Compliance Benchmarking Survey 2010

How do you navigate the present while building for the future?

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What would you like to change?

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Important notice

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Setting the scene

This is the third year that PricewaterhouseCoopers has conducted a study of the compliance practices and key trends for organisations in the managed investments industry. The information in this study has been collated through discussions with our clients' compliance practitioners and input from the audit teams.

> Companies with an appropriate and measured appetite for risk – i.e. those that can see beyond the risk to the opportunities they present – are much more likely to prosper.
>
> Being smart about the risks you take: Get up to speed, PricewaterhouseCoopers.

Nicole Salimbeni
PricewaterhouseCoopers

This year has focused specifically on industry "hot topics" which include governance, regulatory relationships, management of compliance issues and complaints, and the current state of compliance monitoring.

At a time when investors expect integrity as well as competence from their financial services providers, effective compliance is becoming as much a competitive differentiator as a regulatory imperative. A predominant theme in this year's findings is the importance of the Compliance Function in acting as a business advisor and assisting with the effective implementation of regulatory change. With many financial services regulators focusing on the scope of the Compliance Function, this study explores the evolving nature and responsibilities of the function in the aftermath of the Global Financial Crisis (GFC).

Key themes that have emerged in this year's study include:

- a marked increase in the number of investor complaints predominantly in relation to fund performance. While this is understandable given the financial fallout from the GFC, it is promising to see that the time taken by organisations to resolve complaints has dropped over the past 12 months.
- In addition, we have also seen a reduction in the percentage of complaints escalated to the Financial Ombudsman Service (FOS), indicating that investors are generally satisfied with the mechanisms in place for dealing with their concerns.
- a drop in the level of resources within most Compliance and operational functions. This has placed pressure on Compliance's ability to carry out effective monitoring and business support activities while simultaneously responding to regulatory changes.

As a result of the drop in the level of compliance resources, an increased reliance has been placed on the business to conduct "first line of defence" control monitoring, with support from internal or external audit functions in monitoring high risk areas. We have seen this trend reverse over the past six months, as the market has stabilised and organisations have reviewed their strategic compliance priorities.

In the coming year we expect to see continued growth in fund performance and a robust market for compliance resources.

Governance – good governance starts from within

Organisations with decentralised compliance models are juggling a deeper compliance understanding of business issues with the need to demonstrate independence in decision-making to regulators and other key stakeholders.

An effective Compliance operating model provides the business with assurance over their controls and compliance activities, which ensures allocation of appropriate resources and provides employees with guidance on how to execute their roles appropriately. Our study indicates that in addition to the centralised and decentralised models, organisations are also adopting a hybrid version.

A centralised model permits standardisation of compliance and reporting activities across the organisation, allowing for efficiencies in training, communication and resources.

A decentralised model, on the other hand, allows for a measure of customisation in the approach and scope of compliance activities, enabling the Compliance Function to "partner" with its business unit and deliver tailored solutions specific to the needs of the business.

While a decentralised model offers clear benefits to the business, a key challenge is the maintenance of independence by the Compliance Function. This receives a high level of attention from regulators, Boards and other key stakeholders. As a result, a number of organisations are moving towards a hybrid model, where a group Compliance Function is supported by dedicated resources within each business unit.

In addition to the benefits demonstrated by the decentralised model, the hybrid version enables the Compliance Function to maintain and clearly demonstrate their independence from the business units. It also facilitates the sharing of compliance initiatives of "lessons learned" across the business.

The choice between centralised and decentralised structures should take into account the need to maintain and demonstrate independence while "partnering" with the business.

Our study revealed that while compliance continues to be managed through both centralised and decentralised functions, the last 12 months has seen a 19% increase in the adoption of the decentralised model.

Interestingly, this has been matched by a corresponding decline in the number of compliance resources. This trend is more relevant to investment managers compliance stand alone and do not operate within a larger group.

The decrease in resources has posed a significant challenge to participants as they endeavour to establish more robust compliance controls and monitoring in response to the GFC and increased regulator scrutiny. While this reduction in numbers is not surprising given the fallout from the GFC, it highlights an underlying issue where compliance is often perceived as a cost to the organisation, and as a result, is at the forefront of cost-cutting measures in times of crisis. It is important that the Compliance function is able to demonstrate measurable value add to the business, for example the benefits of compliant business decisions and the protection from regulatory fines or enforcement action. A deeper understanding of the Compliance department's value proposition will assist in ensuring that resourcing levels remain appropriate to the nature and scale of the business.

Table 2 Examples of how compliance adds value

Measures

- Quality and speed of regulatory interpretations, and related compliance policies and procedures
- Improved regulatory relationship, including good feedback from supervisory reviews
- Improved relationship with shareholders
- Improved relationship with customers (customer surveys)
- Positive feeling which comes from doing the right thing
- Good internal/external audit reviews of compliance function
- Compliant business decisions
- Speed of new compliant products to market
- Positive internal feedback from business (through surveys, 360° reviews)
- Compliance training assessments
- Effectiveness reviews of compliance function
- Compliant marketing documentation
- IT systems that are designed from the outset to be compliant
- Increased professionalism of Compliance
- Level of ethics/compliance culture throughout the organisation (internal surveys)
- Clarity and comprehensiveness of compliance reporting
- Timely rectification of breaches/deficiencies
- Results of compliance monitoring

Inverse Logic Measures

- Absence of fines/penalties
- Less fines/penalties than peers
- Insurance policy
- Absence or reduction of compliance breaches/deficiencies
- No reworking required to achieve quality
- Reduced complaints (less resources required for complaints handling)
- No licence withdrawals or restrictions
- Management and business "silence"
- Gate-keeping: stopping bad business decisions

Source: PricewaterhouseCoopers, Protecting the Brand

An increase in independent Boards – however, Compliance Committees continue to remain the preferred governing body

The past 12 months have seen a 9% increase in the number of independent Boards responsible for compliance oversight of managed investment schemes.

In most cases, independent Boards are favoured by boutique fund managers or entities with specialised assets such as pastoral funds.

However, despite the increase, the majority of the industry continues to rely on an independent Compliance Committee to maintain oversight of compliance by the Responsible Entity (RE). The study indicates that Compliance Committee members have diverse backgrounds, with a mix of management, compliance and financial expertise. While 28% of organisations have a 3-member Compliance Committee, an additional 24% have opted for a 5-member Committee to facilitate access to a broader mix of skill sets and experience. The latter applies predominantly to larger retail fund managers with a wide range of underlying assets.

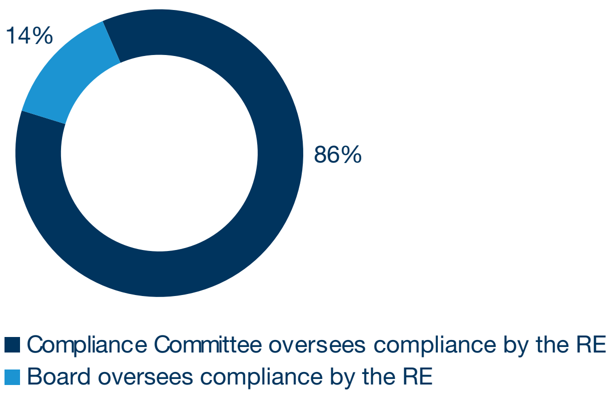
Compliance Committees continue to interact closely with Boards, with 93% reporting to the Board in the form of provision of minutes of Compliance Committee meetings. Committee members regularly attend and present at Board meetings on key compliance decisions and high risk issues.

Our study shows that over the last year, organisations have become better at defining the appointment period of Compliance Committee members. Last year, 52% of members did not have a defined appointment period, while this year it has dropped to 20%. It is most common for members to be appointed for a 3 year period.

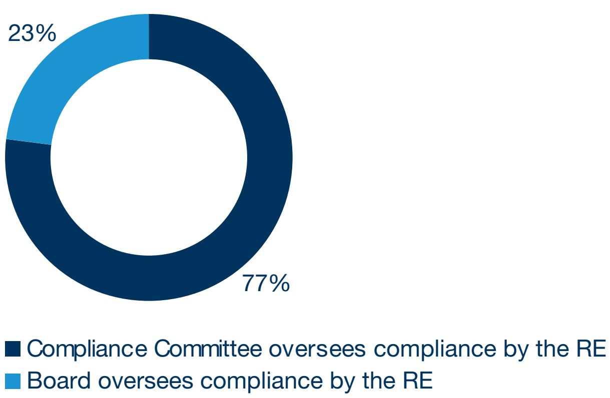
Less than half of all independent members undergo formal performance evaluation. In cases where the latter occurs, evaluation consists of a mix of self-assessment and feedback from senior management.

Figure 3 Overseeing Compliance operations

Overseeing Compliance in the RE (2009)



Overseeing Compliance in the RE (2010)



Better practice is to have an independent Compliance Committee which engages with the Board on key compliance decisions and high risk issues

Regulators –
how close is your organisation?

Participants in the survey identified managing regulator expectations as a principal challenge in the current environment. There appears to be uncertainty on how to meet regulators' rising expectations and a perception that the compliance goalposts have been moved retrospectively.

Our survey revealed that 48% of organisations currently have limited involvement with their regulators. 28% of organisations have not met with their regulator in the past three years, while only 16% have met with their regulator once in the past three years.

While the level of regulator engagement will be dependent upon the size and nature of a business, it is important that the organisation clearly understands regulatory expectations and is able to demonstrate this understanding especially in the event of a regulator surveillance visit. Businesses with a sound relationship with their regulators can benefit from open communication in which issues are managed effectively and efficiently.

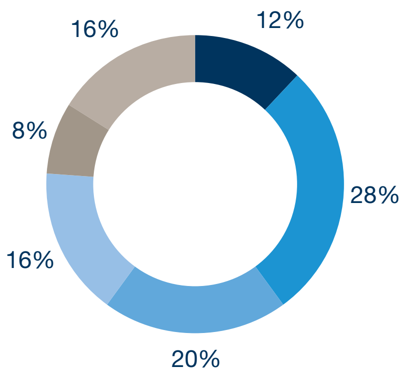
Our survey has identified that a sound regulator relationship can also facilitate a good consultation process when regulatory change is being considered.

Regulator relationships are generally owned by Legal or Compliance heads. Developing an open relationship with the regulator is important because with imminent regulatory change, consultation with the regulator is ideal. Additionally, while it is important to note that Compliance should have direct contact with regulators as they are best placed to understand regulatory expectations, it is also important that Compliance is not placed as a buffer between management and regulators in terms of the overall relationship. It is important that management have some sort of involvement and interaction with the regulator, for example through attending regular meetings or engaging with regulators on significant business initiatives.

Assessing the impact of any regulatory changes on current strategies and operations quickly will enable organisations to adjust to changing requirements in a considered manner. The organisation, with assistance from the Compliance Function, should aim to anticipate regulatory intentions, and make an early assessment of potential impacts on business from a compliance perspective. This, coupled with effective lobbying, can help obtain relief from or rationalise requirements where the cost may far outweigh the potential benefits.

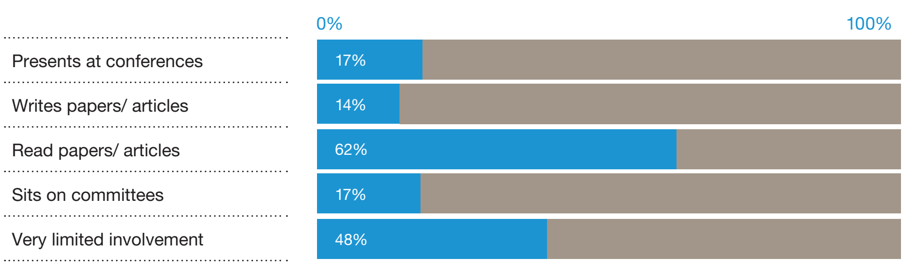
It is also important that organisations engage with industry bodies as a means of remaining aware of upcoming regulatory change and participating in impact analyses and industry submissions.

Figure 4 Meeting with key regulators



- Meet as/ when required
- Has not met in past 3 years
- Meets on annual basis
- Has met once in past 3 years
- Has met 2, 3 & 4 times in the past 3 years respectively
- Other

Figure 5 Clients' involvement with industry bodies



28%

No meetings with regulators in the past 3 years

12%

Meet with regulators as/ when required

Breach and issue management – how effective is your organisation at monitoring and resolving issues?

Figure 7 Classification of breaches

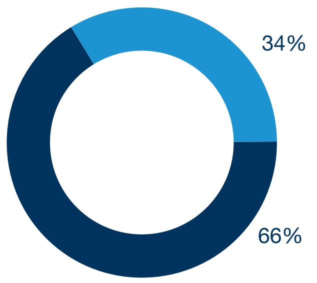


Figure 8 Breaches reported to ASIC

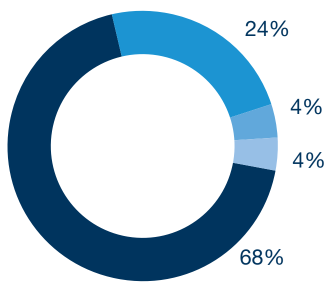
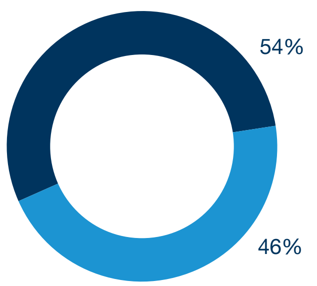


Figure 9 Trend analysis on issues and breaches



Definitions and classifications of 'breach' are inconsistent across the industry

Organisations continue to experience varying numbers of breaches and issues being identified and reported. While this is due to a number of reasons including volume of funds under management and complexity of scheme assets, it is also a result of the variance in definition of what constitutes a breach, as well as the level of staff awareness in relation to how breaches are identified and dealt with. Our survey showed that 34% of organisations do not categorise or classify breaches when assessing or reporting them.

The key types of breaches being detected and reported include:

- Inaccurate valuation of scheme assets
- Unit pricing issues
- Inaccurate calculation of expenses and fees
- Incorrect statement of fee rebate
- Non-lodgement of audit opinions

Organisations have adopted varying approaches to identifying, defining and capturing breaches. Some participants choose to record any breach of internal policy, while others record only specific breaches of the Corporations Act. Additionally, the mechanism for logging breaches varies depending on the size and sophistication of the business. Some log breaches in a hard copy filing system while others use electronic registers or databases to store the information.

Organisations continue to be cognisant of the need to report significant breaches to the regulator. The number of breaches reported varies from organisation to organisation. Our survey showed that 68% of respondents did not have any reportable breaches during the period. Others reported between 1 and 7 significant breaches to ASIC.

54% of organisations conducted trend analysis on issues and breaches. Regardless of the "sophistication" of the organisation, it is important that regular trend analysis is conducted in order to determine sources of potential systemic or recurring breaches and to assist in timely rectification.

Effective trend analysis provides enormous value to organisations in assessing whether compliance controls are failing to operate effectively and therefore exposing the business to risk.

Our survey showed that 68% of respondents did not have any reportable breaches during the period

Complaints – how well does your organisation handle them?

The top 4 causes of customer complaints in 2009 were:

64%
Fund performance

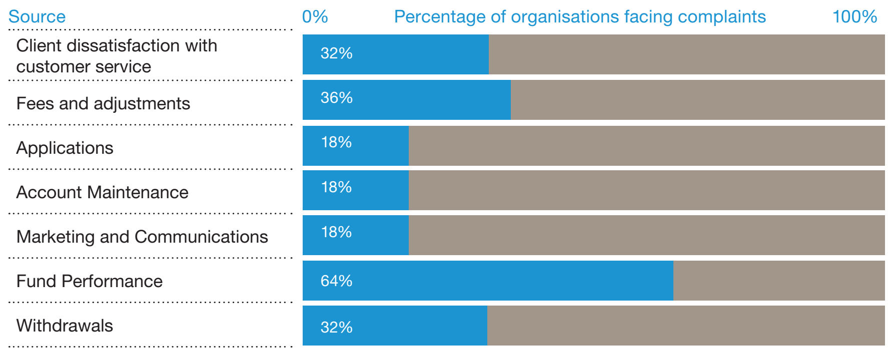
36%
Fees and adjustments

32%
Client dissatisfaction with customer service

32%
Delays in processing withdrawal

The nature of complaints and key sources is understandable given the market volatility caused by the GFC over the past 12 months.

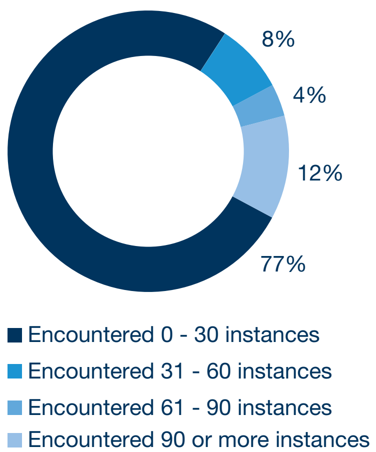
Figure 11 Nature of complaints



The number of complaints recorded by participants has increased over the past 12 months, with an average of 30 complaints per organisation. 16% of organisations received over 61 complaints over the 12 months, resulting in significant investment of resources and financial compensation.

The majority of participants confirmed that responsibility for complaint resolution lies with the business units that deal with the client. Better practice Compliance Functions play a role in maintaining line of sight of resolution activity, and analysing complaints to determine whether there are any underlying compliance concerns.

Figure 12 Trend analysis on complaints



The number of complaints recorded by participants has increased over the past 12 months, with an average of 30 complaints per organisation.

Conflicts of Interest – how does your organisation prevent conflicts?

Figure 13 Conflicts of Interest

8%

encountered one instance of a conflict of interest during the period under review. The rest did not encounter any conflicts

60%

of these organisations' Conflicts of Interest Registers can identify potential conflicts as well as actual conflicts

76%

of these organisations' conflicts of interest are usually identified through the compliance function who undertake specific monitoring of conflicts of interest.

A robust conflicts of interest framework assists in upholding the integrity and reputation of organisations.

92% of participants noted that they did not identify any new potential or actual conflicts of interest during the period – an increase of nearly 20% on last year's figures. This could indicate that either controls which are in place to manage conflicts are operating effectively, or that there is a lack of awareness as to what constitutes a potential or actual conflict.

In general, the approach to managing conflicts of interest seems to be to document potential and/or actual conflicts in a register together with the associated controls for managing those conflicts. While all organisations maintain a Conflicts of Interest Register, only 60% record potential as well as actual conflicts as outlined in Regulatory Guide 181: Licensing: Managing conflicts of interest.

Our study also found that in the majority of instances, controls are not reviewed regularly to determine whether they remain appropriate and/or effective in continuing to manage the relevant conflict.

It is imperative that organisations adopt good business practices to manage their conflicts in today's continually evolving environment. Senior management oversight and culture are critical management techniques. Being actively involved in the development of the conflicts of interest framework sets the 'tone at the top'. In addition, senior management need to ensure that the framework is understood by the organisation and all control measures underlying the policy framework are appropriate, workable and sufficiently adaptable to meet changing needs.

Senior management essentially relies on staff to proactively avoid, disclose or escalate conflicts, hence building a culture that is open and honest is integral to an organisation's approach in defining and articulating the desired behaviours, value and expectations of the organisation. Training (including scenario-based education), discussions and forums on high-risk business practices and the dissemination of incidents of likely conflicts are some ways of informing and communicating to staff where the boundaries lie and what is not acceptable.

Effective compliance monitoring is also critical in timely identification and management of organisational conflicts

Outsourcing -
do what you do best and outsource the rest

Our survey has identified that custody is still the most predominant outsourced business function, with 89% of organisations continuing to engage third party service providers

Encouragingly, 78% of organisations that participated in our survey stated that they review their Service Level Agreements (SLA's) on an annual basis. However, 14% of organisations review SLA's less often than annually, or have never reviewed them at all, leading to the risk that these become outdated and do not reflect what the business needs and expects of their external service providers. This is a continuing trend from the 2009 survey. Organisations should review their SLAs at least annually.

The survey shows that 93% of monitoring of outsourced providers is conducted by the Compliance Function. Ongoing monitoring assists organisations to form stronger relationships with the external service providers, as it results in more frequent communication and offers the benefit of more timely identification of control breakdowns or compliance issues.

78%
of organisations that responded to our survey stated that they review their Service Level Agreements (SLA's) on an annual basis

Figure 14 Outsourced business functions

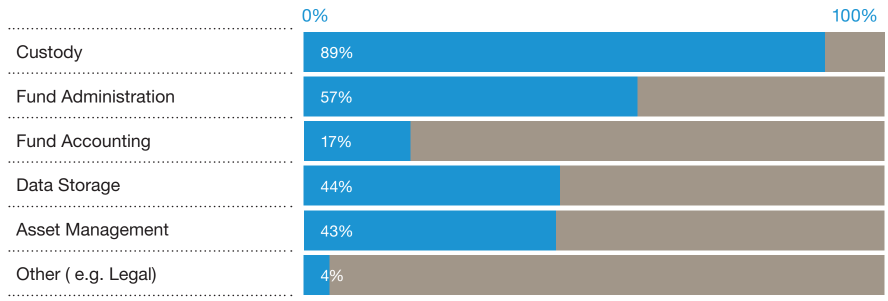


Figure 15 Frequency of SLA review

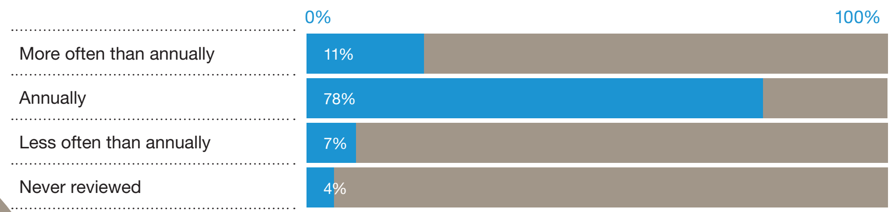
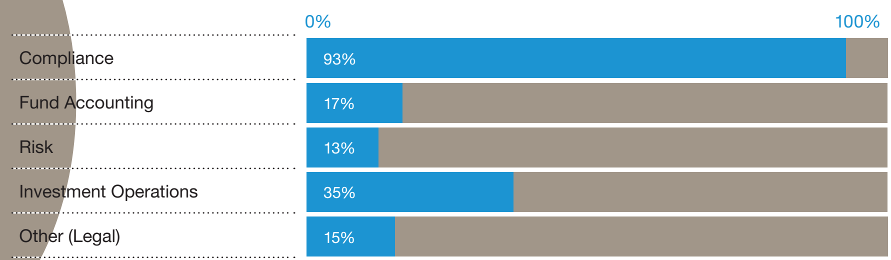


Figure 16 Monitoring of outsourced providers



Reviewing the Compliance Plan – do you 'walk the current talk'?

83% of organisations review their Compliance Plan at least annually, with the remaining 17% reviewing their Compliance Plan once every 2 years. Given the current level of regulatory change and enhancements to operating controls, it is better practice to review Compliance Plans annually to ensure that they are current and relevant.

62%

of organisations review their compliance plan annually

43% of organisations felt that the level of rigor in conducting the review of the Compliance Plan was average. The review of Compliance Plans should not be limited to regulatory updates - organisations should ensure that the Plan adequately reflects the changing nature of the business. Additionally, the level of monitoring and reporting specified in the plan should be assessed to determine whether it is adequate to manage the residual risk and the organisation's current regulatory risk appetite.

A Compliance Plan should be integrated with the risk management and compliance programme, and subsequently a review of the plan should focus on the adequacy of processes and controls in place to manage the risk of non-compliance with obligations. It is also critical to obtain feedback and buy-in from the business when considering changes to the plan – this assists in ensuring that changes are practical, well understood and sustainable.

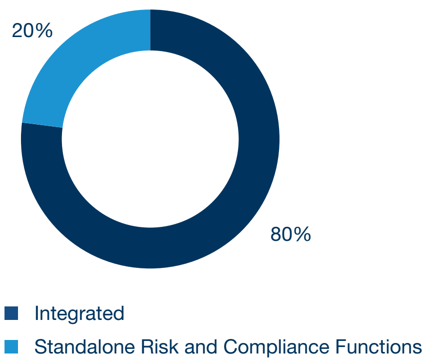
Figure 17 Level of rigour of Compliance Plan review

Figure 18 Frequency of Compliance Plan review

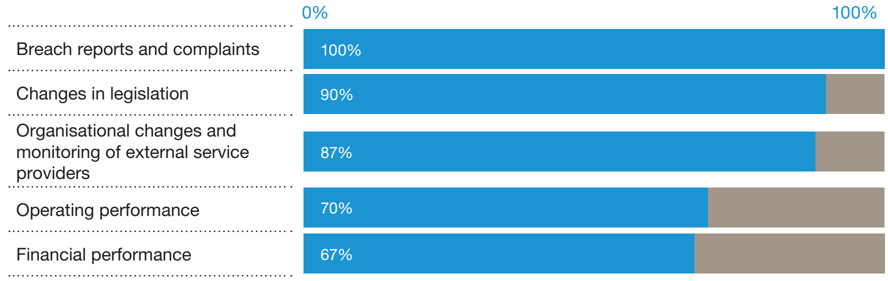
Appendix – Other key facts and figures

Governance & Regulators

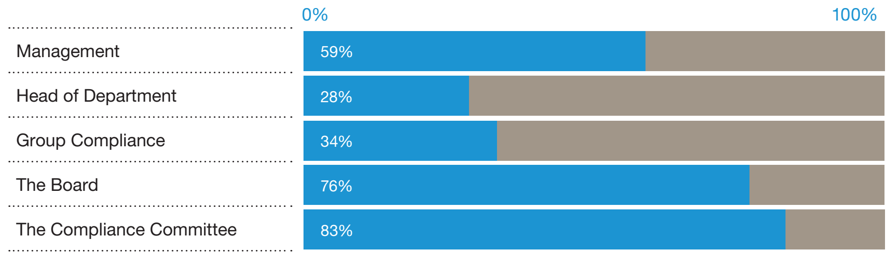
A Percentage of integrated Risk and Compliance Functions



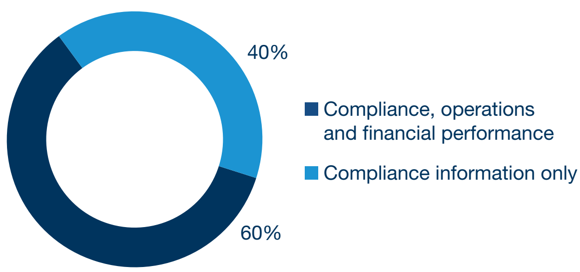
D Information submitted to the Compliance Committee



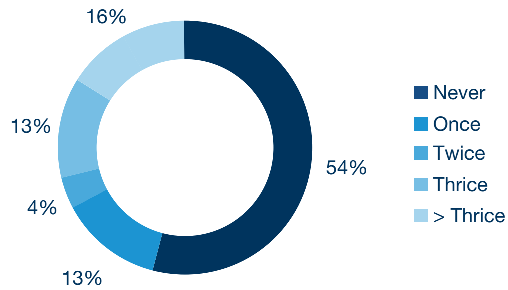
E Recipients of compliance reporting



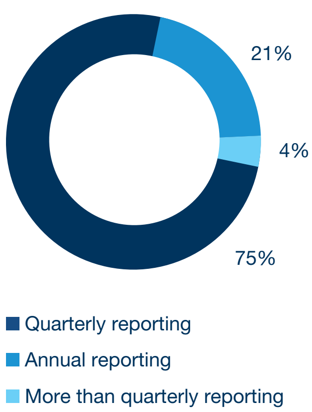
B Nature of information in compliance reports



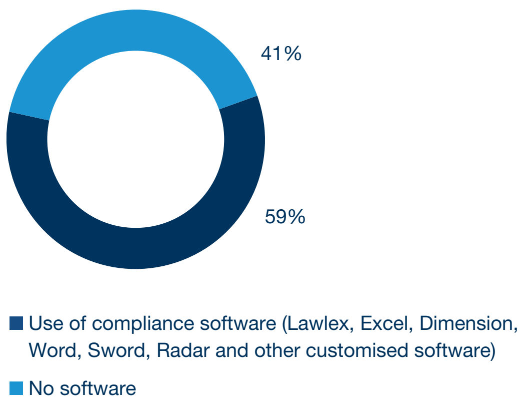
F Clients reviewed by regulators in the past three years



C Frequency of compliance reporting

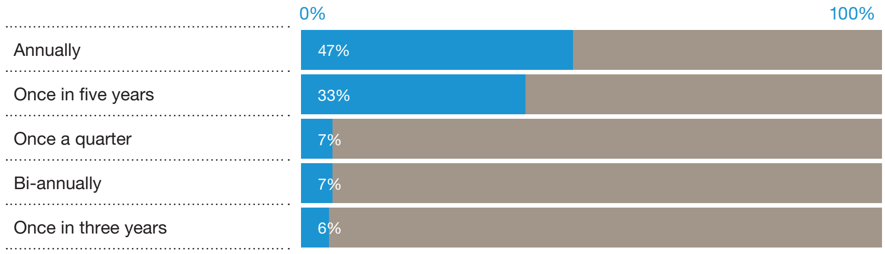


G Use of software in compliance monitoring



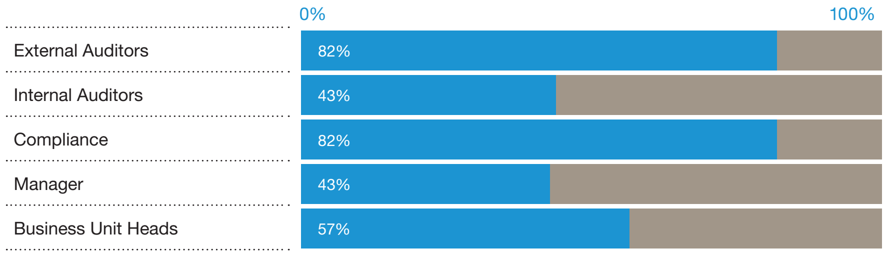
Demographics

H Appointment of committee members



I Frequency of Board/ Compliance Committee engagement

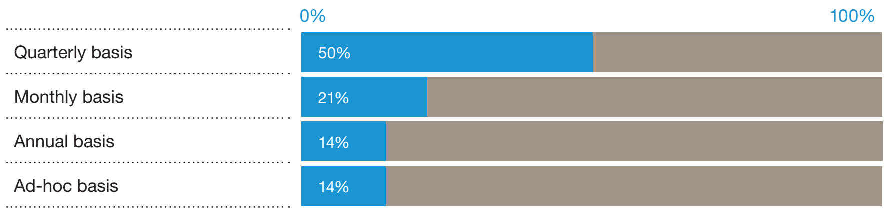
J Presenters at Compliance Committee meetings



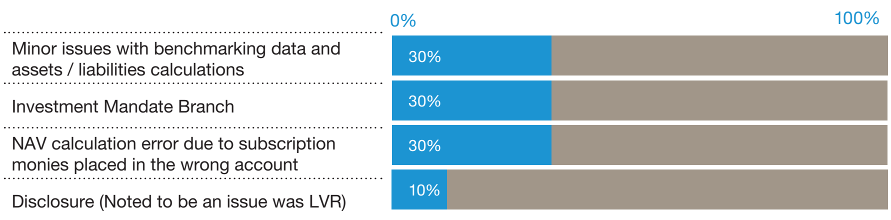
Breach-Issue Management

N Percentage of incidents classified as high or medium

O Frequency of trend analysis



P Nature of incidents in relation to valuation of scheme assets



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Next steps

PwC is the leading provider of innovative and practical governance, compliance and risk management services and thought leadership. We offer a wide range of skills and expertise in the review, design and implementation of effective governance structures and compliance frameworks.

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