Outsourcing
IN THE FINANCIAL SERVICES INDUSTRY

The term "outsourcing" means different things to different people. To young MBA students, it represents one of primary buzzwords (along with "networking", "synergies", and "economies of scale") that will help guide them on their roads to business (and hopefully financial) successes. To average non-technologically savvy consumers, it represents those lengthy phone calls with friendly tech support professionals at call centers half a world away. To manufacturing employees, it represents the ongoing fears that they may one day be downsized in a cost-cutting measure by their global corporations. To management execs, it represents hours of insightful discussions in the boardrooms as their companies weigh the advantages and disadvantages of using strategic partners in certain areas of their businesses. For those grandstanding politicians, it represents a rallying cry for their constituents as they push their very specific pro-business vs. pro-labor agendas. For certain noted journalists (such as Thomas Friedman of the New York Times and Lou Dobbs of CNN), it represents a timely and controversial topic for their best-selling books and popular cable programs.

By Ron Brounes

In its simplest definition, outsourcing means "focusing on what you do best and letting someone else do the rest." For the past two or more decades, it has been considered a core business practice used throughout many diverse industries as corporations seek ways to better focus on their core competencies and become more profitable in the process. By farming out certain aspects of their operations to other specialists, management has found that their companies can play to the strengths of their employees and often become far more effective and efficient in their day-to-day business practices.

The decision to outsource is usually based on both time and cost considerations. While some companies may choose to manage their own internal human resources or information technologies departments, for example, management often finds that they can produce similar (if not better) results by outsourcing outside professionals to perform those essential, yet non-core business tasks. They can free up their human capital to perform the most critical jobs in a more productive manner, and limit their labor forces (and compensation and benefit expenses) by directing certain other services to specialized venders.

Of course, such cost-cutting decisions must be weighed against any potential negative ramification that outsourcing can bring. After all, the end user (or ultimate client) rarely knows about the existence of any specialty vender, so any shortfall in product quality or service reflects poorly on the company itself. Management does not wish to have to explain poor performance, or worse, have a public relations nightmare on its hands because a strategic partner has fallen short on expectations. (In a relatively timely example, parents of young children may be boycotting Mattel, not the outsourced Chinese partners who used lead paint in the manufacturing of toys.) Therefore, the RFP (Request For Proposal) as well as the past experiences and reputations of these providers become vitally important in the ultimate outsourcing decision-making process.

While the reasons behind these decisions may be quite unique from company to company and from industry to industry, the areas they choose to outsource are often very similar: IT, HR, facilities management, real estate, accounting, marketing/public relations. In fact, a recent Gartner Dataquest study showed that 85% of U.S. companies outsource at least one aspect of their human resources functions.

The World of High Finance

Companies within the financial services industry are actually among the most likely to seek various outsourced products and services in their business practices. Within the advisory (sell-) side of the business, the ability to effectively outsource is often a primary factor for brokers choosing to leave a larger wirehouse environment and take their practices independent.

Financial services firms are likely segregated into three main divisions with various personnel performing key tasks within each. The front offices include the employees on the front line, the faces of the organizations who are involved in sales and trading, business development, and investment banking or corporate finance services.

The back office represents more of the behind the scenes employees who provide all of the administrative and support services that relate to operations, performance reporting, accounting, and billing. The middle office generally manages the risk of the firm and provides services related to IT, compliance, etc. Because clients rarely deal directly with the behind the scene back office, or even middle office personnel, these areas are typically the easiest to outsource to specialty service providers.

While many large wirehouses still provide most crucial front, middle, and back office services through internal departments, smaller independent practices are more likely to seek outsourced

relationships to help them effectively manage their businesses. These investment professionals tend to be more entrepreneurial in nature and may choose to leave the bureaucratic world of the large firm for the potential of a higher payout and more control over their day-to-day practices. They spend the bulk of their time managing relationships, developing new business, gathering assets, and are often content to outsource other aspects of their business to experienced third party providers.

"If you think about it, the whole advisory industry is really about outsourcing," said Steven Graubart, Chairman and CEO of US Fiduciary, Inc., a Houston, Texas-based boutique financial services firm serving high-end investment advisors with independent and sophisticated practices. "The advisor is all about giving advice, and yet, their firms must also provide an array of products and services ranging from clearing and custody to retail brokerage and alternative investments."

John Phoenix of Denver-based Metamorphosis Money Management agrees. He points out that specialty firms known as TAMPs (Turnkey Asset Management Providers), have evolved through the years and represent the epitome of outsourcing solutions as they provide a laundry list of services to their advisor clients that are actually delivered by strategic partners.

"These groups have been embracing the best of breed in every facet of the business," said Phoenix. "Through an affiliation with a TAMP, independent advisors can receive portfolio management, financial planning, CRM (Customer Relationship Management), an array of investment products, custodial services, recordkeeping, and even tax management."

A Growing Trend

Phoenix also believes that outsourcing is a major reason for the growing trend toward more advisor independence.

"In the past, these products and services were reserved for only the largest investment firms," said Phoenix. "Now they are readily available for the independents as well. The breakaway brokers are no longer captive to the in-house products offered by the big name firms and can now offer their investor clients an open architecture in terms of every aspect of their practices. They can cobble together what the wirehouses have created in-house by outsourcing through a TAMP or other service providers."

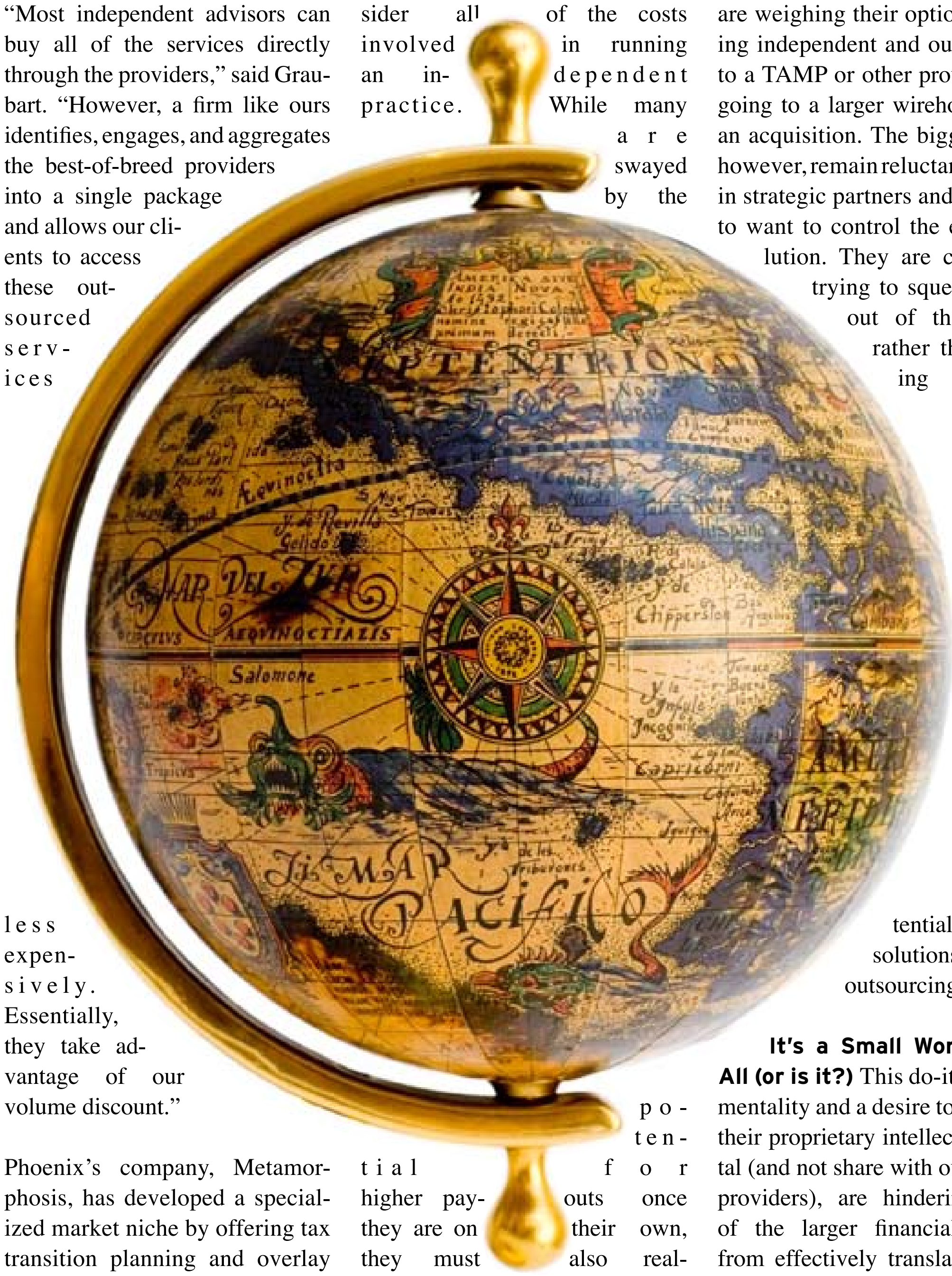
A 2006 study by Tiburon Strategic Advisors confirms the growth and popularity of these TAMPs. In 1994, $4 billion of assets were managed through such platforms. That number had grown to over $200 billion by late 2006.

With more and more financial services firms outsourcing certain products and services, the NASD (now FINRA) recently devised new regulations pertaining to third party providers to help protect the ultimate investor. Such individuals or companies that perform certain defined outsourced activities that require registration under NASD rules will be considered "associated persons" of the broker dealer. Further, the member firm must enact a supervisory system of compliance oversight and due diligence analysis of these third-party outsourced services.

US Fiduciary's Graubart believes that the trend toward advisor independence, while growing significantly, is actually just in its adolescent stage.

"Historically, advisors had few options regarding the service providers needed to effectively run their practices. Today, they still face some confusing decisions once they move outside of the big firm environment," he adds. "Independent advisors must navigate which products and services are imperative and which are not in meeting the needs of their investor clients. They must determine how to aggregate best-of-breed providers under one umbrella. They must decide if they want to maintain both fee-based and commission-based business." Research support through independent sources like CRA RogersCasey, product platforms with access to mutual funds, separate account managers, ETFs and alternative investments, operations/back office support, IT, HR, marketing and education, and compliance, are among the products and services US Fiduciary offers to its advisory clients.

"Most independent advisors can buy all of the services directly through the providers," said Graubart. "However, a firm like ours identifies, engages, and aggregates the best-of-breed providers into a single package and allows our clients to access these outsourced services less expensively. Essentially, they take advantage of our volume discount."



Phoenix's company, Metamorphosis, has developed a specialized market niche by offering tax transition planning and overlay management for financial advisors whose investor clients have the potential for significant tax liabilities within their portfolios.

"The very nature of tax transitioning is ideal for outsourcing," explains Phoenix. "Our company spent millions of dollars developing this specialized technology that may only be applicable to a specific advisor a few times per year. For example, one of our advisors may obtain a new client who holds a significant concentrated stock position with a very low cost basis. Our technology can help diversify the portfolio, while minimizing the tax costs incurred. While advisors find such services to be highly beneficial for certain investor clients, most would not find it cost effective to develop a similar system in-house or even purchase a canned product off the shelf. We believe they are better off using an outsourcing solution like the one we offer."

Inside the Costs: Comparing Apples with Apples Graubart warns advisors to carefully consider all of the costs involved in running an independent practice. While many are swayed by the potential for higher payouts once they are on their own, they must also realize that this makes them responsible for a number of expenses that will cut into their take-home compensation.

"The advisor must determine their real payouts and consider exactly who will incur those costs and fees regarding products, brokerage, managers, practice transition, compliance, and many others," Graubart said. "Will they be responsible for these costs or can they pass some of them along to their clients? In many cases, by going independent and outsourcing many of these products and services, they can still earn payouts greater than 50% and recognize significant increases in compensation." While Phoenix believes larger firms will continue to lose talented advisors to the independent route, he does not see the wirehouses embracing the concept of outsourcing to a significant degree any time soon.

"We continue to see a complete shift in the investment advisory business," he said. "In fact, many talented brokers at regional shops are weighing their options of going independent and outsourcing to a TAMP or other providers vs. going to a larger wirehouse after an acquisition. The bigger firms, however, remain reluctant to bring in strategic partners and continue to want to control the entire solution. They are constantly trying to squeeze more out of the turnip, rather than seeking out potentially better solutions through outsourcing."

It's a Small World After All (or is it?) This do-it-yourself mentality and a desire to maintain their proprietary intellectual capital (and not share with outsourced providers), are hindering many of the larger financial players from effectively translating their successful business models to a more global stage. According to a recent study conducted by IBM and the Economist Intelligence Unit (EIU) entitled Get Global… Get Specialized…Or Get Out, globalization is one of the primary factors behind future industry growth, and yet most companies are ill-prepared to effectively participate.

This survey of over 950 industry executives and corporate clients from financial services firms across in the world (throughout the Americas, Asia Pacific, Europe, the Middle East, and Africa) revealed that 93% of respondents do not believe they "operate in a globally integrated fashion." Almost two-thirds rate their "current proficiencies in global organizations and operating practices as poor to moderate." Specifically, these professionals were asked about: 1) their abilities to attract and retain top talent, 2) their technology capabilities, and 3) their global alliances.

These negative views are so telling because the EIU projects worldwide investments to double to around \$300 trillion by the year 2015 and to approach \$700 trillion by 2025. The report estimates that well over half (about 60%) of this future growth will come from non-traditional or emerging markets like China, India, Russia, Indonesia, South Korea, Chile, and Mexico. Without some dramatic changes to their seemingly antiquated business models (which should include new approaches to outsourcing), these firms may not be able to reap the full benefits of that growth. With that in mind, 86% of the respondents claim that globalization will become a key factor in their firms' strategies over the next five years.

"What we're seeing today is that organizations have a tremendous herd mentality," said Suzanne Dence, Senior Consultant of the IBM Institute of Business Value, whose research team led this survey. "They're taking a me-too strategy, following one another to India to save money. Now, they're starting to look at China to save money. Organizations really need to take a much more scientific approach to truly profit in realizing value from globalization, both from a sourcing standpoint and also from a revenue production standpoint." This herd is mentality indicative of a general disconnect between these large investment companies and their global clients. The study shows that many firms do not truly understand the non-traditional, emerging markets and cannot make educated decisions about which products and services to introduce and how they will be received abroad. So, like a herd, they simply monitor what others are doing and follow suit.

Management themselves do not know what their clients are willing to pay for, and their same old models simply will not work any longer, at least not from a global perspective. For example, within the survey, global clients placed a firm's ability to provide a one-stop-shop approach and best-of-breed products, two primary selling points of the large investment brokerage houses near the bottom of their wish lists.

Culture is the Key
A global footprint is extremely critical to these clients as cultural barriers are the most challenging to overcome when attempting to compete in the global markets. Many large financial companies have been reluctant to openly collaborate with local partners through outsourcing, and remain fearful of the perceived lax intellectual property laws and different regulatory environments. However, these very reasons actually help make a stronger case for outsourcing. In order to become more globally integrated and capture a larger percentage of these growing markets, financial firms must change their mindsets and loosen their reins. They should specialize in certain areas where core strengths exist, and seek out those experts who have first-hand knowledge and experiences about these local cultures and the business climates.

"This is a very, very challenging time within the financial markets, given the fact that firms have had a 'bigger is better' mentality for decades," said Dence. "This is an industry that has been borne out of its ability to keep information

> "They're taking a me-too strategy, following one another to India to save money. Organizations need to take a more scientific approach to realize value from globalization."

proprietary and profit from that. Large organizations lean toward captives. Now they're trying to figure out what they really want to do."

While cost reduction has always been a primary motivation for outsourcing, the report emphasizes that leveraging assets like local talent, shared services, cultural knowledge, and strategic partnerships are becoming more critical for companies to grow revenues globally. The truly successful financial companies will be those that begin collaborating extensively and effectively with resident experts and develop more specialized business models. "This specialization concept is not just about saving money," adds Dence. "It's really about focusing on what they should do as an entire organization. There is a lot of talk, but not much action yet. However, we do think that we will start to see some encouraging developments take place." On a more optimistic note, Dence points out that some firms have accepted this need for change and are reaching out to local strategic partners to help develop and adopt new global models. "Boston-based State Street is a fantastic example; the company is among the largest custodians in the world and became one of the first movers in China" said Dence. "Management realized that its applications-development team in Boston didn't have enough talent, so they formed an alliance with China's Zhejiang University. While State Street recognizes that the capital markets in China are just in their infancy, the company made this very strategic move to gather key talent, understand the dynamics of the Chinese market, and gain the trust of the government, the regulators, the university and ultimately the asset managers. The ultimate goal is to turn this into a revenue-production center. It was a very unique move within the industry."

Outsourcing Revisited

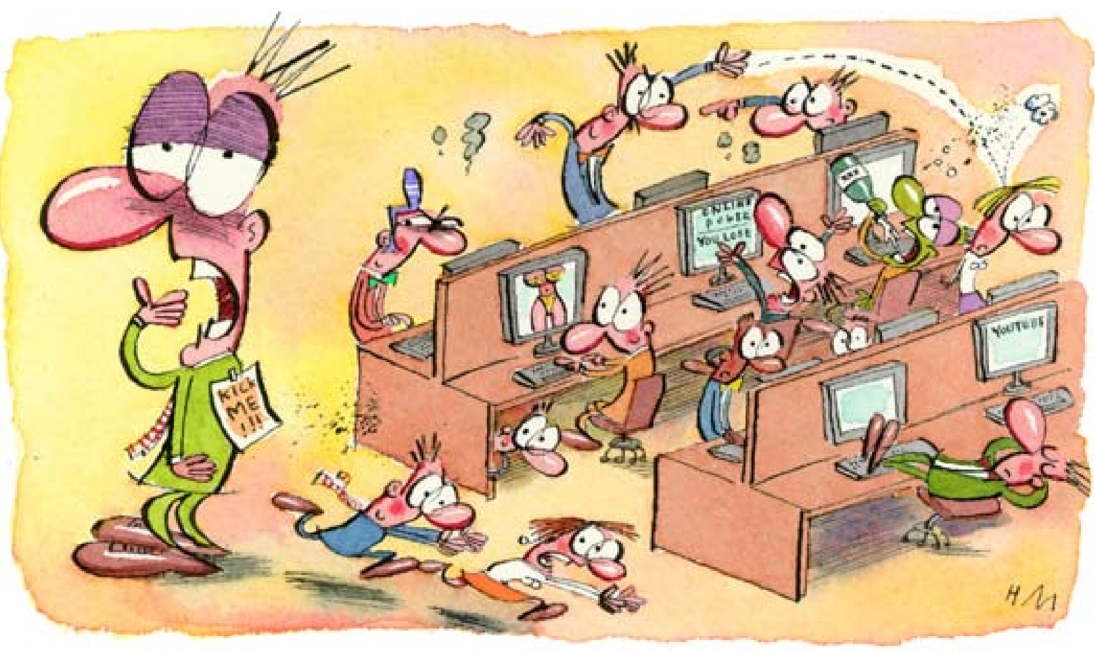
Though the progress has been slow and many large firms are reluctant to change, the growth numbers are simply too large for management to ignore. With China and India hot on most radar screens, other markers like Dubai have started to attract more talent and seem primed to develop as a key financial center. For decades, firms have recognized the successes that outsourcing can provide domestically. Now, they are beginning to take those lessons abroad as they seek to benefit from the vast potential of globalization. As the name implies, the study concludes that firms wishing to successfully compete on the world's stage and must find their specialized niches and engage with local partners. In other words, "Get Global…Get Specialized…Or Get Out." ■

Ron Brounes, CPA, is a financial writer and president of Brounes & Associates (www.ronbrounes.com), a Houston, Texas-based consulting firm that provides writing, communications, and educational services for financial services professionals. He can be reached at ron@ronbrounes.com.

ARBITRATION

Supervision, A LAUGHING MATTER?

BY WALTER L. BAUMGARDNER



Why do so many managers and supervisors complain about their supervisory duties? How many times have you heard a supervisor grumble and complain about attorneys who file arbitration claims against "innocent" stockbrokers? How innocent was Frank Gruttadauria, who allegedly defrauded his clients over a 15-year period? Face it, supervision starts at the top. It is like a stream that trickles from the top down, and not like a well that seeps from the bottom up.

It is not the claims against "innocent" stockbrokers that should bother supervisors, but rather the ones filed against the dirty stockbrokers. In every large office, everyone knows who they are. Examples abound from arbitration hearings about the lack of adequate supervision programs. The attorneys who represent the claimants cannot be blamed for the failure of the firms to put in place strong, meaningful supervision programs. It all starts with the training and education of the RR. If the RRs were taught from the beginning that certain procedures are going to be followed and enforced, they would not be surprised when they are terminated for unethical and illegal conduct.

The NASD ("FINRA") not long ago stated that it was going to look at the failure to enforce supervisory standards and possibly bring enforcement actions based on arbitration claims. Starting at the top means making firms institute and enforce programs that have teeth in them. Finally, the NASD adopted rules 3012 and 3013. These two rules require that there be review systems for supervisory procedures, a reporting system on the results, and an independent person who is required to enforce the system. Ultimately, the CEO must sign off on the program. The question is whether this is just going to be a paper exercise, or will there be real teeth in the program?

For starters, is every RR going to have a copy of the NASD Manual on his desk? They should, since it contains the Rules and Regulations of the NASD. For the people who have never seen or read it, the Manual is a treasure trove of information on how to stay out of trouble. For example, it contains the Code of Arbitration Procedure, Reg. T rules and the Code of Conduct.

In addition, is the NASD now going to make it mandatory for the RRs to read the Notices to Members (NTMs)? For those not familiar with NTMs, they are policy guide lines published by the NASD. They cover areas such as suitability, churning, price spreads, electronic communications, doing business away from the firm, borrowing money from clients and guaranteeing them against loss. In case this article piques your interest, they are all available on the NASD web site. The NTMs supplement the Manual. Every broker should be required to keep a copy of the NTMs. Ask a registered representative if he has read the latest Notice to Members, and the likely answer is, "What are those?" In my thirty-five years in the securities industry, from wirehouse to independent, I have never been provided one by the firm; yet every experienced claimant's attorney knows where to find them and how to use them in an arbitration proceeding.

The NASD web site contains the results of its disciplinary actions. This should be mandatory reading for every RR and supervisor. The amazing part is the similarity between so many of the offenses. These decisions offer a good insight into what the enforcement division thinks about supervisory responsibilities. It would appear from the disciplinary decisions that the standard for the industry is to do the least necessary to get through an inspection or audit. This is the biggest reason why so many arbitrations are lost. A good, no nonsense, no tolerance supervisory program should eliminate most arbitrations and enforcement proceedings. The new rules will also provide fodder for Plaintiff attorneys if they are not followed.

The SEC has a great website, too. It has all of the enforcement proceedings. It is a great way to find out how you can lose your license. It contains litigation releases and other announcements on actions brought on by the SEC. In addition, it has No-Action letters, legal briefs, policy opinions and investor alerts.

In 1996, the SEC brought an action against an office manager for lack of supervision in the case of Johnson v S.E.C. It was ultimately decided that the action by