THE NEW WEALTHTECH FRONTIER

OUTSOURCED COMPLIANCE CONSULTANTS AND THEIR NEED FOR TECHNOLOGY SOLUTIONS

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EXECUTIVE SUMMARY

We are recommending that compliance consulting firms add direct surveillance to their usual staple of regulatory compliance services. The recent growth in demand for direct surveillance is being driven by trends we see continuing into at least the medium term:

1. Increasing Regulatory and Litigation burden.

2. A strong desire at advisory firms to outsource, automate, or otherwise streamline virtually all operations to combat fee pressure.

3. A strong desire at advisory firms to unify disparate systems into fewer vendors and more seamless experiences.

Despite the rising demand for direct surveillance, we find that it is offered by few compliance consultants. There have been legitimate reasons for this in the past, including complexity, cost, and resource constraint, but these barriers have quietly disappeared with the recent advances in technology and a shifting landscape.

We believe that compliance consultants who position now for direct surveillance will be able to deliver more value to their clients and be a stronger competitor in a consolidating vendor environment. Implementation is also now easier than ever with technology driving the daily process and consultant expertise providing the intellectual capital. A relatively recent option for tech-light consultants is to partner with a WealthTech firm, removing the cost and complexity of building a system while also decreasing time to market and execution risk.

The demand for outsourced compliance

Many Wealth Management firms employ specialized outside consultants to enhance and implement their regulatory compliance procedures and initiatives. This trend has been accelerating overall due to three main factors:

1. Increasing Regulatory and Litigation Burdens
2. Decreasing Profit Margins
3. Increase in Staff-Light Firm Models (particularly driven by the growth in breakaway advisors)

The consulting model helps mitigate these trends by offering a form of "centralized utility" to their clients. Since the specific expertise of consultants is applicable across a broad array of firms, there is some ability to scale that expertise across many clients. This allows consultants to provide the required services at a lower cost while increasing, or at least maintaining, the level of expertise available.

We see these trends as continuing given increasing regulations, increasing regulatory complexity, increasing litigation, and a commitment to increase audit activity from the various regulatory bodies. While we can never predict the future, this has been a strong and persistent trend for the last 10 years and many feel the odds-on bet is for it to continue. This will put a strong emphasis on hiring compliance expertise, experience, and resources, all of which may exceed the budget of some firms.

At the same time, advisory firms are under fee pressure and, by extension, margin pressure. This has forced firms to either lower costs or increase revenue, or both. With respect to increased revenue, while it is possible for a firm to attract higher net-worth clients that pay more in fees, the more controllable path is for each firm to service more clients with the same amount of resources. This again favors the outsourcing model, where better resource efficiency allows for more volume. While fees can only drop so far mathematically, this is a trend we are seeing across almost all financial services, and it does appear set to continue at least for the intermediate term.

The third trend, higher instances of staff-light business models, could be seen as related to margin pressure, but we look at it as more driven by an increase in breakaway advisors who leave large, well-funded institutions to start smaller, less well-funded practices. While we can't necessarily say this is a long-term trend, it is being partially driven by an increased abundance of outsourced service vendors and substantial advances in advisor technology, two trends that we see persisting.

With the demand growth for outsourced services continuing on-pace or accelerating, we feel that compliance consultants can expect an increased demand for their services overall as clients switch to the outsourcing model.

Direct Surveillance could be the next big thing

One area of compliance that has seen outpaced growth since the financial crisis is what some practitioners call "Direct Surveillance". Direct Surveillance is the constant or near-constant testing of all client portfolios for various breaches in compliance protocol. An example would be the suitability of a portfolio for an investor from a risk standpoint. Risk Tolerance, the amount of risk an investor should have in a portfolio, typically changes very slowly, if measured correctly. But the amount of risk in a portfolio can change much more rapidly due to things like transactions, contributions, withdrawals, market movements, or style drift of the underlying investments.

This potential change in portfolio risk over time suggests that advisory firms need to be auditing their client portfolios frequently. Unfortunately, this can be a resource-intensive endeavor and many firms just rely on periodic tests at the time of investment recommendation and, hopefully, at subsequent annual reviews. But more firms are realizing that this creates a regulatory/litigation liability to the extent that the risk in a portfolio changes after implementation or in between the arbitrary review periods. If regulatory and litigation trends continue, a growing number of firms will feel that this exposure is pronounced and unacceptable.

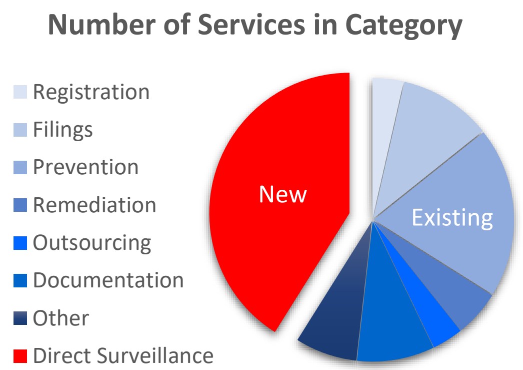
It also appears that this sporadic testing cadence has already attracted the attention of the regulators. Recent comments from regulators suggests that their auditors will be focused on evaluating the systemic compliance processes and procedures at the home office level as opposed to sampling individual client portfolios. This brings a particular peril to the practice of manually testing occasional client portfolios and a substantial benefit for the daily, automated testing of all client portfolios, especially if the consultant properly documents the process and all the daily results are automatically documented and stored in an audit trail.

Ultimately, the problem of direct surveillance can only be solved with technology given the volume of testing required. But many advisory firms have trouble acquiring, implementing, operating, and optimizing these technology solutions. For many of these clients, the ideal solution would be to partner with an outside compliance consultant with specific expertise and technological resources in this area. We believe this is another function that compliance consultants can provide more efficiently and at higher scale than individual client efforts due to the "centralized utility" model. This would suggest that direct surveillance design, implementation, optimization, and operation would be a highly valued outsourced service with a strong demand trajectory.

What is most interesting to us is that, contrary to our thesis, compliance consultants are largely focused on more traditional regulatory compliance, such as documenting procedures, audit support, and regulatory filings. This suggests that compliance consultants have an opportunity to add a value-added horizontal service in a rapidly growing demand category.

Why don't compliance consultants currently offer direct surveillance?

It is a valid question to ask why few compliance consulting firms offer direct surveillance. We surveyed the product offerings of 31 independent compliance consulting firms and found that almost all the products were more of the traditional regulatory filings and procedures variety. Specifically, they fell into the 7 categories in blue below:



One thing you might notice about most of these existing services is that they are low volume, relatively labor intense services that can benefit from the efficiency and shared expertise of an outside consultant.

We believe direct surveillance services are largely absent from the list of offerings for a few reasons:

1. Most compliance consulting firms started in an era where direct surveillance was not prioritized, at least in the sense of nightly/continuous testing of investor portfolios.

2. Screening millions of portfolios nightly has traditionally been thought of as technologically intense and expensive.

3. Since a reasonable part of what compliance consultants are hired to do is manual and expertise-related, it is prudent to stay away from daily processes and focus on larger, more periodic projects from a resource perspective.

While these have all been very legitimate reasons, in the face of rising demand for direct surveillance and an overall trend towards wealth management firms consolidating vendors, we feel that compliance consultants should revisit these barriers with an eye towards overcoming them.

What has changed?

One of the reasons we feel strongly about re-examining direct surveillance is that we feel the traditional barriers have rather quietly disappeared over the last few years with the advancement of technology.

The main hurdle to deploying direct surveillance centers around the technology platform required for a compliance consultant to conduct daily surveillance of all portfolios at scale without impacting the rest of the business. Most compliance consultants have an expertise in regulatory and legal as opposed to technology. But, we also note that advances in technology over the past 5 years have made these sort of systems much cheaper and more accessible than ever before.

In addition, The WealthTech ecosystem has started to shift its focus from stand-alone services to partnerships and integrated functionality with other vendors. Most WealthTech firms are experts in technology and user experience. What they need is distribution and underlying subject matter expertise. We believe that this should make for some willing partners for the right consultant.

We favor the partnership route vs directly building a system in-house, at least to start. Some firms have the resources, expertise, and desire to build such systems. Should they choose to do so, they will be rewarded with a larger share of the revenue pie, although they would have all the expense and execution risk as well.

However, many firms do not have the resources nor expertise to develop a competitive system. And, given that this will be many firms' first foray into systematic direct surveillance, we believe it is less expensive and less risky to partner with an existing vendor. It also greatly improves time-to-market, which could be an important competitive factor.

We believe the advances in technology, along with the potential for partnership with established and willing WealthTech platforms mitigates the barriers of the past at exactly the time that demand is growing the fastest.

What would a partnership look like?

While partnerships can certainly take many forms, we believe most will take the form of the WealthTech firm providing the underlying technology platform while the compliance consultant provides the expertise and maintains the client relationship.

From a technology standpoint, direct surveillance is a large undertaking. The process involves large computer systems performing various nightly tests on each portfolio and household at an advisory firm, a number that can rank in the millions. A WealthTech firm with that sort of system already established could be able to provide a ready-made solution that just needs to be "hooked up" to the consultant, potentially even via a simple web site login.

The compliance consultant would provide a much-needed layer of professional expertise and service. This would include guidance on tests, validation of tests, establishment of procedures, documentation, and assistance with resolution. A consultant could even offer to interpret the nightly data along with or in lieu of the client, providing consolidated reports and recommendations. Our observation is that successful compliance consultants are generally experts in all of these areas. We also note that these services, while still direct surveillance, generally conform to the lower volume/higher expertise labor model.

Opportunity for Growth

We believe that there is a tremendous wave of change overtaking wealth management in general and compliance in particular. Wealth management firms are also on an aggressive mission to streamline all processes, consolidate vendors where they can, and lower cost while maintaining or increasing service. We see no reason why compliance consultants should not lean into this trend apart from the fact that they are typically not technology experts, with a few notable exceptions.

But our view is the entire technology part of the problem can be partnered away in the short/intermediate term with little risk given the trend towards partnerships and integrations amongst WealthTech platforms. This may indicate a reasonable chance to significantly enhance a compliance consulting business by adding additional needed services to clients in an efficient way.

One of the luminaries of the outsourced compliance market, Mitch Avnet, CEO of Compliance Risk Concepts (CRC), put it rather bluntly: "At CRC, we continue to experience strong tailwinds in our business due to the increased demand for outsourced compliance support – or 'compliance-as-a-service'. We believe that the compliance consultant of the future needs to embrace a technology-focused approach to lever internal resources and provide the tailored, white glove service clients need while also providing scaled-up services like direct surveillance to really control costs."[1]

We also believe that such a system should deepen and enhance the relationship between the consultant and the client, which should be a benefit to both parties. As an example, such a system could give compliance consultants a more complete and more detailed picture of the situation on the ground at the client at any given time. This could potentially surface some issues that need to be addressed, adding a further layer of protection to the client.

[1] Neither author is affiliated with CRC, which has given permission to use this quote. More information at www.compliance-risk.com

About the Authors

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Aladin Abughazaleh is the founder and CEO of Foresight Financial Technologies, LLC. Foresight offers enterprise cloud-based compliance, risk and business intelligence technology (and recently acquired the assets and intellectual property of ATA RiskStation, LLC). Mr. Abughazaleh has been involved in the Alternative Investments industry since 1983. From 1985 until 2000, Mr. Abughazaleh ran his own investment firm that specialized in allocating both proprietary and investor capital to commodity trading advisors, option traders and hedge funds and overseeing performance and risk in those portfolios. In 1997, Mr. Abughazaleh spun out his investments firm's back and middle office groups into a new service provider, LAMP Technologies, LLC, that he grew and ultimately sold to the Bank of New York in 2008. In 2010, Mr. Abughazaleh retired to manage his family's proprietary capital and developed the required technologies to support the risk oversight process. Mr. Abughazaleh no longer manages outside capital and does not provide risk or investment advice to investors. Mr. Abughazaleh holds a bachelor's degree in Business from Southern Methodist University and an MBA from the University of Dallas.

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Kendrick is the Founder and Managing Partner of qSpur, a consultancy operating at the intersection of finance, technology, and people. Prior to founding qSpur, he was the Founder and CEO of FinMason, a financial technology company that built one of the world's largest and most scaled investment analytics and risk platforms. He has over 30 years of institutional investment and technology experience across a broad range of asset classes and has developed, built and run institutional-level analytics and risk management programs at both large and small financial institutions.

Prior to founding FinMason, he was a Portfolio Manager/Analyst for a hedge fund at Lazard Asset Management, a Managing Director/Department Co-Head at Wachovia, and the Director of Research at Forum Capital Markets. He has a BA from Dartmouth College and holds the Chartered Financial Analyst designation.

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