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DTCC Fills Technology Leadership Vacuum: Plans To Offer A Standardized, Centralized Communications System For Separately Managed Accounts

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The Depository Trust and Clearing Corporation (DTCC), a non-profit organization that acts as a centralized, industrywide custodian and clearing agent for virtually all stock, bond and mutual fund transactions, has announced its plans to extend its services to the separately managed account (SMA) industry. The SMA industry has long faced extraordinary administrative and operations problems similar to those that were resolved for the mutual fund industry by the National Securities Clearing Corporation (NSCC – a subsidiary of DTCC) some 20 years ago (see "Will the Managed Account Industry Collapse Under A Tidal Wave of Demand?" *Senior Consultant,* October 2000, http://www.SrConsultant.com/Articles/2000-10-Managed-Acct-Bus.pdf). The growth pains expereinced by the SMA industry require a similar industrywide protocol to achieve operational and administrative efficiencies that the NSCC facilitated for the mutual fund industry. The implications of the DTCC creating a standardized, centralized communications system for separately managed accounts are profound.

> **THE IMPLICATIONS OF THE DTCC CREATING A STANDARDIZED, CENTRALIZED COMMUNICATIONS SYSTEM FOR SEPARATELY MANAGED ACCOUNTS ARE PROFOUND**

1. **Democratization of Distribution for SMA Managers.** Many very-able money management firms have not participated in the SMA industry because, to make it economically self-sustaining, a massive commitment of human and technological resources is required in order to cultivate and manage a very large number of distribution organizations, each with their own operating protocol. With the DTCC creating a standardized, centralized industrywide protocol, the barriers to entry in terms of capital, technology and staff would be greatly lowered. Essentially, money managers would gain a more efficient means to participate in the SMA industry, democratizing distribution access for SMA managers, bringing in-line their merit as asset managers with their operating prowess.
2. **Democratization of Financial Advisor Access to SMA Managers.** Though the SMA industry has grown very rapidly, it has been concentrated in a very small number of firms. Only a few thousand advisors at the five major wirehouses account for 75% of SMA assets, with 65% of SMA assets being concentrated in just 25 SMA managers. The DTCC will take a highly concentrated, inefficient SMA industry and democratize access for both money managers and advisors. This will result in the exponential growth of the SMA industry that greatly benefits the investor, the financial advisor and the financial services industry.
3. **A Catalyst for Technological Innovation.** The DTCC will foster a round of technological innovation that (a) introduces real-time information; (b) provides direct client- permissioned access to all holdings; (c) facilities an extraordinary level of account detail to be managed; and (d) introduces web-based tools and methodologies that greatly elevate the role of the financial advisor, the counsel they provide, and the values they address and manage.
4. **Greatly Elevates the Importance of SMAs.** SMAs will become the primary means of managing values like risk return, efficiency, liquidity and cost structure which are required to be managed by regulatory mandate. For example,
   a. Tax lot accounting information in SMAs make it possible for advisors to construct and manage tax efficient portfolios.
   b. Direct ownership of the securities in a managed account makes it possible for the advisor to manage a high level of portfolio detail.
   c. Investment management style discipline in SMAs make it possible for the advisor to develop comprehensive, real-time understanding of all the over-arching style-based investment disciplines engaged that allow risk and return to be more effectively managed.

d. Real-time analytical tools elevate and accelerate the timeliness of advisor counsel. Rather than having to wait 14 weeks until manager peer group rankings are published in order for the advisor to counsel their clients on account holdings, the advisor, their technical analyst and/or their overlay manager can use real-time attribution analysis and PODs to evaluate each style-based investment discipline in real-time.

e. Advisors will more effectively manage SMAs utilizing outsourced investment methodologies that explain in real-time, the movement in the capital markets. (Required intermediate tactical adjustments would be executed by shorting styles and sectors with ETFs, thus minimizing turnover and trade execution costs, while maintaining the integrity of each manager's underlying holdings.

5. **Industry-Transforming Connectivity.** The free flow of highly reliable information among all parties (money managers, custodians, advisors and clients) is essential for high level counsel. The DTCC has or will become a centralized, standardized communications hub for stocks, bonds, mutual funds, managed accounts, fixed/variable annuities and insurance, and will facilitate unprecedented real-time connectivity to information that makes continuous, comprehensive counsel possible. This highly reliable, real-time information will dramatically lower administrative cost while innovative, highly sophisticated evaluation and analytical tools will gain relevancy in the management of real-time information.

This connectivity is profound, as it comes with transparency and accountability. The advisor is expected to add value and manage high level of portfolio details by providing continuous, comprehensive counsel. Rather than selling financial products, the advisor is addressing and managing a broad range of investment and administrative values made possible by SMAs, as required by regulatory mandate. The role and compensation of the financial advisor, which has historically been tied to their ability to facilitate trades in volume, evolves to adding value by engaging their counsel for an on-going advisory fee. The DTCC plays a significant role in transforming the role and accountability of the financial advisor. Since the 1840s , in good markets and in bad, the advisor has been only compensated when they sell something; yet it is far better for both the investor and the advisor if the investor would engage the advisor's professional investment and administrative counsel for an on-going advisory fee. Of course, the presumption is that the advisor is capable of addressing and managing a broad range of investment and administrative values. The innovation is that the transparency that comes with connectivity makes it clear to the investor whether value is being added. Thus, advisor compensation and our ability to win business will increasingly be based on the depth and breadth of our fee-based counsel and the value we add.

In essence, DTCC's work with SMAs will be an important trigger for innovation. The adoption of existing post-modern portfolio theory innovation will lead to further innovation that will take advisors and the SMA industry to continuous, comprehensive counsel and the fulfillment of our fiduciary responsibility. Much of post-modern portfolio theory

requires a more dynamic means of transmitting and managing data. This real-time access to, and management of, an extraordinary level of account detail is why managed accounts will become the investment vehicle of choice for advisors who wish to fulfill their fiduciary responsibility and provide continuous, comprehensive counsel. With the transparency of the internet making it clear to investors who is adding value and fulfilling their fiduciary responsibilities, every financial advisor will be forced by competitive market forces to elevate their counsel or be vulnerable to those who have. Thus, the strategic implications of the DTCC extending their services to SMAs is indeed profound for the industry, as it is a catalyst for the broad adoption of much innovation that has already occurred, thus elevating the role of the financial advisor and the counsel we provide. The DTCC will rapidly accelerate the larger financial services industry's evolution from commission sales to advisors adding value through the engagement of their counsel for an ongoing advisory fee.

In this day and age of the web, it is difficult to believe that advisors do not routinely have access to real-time information, especially when the theme that runs through the regulatory parameters (UPIA, ERISA, UMIFA and UMPERS) within which we must work is continuous, comprehensive counsel. SMA-related data currently flows among industry participants (supporting broker/dealers, money managers and advisors) by telephone calls, faxes, e-mails and electronic uploads and downloads through semi-automated and fully automated interfaces. Because there is no standard communication protocol, everyone has a different way of doing things, and there exists wide varying levels of efficiency. There are a large number of one-of-a-kind interfaces created to attain the current limited level of automation. Considerable resources are being expended to improve business processes in an attempt to become more fully automated, but there are limits, as to the efficiencies one firm can achieve, as it cannot influence how others send data and in what form the data may take. As you would imagine, 70% of SMA managers view operations as their single most significant challenge facing the SMA industry, and there is a universal understanding that the desired efficiencies require an industry-wide protocol that is beyond the ability of any single firm. A non-profit utility that acts as a centralized, standardized means to stimulate the free flow of highly reliable information is essential.

There are several reasons why the SMA industry has not developed a more efficient means to administer and manage SMAs. The flow of information between industry participants has been stunted by virtue of 75% of SMA assets being controlled by the five major wirehouses (Smith Barney 33.5%, Merrill Lynch 24.5%, Morgan Stanley 7.7%, UBS 6.8%, Wachovia 5.9%) and by 64% of SMA assets being managed by the top 25 SMA managers. These firms have had to design their administrative and operating processes around existing outdated legacy technologies and have developed "work-arounds" to meet immediate user needs. As the SMA industry expands, these "work-arounds," which are not scalable, will no longer provide the level of efficiencies that all participants desire. Many SMA managers cannot pursue expanded distribution opportunities because of the resources required. Even some of our most well established SMA distribution and money management firms are experiencing an increase cost as volume increases, rather than a decrease in cost. This is an untenable position for virtually all SMA participants and potential participants. As James McKinney of Harvard observes, "Brokerage systems are notoriously inefficient. In a period where systems costs are dropping like a stone, brokerage systems cost are increasing. This is because they are built to respond to specific needs but have no overall design in mind." If there were an overall design, the question today is whether firms would choose to empower their advisors to add value and fulfill fiduciary responsibility, or to facilitate trades in volume. Essentially, today most legacy brokerage systems are designed to automate manual administrative functions associated with trade execution. The brokerage systems of today are of a different era. They are not designed to address and manage a broad range of investment and administrative values, as required by regulatory mandate. Nor are they equipped to import or export large amounts of data, process information in real-time, or accommodate multi-currencies or the full array of alternative investments. These legacy systems are inflexible and difficult to recode, and rely heavily on batch processing cycles. They are not consistent with the massive volume and scale of data transfer required in order to facilitate a higher level of counsel and reach a much broader constituency of advisors. Clearly, a next generation of operations technology designed to add value is needed to grow the SMA industry and to elevate the role and counsel of the financial advisor.

AS YOU WOULD IMAGINE, 70% OF SMA MANAGERS VIEW OPERATIONS AS THEIR SINGLE MOST SIGNIFICANT CHALLENGE FACING THE SMA INDUSTRY, AND THERE IS A UNIVERSAL UNDERSTANDING THAT THE DESIRED EFFICIENCIES REQUIRE AN INDUSTRY-WIDE PROTOCOL THAT IS BEYOND THE ABILITY OF ANY SINGLE FIRM

Though the SMA industry has historically been pre-occupied with the marketing and distribution of SMAs and as the financial advisor has become more adept in articulating and delivering higher level counsel using SMAs, the profit margins in the SMA industry have been declining. Thus, the operating focus in the industry has shifted from sales and marketing to operational efficiency. Seventy-percent of SMA managers view operational efficiency as the SMA industry's greatest challenge. As a result, the DTCC plan to extend its services to the SMA industry is more than welcomed. Many operational efficiencies that have long been introduced in other areas of the financial services industry are long overdue. The software options available to resolve these issues have been limited and largely repre-

sented old technology. Because many firms have heavily invested in building their own proprietary processes around existing but outdated technologies, new technology providers with advanced technology have had difficulty getting traction in that it requires users to abandon their expensive proprietary technology built around what has become outdated technology. Therefore, the incentive to innovate must be accompanied by extraordinary functionality, as well as operating efficiencies, which is exactly what the DTCC promises. The enterprise efficiencies promised by the DTCC are truly extraordinary. It is important to note that these innovations cannot be achieved by one firm going it alone:

1. Most distribution firms and SMA managers would agree that present sub-accounting, trade and order routing, and reporting systems are not scalable so cost cannot be aggressively driven down and volume cannot be effectively managed. Trade and order interfaces with SMA managers and the internal and/or external trading desk of distribution firms can be manual. Not only do large distribution firms require SMA managers to use their proprietary trading system, but they also require distribution firms to incur the expense of training SMA managers to use the system and to continually upgrade and maintain their software. Given the typical SMA manager has to deal with 24 distribution firms, the efficiencies that can be achieved with the DTCC are quite substantial, both on the part of the SMA manager and the distribution firm.

THEREFORE, THE INCENTIVE TO INNOVATE MUST BE ACCOMPANIED BY EXTRAORDINARY FUNCTIONALITY, AS WELL AS OPERATING EFFICIENCIES, WHICH IS EXACTLY WHAT THE DTCC PROMISES

2 .When SMA accounts are set up and/or terminated, there can be a large number of small trades that can be very expensive because of the absence straight-through processing and the number of people involved in the trade. In the interest of best execution, some distribution firms accommodate "give-up" and "step-out" trades, yet the trading systems of many distribution firms are not built to handle these and other special order trades like limit orders. This type of trade usually requires manual intervention and with it, the likelihood of higher error rates and trading cost for the distribution firms. The DTCC can clearly streamline this endeavor and facilitate efficiencies that otherwise would not be possible.

3. The process of providing trade execution and allocation information to SMA managers varies from being automated (assuming the distribution firm and the SMA manager systems are compatable) to being highly manual and error prone. If the process is manual, communication occurs via fax or e-mail. Because there is little in the way of common protocol between proprietary systems, SMA managers are precluded from achieving reasonable scale in the trade communication process. The DTCC readily resolves this.

4. The process of sending trade-related information is highly manual and time-consuming. The SMA manager's portfolio accounting system generates a list of trades by account and a consolidated trade blotter. Restrictions and wash sale violations are taken into account, and the trade blotter is adjusted accordingly. The consolidated trade blotter is then broken down by distribution firm trade blotters that are communicated accordingly. This process can delay trade execution and create unnecessary costs for the SMA manager. The DTCC again would greatly streamline this process.

5. The SMA manager should have a trade rotation policy to secure best execution for their clients. The rotation policy both rotates trades among distribution firms and rotates trades among its other institutional investors. The lack of connectivity can delay the entire trading process. These delays can have a direct impact on the individual investor's returns, as well as the returns for the SMA manager's institutional clients. The DTCC can readily resolve any trade delays due to connectivity and its associated impact on performance.

6. The same technology a SMA manager uses to obtain execution prices from distribution firms is used by SMA managers to provide asset allocation instructions back to distribution firms, which, in turn, is similar to the systems used for trade and order routing. The resulting duplication of effort and expensive replication of data entry can be eliminated by the DTCC, creating an integrated, standardized, and centralized communication system.

7. The process to set up new managed accounts is largely manual, which is why the average new managed account is ready to trade in two or three days, when the typical mutual fund account can trade almost immediately. The principal reason for this delay is the redundant entry of the same new account information into multiple systems. This information is manually entered by the advisor, their distribution firm and the SMA manager, and does not flow straight through from the advisor to the SMA manager. Today's new account methodology is inefficient, error-prone, non-scalable and very expensive. And again, this is readily mitigated by the DTCC. Though much effort is being spent on streamlining the communication between the advisor and their distribution firm, little progress has been made in streamlining communications between distribution firms and SMA managers. A platform-neutral, web-based, centralized communications system, as conceived by the DTCC, would foster an efficient, secure flow of highly reliable information among all parties.

8. Managed account reconciliation between the distribution firm and the SMA managers is an on-going challenge, as distribution firms maintain the official books and records for SMAs but do not reconcile these with the SMA manager's in-house books and records. As a consequence, SMA managers cannot be AIMR-compliant in their reporting (see "Managed Account Wrap Managers Can't Meet New AIMR Reporting Guidelines, MMI Poses Resolution", *Senior Consultant,* November

2002, http://www.SrConsultant.com/Articles/2002-11-AIMR-Guidelines.pdf). The reliance on distribution firm systems and the lack of connectivity with SMA managers has resulted in SMA managers having to duplicate the accounting for each managed account. SMA managers must enter data in each distribution firm's system and in their own system, and reconcile their information with 24 or so distribution firms with which they work. The lack of standardized procedures and data protocol within the industry, in concert with the low level of connectivity and the nature of closed architecture systems, has made the reconciliation process extremely difficult. Reconciliation reports are exception-based reports and are generated monthly or weekly, depending on connectivity. These reports are voluminous and the largely manual clearing of variances requires extraordinary expenditures of time. Undetected and unresolved errors compound, leading to significant economic exposure to the investor, the distribution firm and the SMA manager. The standardized, centralized communications system proposed by the DTCC readily resolves this challenge in managed account reconciliation.

As you can see, there is little reason for distribution firms and SMA managers wanting to continue with the antiquated, outdated, unscalable systems and technologies that drive today's highly inefficient managed account industry, especially when it is clear that all parties would be well served by the DTCC in ways that no single firm could achieve on their own. Improved industry-wide connectivity will translate into massive cost savings and enhanced profit margins for all. Manual processes are not scalable. A common centralized protocol for SMA data transmission will greatly accelerate the use of SMAs and foster a much higher level of investment and administrative counsel. So, why wouldn't everyone associated with the SMA industry embrace the DTCC? Everyone should. But there is the question of whether the largest SMA distribution firms will participate in an industry-wide standardization initiative. They have scale and have made substantial investments in proprietary technology that gives them some level of efficiency that translates into a competitive edge in a highly inefficient SMA industry. Smith Barney and Merrill Lynch alone account for nearly 60% of SMA assets. Much of their investment in proprietary SMA systems is a fixed cost, amortized over a massive and growing asset base, which means their costs are declining, when the costs for the SMA industry at-large are increasing. The point that our largest firms are missing is that they are losing SMA marketshare, and at the point where the rest of the industry accounts for 40% of SMA assets, DTCC will achieve scale, serving smaller firms and will offer far greater efficiencies than is possible for the industry's largest firms to achieve alone. The largest firms will inevitably become high-cost providers. Importantly, a very small constituency of financial advisors at the major firms account for the vast majority of SMA assets. This constituency of advisors is very adept at sophisticated forms of portfolio construction and are the beneficiaries of the technological innovation fostered by DTCC. These innovations are the differences between the advisor being able to elevate their counsel or not, and the assets advised by the top SMA advisors have legs. If the largest SMA distribution firms do not participate in the DTCC initiative, they will run the risk of losing their top advisors to more progressive and supportive smaller firms with lower cost structures and better technologies. Thus, large firms today may face the competitive disadvantage of having inefficient technology, becoming a high cost/low value service provider and not having the ability to share the cost of future innovations necessary to gain parity and drive down cost. Therefore, a persuasive argument can be made for even the industry's largest firms participation in DTCC. This would be welcomed, as a capital investment required of all participating firms is minimized in order to develop a non-profit, low-cost, industry-wide utility like the DTCC for SMAs. There is where vision and leadership come into play.

The DTCC plan to build a standardized, centralized communications system for the SMA industry has most profound industry-wide implications. The DTCC is central to the financial advisor providing continuous, comprehensive counsel as required by regulatory mandate, and is central to the larger financial services industry supporting the financial advisor in fulfilling their fiduciary responsibilities. Along the way, the distribution firms that support financial advisors will discover that by empowering their financial advisors with the processes and technology necessary to add value, they can achieve a lower cost structure and greatly enhance their earnings, margins and multiple. The DTCC triggers a chain of events that will transform the financial services industry in how advisors do business, how firms support advisors, how advisors are compensated and how distribution firms add value. DTCC's work in the SMA industry is an important breakthrough in the financial services industry's evolution towards advisors engaging their professional investment and administrative counsel for an on-going advisory fee. The DTCC fills the leadership vacuum in core technological innovation that will drive the industry for many years to come. ■

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