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Software Shines Light on Subadvisor Trade Compliance

By Hannah Glover

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While most mutual fund and variable annuity providers still rely on good faith, tight investment mandates and post-mortem checks on their subadvisors' trades, Denver-based **UAT** has a system that it says allows product manufacturers to track subadvisor trades pre-execution and in real time.

The UAT System was first tested with clients last August and was recently awarded a 20-year patent. UAT has applications pending for further patents, including protection for its system in 37 countries, says the company's CEO, Allan Chiulli.

Regulators require asset managers to use a "reasonable basis" to ensure that subadvisors' trades adhere to the investment guidelines of a fund, says Jeff Squires, founder and principal of **Vista 360**. And while pre-trade compliance screening is seen as a best practice, it is also a relatively new one, even for firms that manage their assets in-house. But it has historically been a particularly tricky issue for subadvised products, he says. "Pre-trade compliance' and 'subadvisors' weren't spoken in the same sentence," Squires says.

Typically, managers examine post-trade reports delivered by subadvisors for any violations of their investment mandates. Any such problems may require the firm to correct the trade — which can be time consuming and costly — or could expose the manager to regulatory fines or scrutiny, he says.

As of the end of May, the subadvised market represented \$1.4 trillion in assets overall, according to data from **Financial Research Corp**. Of those assets, \$966 billion was in mutual funds, while \$482 billion was in variable annuity products. Those figures include assets managed by both affiliated and unaffiliated subadvisors.

Although subadvisory agreements may represent more assets in mutual funds, the relationships between managers and subadvisors is more significant in the variable annuity world, says Loren Fox, senior research analyst with **Strategic Insight**. Subadvised funds account for about 40% of all VA fund assets under management across 886 variable annuity funds. By comparison, unaffiliated subadvisors manage only about 6% of total assets spread across 1,128 funds in the traditional mutual fund industry, according to Strategic Insight data.

The key to the UAT System is what the firm calls its HiLo Engine, which links into a subadvisor's trading system. The manager who has hired the subadvisor sets up rules, based on the investment mandates of the fund. For example, one such rule could be a limit on the percentage of international equities a fund can hold. If the subadvisor places an order that violates that mandate or brings the portfolio within a certain percentage of such a restriction, the trade is stopped and flagged. The manager can then look at the trade and, if it violates the mandate, reject it and send it back to the subadvisor. If the trade is determined to be appropriate for the fund, but is more complicated or would be better executed manually — or, in other words, is "high-touch" — the manager can process the trade in a way deemed more suitable.

The system can also save firms money, says UAT, by sending simpler, "low-touch" trades, or those that are easily executed and well within the confines of the management agreement, through an electronic trading network. Trades on such networks can cost half a penny per share to execute, compared to two and a half cents for traditional brokerages, says Chiulli. About 75% of the trades processed by managers are low-touch, which can result in significant savings for funds and their shareholders, according to UAT.

Understanding the low-touch, all-electronic order flow of their trades can help firms negotiate lower-cost brokerage agreements, says Tom Warren, president of UAT. Such savings over time can be especially important in an era of increased fee waivers and competition over fund expenses, notes Chiulli.

"We are giving managers control... For the first time, you have the ability to monitor the standards you have set in place," Warren says. UAT also markets the product as a means for pension and defined contribution plan sponsors to ensure that their investment providers adhere to any screens they may have in place.

Because firms currently have no way to see how subadvisors trade until after the fact, managers typically rely on well-defined guidelines in their investment mandates. "Something like this can provide more flexibility and tools to the manager," says Vista 360's Squires.

Aside from compliance and trading costs, the program also provides general transparency, says Warren. For example, the reporting features of the system help managers see their aggregate exposure across subadvisors and react more quickly to events such as the 2008 collapse of **Lehman Brothers**. Warren gives the example of a manager for whom determining overall exposure took nearly a week and a series of phone calls to 49 different subadvisors.

Pre-trade compliance may be of particular interest to foreign managers with U.S. arms that use subadvisors, says Lynette DeWitt, director of research for subadvisory market and lifecycle funds for FRC. "They may be more apt to require the use of automation to maintain the mandates and make sure there is complete adherence to their investment policy in light of market events," she says.

And while managers should always select subadvisors based primarily on their product and investment skill, once the best manager is chosen, the ability to tackle trading costs is also important. VAs in particular have faced greater pricing pressure, says DeWitt.

For traditional mutual funds, the newly patented system could be appealing as a means of being certain that all mandates and investment policies are being strictly observed. Or, as DeWitt says, "to be squeaky-clean for regulators."

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