

## Want Some Subadvice? Make Money Through Pre-Trade Compliance

### Technology

By Tom Steinert-Threlkeld

Want to make sure a trade made by your sub-advisor does not get you in trouble with the **Securities and Exchange Commission**?

Want to save money in the process?

Those are the two deliverables being promised by a small Denver startup which early this month was granted a patent for a technology that allows advisors to oversee trading by sub-advisors and make sure they comply with fund policies and federal regulations.

The patent was awarded to **Unified Account Technologies** for a **HiLo Engine** that logically determines which trades are likely to have “high” impact on capital markets or company policy and which will have “low” impact.

This “better compliance mousetrap,” as UAT President **Tom Warren** puts it, allows fund managers to look at the potential impact and risks of a trade before the trade is made. Right now, he contends, a fund manager can’t see what a sub-advisor is doing with the money it is entrusted to invest for the fund’s customers “until after the fact.”

That can be problematic. Sub-advisors are external money managers hired by funds to invest money on their behalf. A large fund operator, such as **AXA Equitable** or **Vanguard**, might have 20 or 30 or more sub-advisors, Warren estimates.

“Now you can do real-time compliance, you can do it pre-trade and you can do it for all your subadvisors,” Warren said.

That “is a big deal,” said **J. Lynette DeWitt**, director of research for sub-advisory and lifecycle funds at Financial Research Corp. in Boston. “A firm is responsible for everything a sub-advisor does.”

Mutual funds delegated \$920 billion to sub-advisors, as of June, according to FRC. That amounts to roughly 14% of mutual fund assets tracked by FRC.

Another \$468 billion was delegated by variable annuity funds to sub-advisors, for a total of \$1.4 trillion.

That gets up to roughly \$3.5 trillion handled by sub-



advisors on behalf of mutual funds, annuities, defined contribution plans and defined benefit plans, in all forms, by UAT’s estimate.

The HiLo engine sits in between the order management system of the sub-advisor and the order management system of the fund company itself.

When a sub-advisor enters an order, the intended transaction and its details are sent to the engine. The engine immediately applies rules set by the sub-advisor and analyzes the impact of the sub-advisor’s action. Each decision takes about two-thousandths of a second.

If the engine determines that the impact will be great or that there is a possibility of running afoul of regulations, the trade is sent back to the fund firm for one of its traders to work, directly. This amounts to roughly one in four trades, UAT estimates.

If the engine determines that the impact is likely to be low or minimal, then that trade and others like it are sent to low-cost execution venues.

This is where the savings come. By determining which trades are safe to trade in this kind of pre-trade analysis, the company can cut expenses on the bulk of its trading.

A typical \$20 billion fund, Warren says, trades about one billion shares of stock a year. Separating out the “low impact” trades from the rest means about 750,000,000 shares can be moved through low-cost venues. Optimizing those trades across those venues, automatically, should shave 2 cents a share off execution costs. Over the course of a year, that tallies \$15 million saved.

“I’m a big fan of cost-savings in funds,” DeWitt said. “Hypothetically, it should lower the cost of the fund and the service fees of the fund.”

A victim potentially could be research, produced by the sub-advisor, though, she noted. The cost of research is typically covered by the fees paid by the advisor.

In any event, sub-advisors can establish the rules, as they like. Rules can be set for flat quantities or total dollars or other measures that make sense, separately or combined.

But the most common approach is to set a threshold tied to the average daily volume of a stock.

That threshold can be, for instance, 5% of the average daily volume. If a sub-advisor places a trade that exceeds 5% of average daily volume in that stock, then the trade gets kicked over to the sub-advisor and its staff to handle. The purpose: To handle the trade in such a way as not to leave a ripple.

“If a trader is worth his weight, he is paid to limit market impact and trade with anonymity,” Warren said.

The system also allows advisors to see what their exposure is, at any given time, because of the trading by any particular

## THE LARGEST USERS OF SUB-ADVISORS

	Mandated assets	
	June 2010	December 2009
Vanguard Group	\$300.3 billion	\$424.0 billion
Fidelity Distributors	64.5	55.9
SEI Corp.	59.4	66.0
Harbor Capital Advisors	46.0	46.3
Hartford	38.4	37.8
John Hancock	29.9	28.9

SOURCE: Financial Research Corp.

sub-advisor. All trades are captured in real-time. Use of that data improves a fund’s risk management.

Or, in theory, will. UAT does not yet have a customer that it can disclose publicly. Its prime targets are the sub-advice trusts which deal out funds to sub-advisors, such as **Wellington Management**, the largest, according to FRC. These include trusts that serve **ING**, **Vanguard**, **Axa Equitable**, **American Beacon** and **Russell Investments** funds, as well as annuity firms such as **Pacific Life Insurance Company**.

Integration between systems is handled to a significant degree by using the Financial Information Exchange protocol for trading messages. UAT operates as an applications service provider, running, maintaining and upgrading the HiLo Engine at a centralized data center.

UAT is seeking a patent on its engine in 38 countries. Warren says UAT intends to seek patents on other aspects of the process, such as the system’s approach to picking the lowest-cost venue for executing the trades.

And, if he has his way—and his math holds out—Warren aims to save advisors a billion dollars a year, if the engine gets widely adopted. **MME**



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