of paper and printing for thousands of accounts.
- A robust, fully automated investment compliance system would automate this testing, leaving the fund manager needing only to review the exceptions to the prescribed rules.
- Equally as important, it would free up resources for higher value-added work.

Client Compliance Challenge C

Uncovering new system capabilities expands ability to onboard new business

- The investment compliance team at a large institutional asset manager had long used a compliance process they were comfortable with.
- But when business growth required new types of investment products and asset classes to be onboarded, the team's business as usual approach raised concern that they would require an outside solution and additional cost to cope with the breadth and scope of testing capabilities to support this new business. Instead, they tapped their existing systems vendor and were trained in how their faithful, robust compliance system was capable of much more complex than they had realized.

While having the right systems and automation, process and approach in place is the goal for best practice investment compliance programs; there are decisions to consider about how best to achieve this.

Is it 'buy versus build' for example? Or should the solution be hosted onsite or in the cloud? Who will maintain and run the system and process? While each of these considerations is critical, it is often the case that compliance teams are missing a critical question – are we fully utilizing our existing compliance system? After all, the potential for flexibility and automation can be as much down to how teams use a compliance system as to the technology itself.



Preparing for the new investment compliance landscape

We have seen a pronounced increase in the speed of proposed regulations being released by the SEC over the past year. The focus on ESG and crypto asset investing, along with shifting geopolitics, is driving industry change at a rapid rate. As a consequence, transparency and adaptability have risen to the top of the investment compliance agenda.

Having a good compliance program has always been a business imperative. But given the volume and velocity of change in the investment compliance landscape, what's considered 'good' today may "only just be good enough" tomorrow - and indeed, 'less than good' looking beyond that.

It's clear for firms managing risk and facilitating business growth that investment compliance is about dealing with changing conditions. Put another way, what is your 'time-to-market' for automated compliance when you're faced with a new compliance requirement? If it means adding a manual process, then it's just a matter of exchanging one problem for another - a zero-sum game or worse yet, a compounded negative.

Keeping abreast of these changes calls for a proactive response from investment compliance programs. Flexibility and adaptability have become key to future-proofing an investment compliance team's approach and processes. Naturally, the right talent, systems and technology are an inherent part of this. No matter how robust, an inflexible compliance system that lacks extensibility in today's fast-evolving investment compliance environment is going to hinder competitive edge. Worse still, it might fail to work sufficiently in mitigating key risks as it becomes outdated.

Competitive advantage will depend as much on the use of data, where automated technology solutions help turn this data into insights - and drive business opportunity. As asset managers evolve into hybrid investment firms positioned for future opportunities, so too must investment compliance programs. This makes it important to forge solid partnerships - to align internal investment compliance capabilities and business strategy with both internal and vendor expertise and adaptable technology.

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- 3 [May 2022, SEC Press Release](#)
- 4 [The Rules of ESG - Linedata Blog](#)
- 5 [SFDR](#)



Matt Grinnell is global product manager and ESG point man for Linedata software solutions, including fund oversight and compliance.

A seasoned industry veteran, Matt's focus is driving vision and strategy, working closely with clients and industry to discover and develop initiatives that grow customer value.

Linedata Compliance

Transform your investment compliance program with award-winning Linedata Compliance, a core component of Linedata's front-to-back technology, data and outsourced services platform. Robust, interoperable compliance technology aligns with user designed insights and dashboards from AI/ML and ESG data, and expert service to enhance every operational model.

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