Issue 80, May 2011

The CutterAdvantEdge
Commentary on Investment Systems and Operations

Taming the Hydra: Managing your Vendor Relationships

Buy-side asset managers are becoming increasingly focused on finding ways to successfully manage their growing stable of third party providers and ensuring that the services and deliverables meet the asset managers' expectations. Central to these goals is implementing achievable service level agreements (SLAs) that firms can monitor, with well-defined rewards when providers exceed the agreements and consequences when they fall short.

Another vital goal of vendor management programs is to mitigate operational risk by identifying where third party services represent key points of failure. In our most recent CutterBenchmarking survey on Managing Third Party Vendors, asset managers revealed their top challenge as effectively managing the growing number of third party vendor relationships.

6.5

The average rating (out of ten) our member firms gave their SLA management program

57%

of firms are looking to enhance their SLAs to include more enforceable metrics

Managing the Growing Number of Third Party Relationships

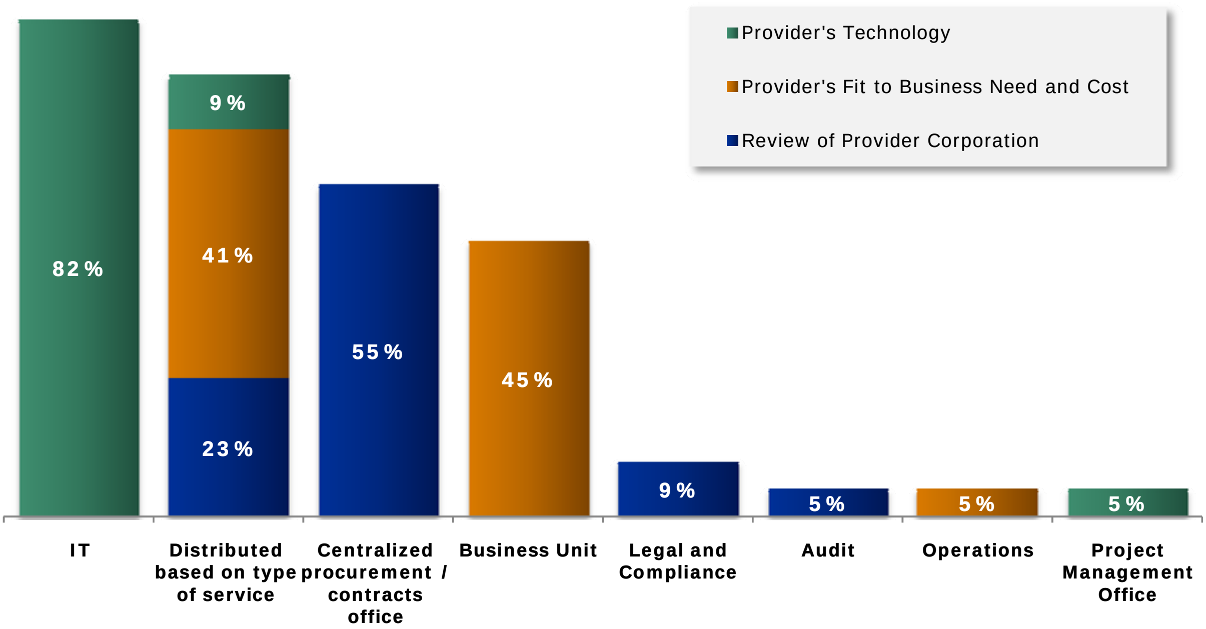
Over the past 10 years, the number of vendors providing services to buy-side firms has exploded. The increase is driven by services providing greater automation for new types of assets and methodologies, which are driven in turn by asset managers' needs for increased efficiency and cost effectiveness. Operationally, third party providers have become extensions of the asset management firms, and vital to the firms' success. Asset managers are increasingly aware that they need to be proactive in monitoring, overseeing, and engaging with the providers, and many have formal third party management programs in place or in development.

Every firm participating in the CutterBenchmarking survey uses a matrix approach for managing their strategic partner relationships, with participation coming from several areas across the firm. A centralized Procurement office is generally responsible for coordination and delivery of the third party services, and for maintaining contact with the third party's SLA Manager. For 64% of participating firms, the Procurement office also negotiates new contracts and contract renewals across the enterprise, regardless of vendor type. But Procurement usually shares responsibility for analyzing vendor fees with several internal stakeholder areas including Operations, IT, and business users. Typically, Operations is responsible for general oversight of third parties that provide data or functional processing while IT is in a support role for the technology. IT also has its share of relationships with external vendor partners who supply the infrastructure support. Business units that directly benefit from a third party service participate in the vendor selection process, and then monitor the chosen vendor's adherence to SLAs alongside the Operational teams.

Mitigating Risk with Formal Vendor Risk Assessments

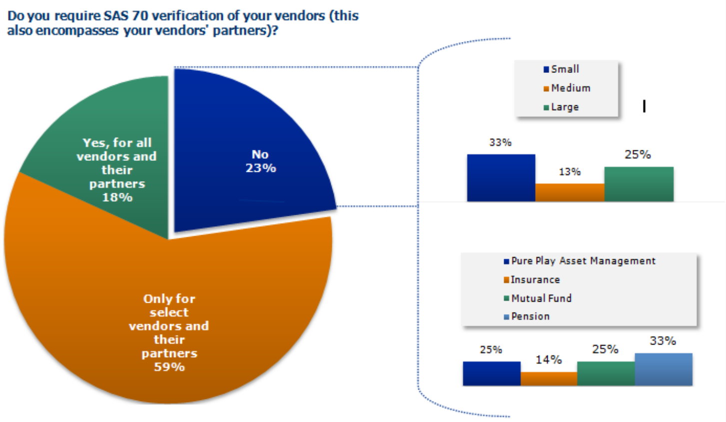
As firms grow more dependent on third party services, they become more exposed to business risk associated with potential problems at the vendor companies. Many firms report difficulty figuring out how to approach popular vendors about adjusting service level expectations or modifying long-standing contracts. Typically, asset managers perform annual reviews of third party providers' company viability and technological fit. But they don't review cost or the fit to business need, once the initial contract is signed. Cutter Associates recommends reviewing cost and business fit on a regular basis, even with mature, long-standing partnerships.

Who is primarily responsible for assessing third party provider risk ?



Leveraging SAS 70

The Statement on Auditing Standards No. 70 (SAS 70) is an internationally recognized auditing standard developed specifically for service providers by the American Institute of Certified Public Accountants (AICPA). A SAS 70 certification verifies that the service provider uses effective internal controls in areas such as physical and environmental security, computer operations (backup & storage and system availability), information security, data communications, and customer access, to name a few. Among our survey participants, 77% require some or all of their third party providers to comply with SAS 70, and of those firms, 52% also audit their providers' SAS 70 certifications. The firms that do not require SAS 70 compliance tend to be smaller organizations.



Getting What You Need... Defining Service Level Agreements

As firms expand their global footprint or invest in new asset types, they need to engage new vendors in different businesses or regions, with different legal requirements, expectations, and levels of technical sophistication. This wide variety of vendor types produces a broad array of Service Level Agreements (SLAs).

Although the components included in SLAs vary widely, the following were used most frequently by participating firms:

- Scope
- Provider Details
- Metrics
- Monitoring
- Service Definition
- Conditions Warranting Change
- Change Conditions
- Change Procedure
- Change Frequency

During interviews, several survey participants stressed the importance of avoiding a vendor's standard SLA terms. They recommended establishing more meaningful SLAs through extensive and scheduled dialog with the provider. SLAs should have clear standards and processes for managing expectations when one party feels the other has failed to meet the terms of the agreement. SLAs should include metrics that the asset manager can monitor, determined specifically by the critical factors driving the business. Within a class or category, different regions or vendor types often require different metrics. The SLA should also include clear definitions of expectations, along with clearly defined rewards for exceeding them and clearly defined consequences for failing to meet them.

CutterBenchmarking produces four reports annually on operational, regulatory and technology risks. In June, we will distribute the findings from our annual CutterBenchmarking survey on Operational and IT Structure & Costs to our CutterBenchmarking members.

"Proscribing a higher than standard service level to a vendor may not always be wise, because if the firm's standard SLA is set, that may be their top capacity."

Medium Sized Asset Manager

"Ideally, we'd like to have formal SLAs with all third party providers but it can be very difficult to get the contractual language we desire and need."

Large Mutual Fund