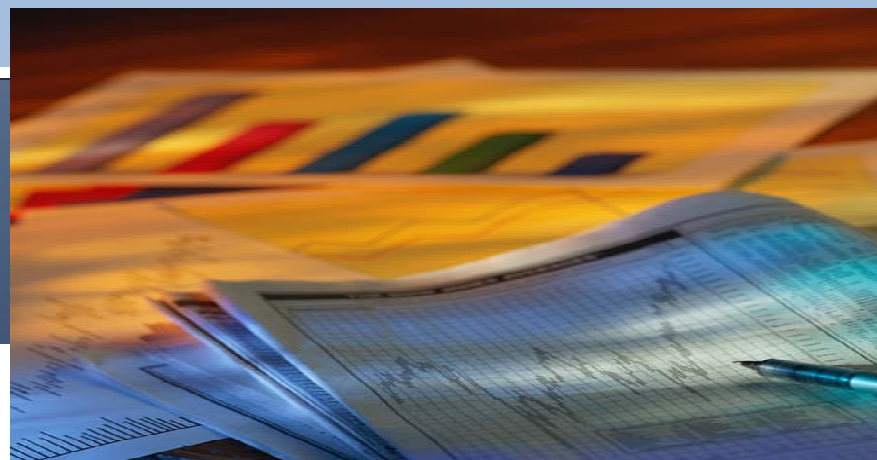


# Benchmarking Compliance Costs

*“Remarkable Profits Potential”*

**Co-Sponsored by Financial Tracking, LLC and IA Watch**

March 2010



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# INTRODUCTION

Compliance has always been an important part of the money management business, but never more than now. After rapid and sustained growth during the 1990s, the asset management industry experienced a challenging first decade of the new millenium. New cash continued to flow into investment vehicles, but a variety of factors contributed to an increasingly competitive and difficult operating environment for asset managers. Unprecedented market volatility meant some investors realized no net gain over the past ten years. Rapid globalization meant assets increasingly flowed to international markets, leaving many managers of domestic-oriented products in the cold. Demographic shifts and the rise of distribution platforms caused fund flows to become lumpier and more volatile. The rise of ‘alternative’ investing had many traditional managers scrambling to retain talent and/or introduce their own hedge funds. Scandals raised the ire of regulators and investors alike.

Proactively addressing compliance issues is more critical than ever before to succeed in the asset management business. With this in mind, Financial Tracking, LLC decided in late 2009 to survey asset managers on a variety of compliance-related topics.

**AUM Peer Groups**  
**XL** = *More than 20 billion*  
**L** = *5 to 20 billion*  
**M** = *1 to 5 billion*  
**S** = *500 million to 1 billion*  
**XS** = *100 to 500 million*

The objective was to answer some key questions:

1. **Measuring the costs of compliance?**
2. **How is compliance being organized and augmented?**
3. **How are managers prioritizing compliance initiatives?**
4. **To what extent are technology and automation being used in compliance processes?**
5. **Can a compliance program offer competitive advantage?**

A total of 256 asset management professionals responded to the survey. Responses were analyzed as a single group, but survey participants were also divided into peer groups based on assets under management (AUM) (*see box*). Organizational size often has a dramatic impact on the cost and treatment of operational issues at money management firms. Large enterprises often bring more resources to bear but often shoulder the burden of additional complexity. Smaller organizations often offer relative simplicity, but can prove less process-oriented than their larger counterparts. Indeed, our analysis highlights some intriguing differences in the approaches to compliance among firms of differing sizes. Additional peer-group specific analysis can be found in the appendix.

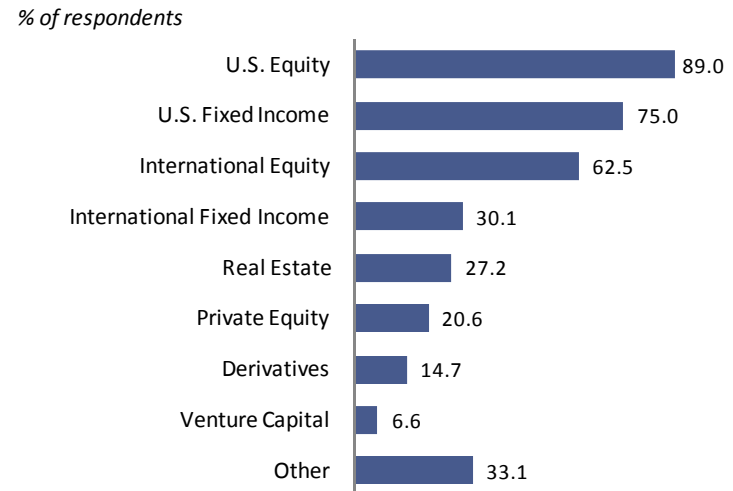
Survey results were also tabulated by the types of products managed, but the analysis revealed no meaningful correlations between assets classes managed and any of the responses provided. As a result, this analysis is omitted from this report.

## PROFILE OF SURVEY PARTICIPANTS

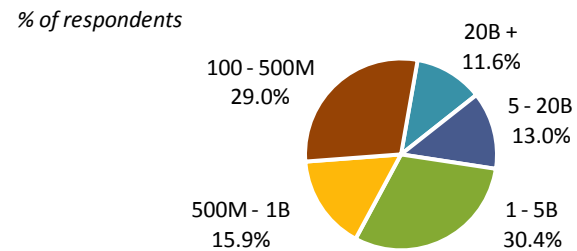
256 asset management firms responded to the survey, which was conducted in late 2009. Participating organizations include both smaller boutiques and large, global financial services organizations. Managers of traditional long-only products took part, as did those managing a variety of non-traditional products and strategies. More than half manage U.S. equities, U.S. bonds or international equity (Figure 1). Asset composition is very consistent across firm sizes.

Assets under management (AUM) ranges from \$100 million to almost \$1 trillion, with an average of \$16.8 billion (Median AUM was \$1.2 billion). For analytical purposes, survey participants were placed into five groups based on AUM (Figure 2).

**Figure 1: Asset Classes Managed**



**Figure 2: Survey Participants by AUM**



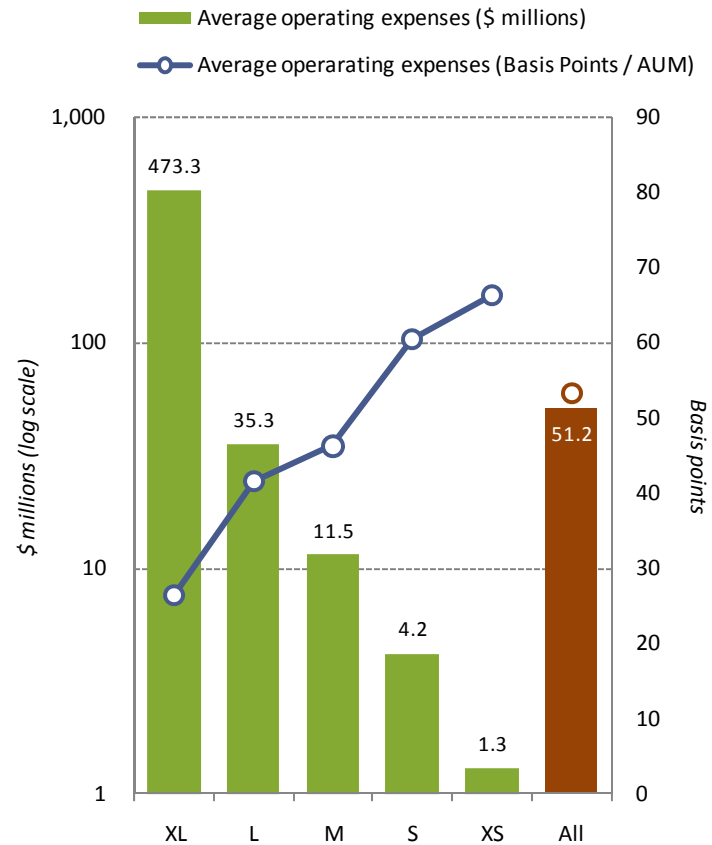
# FINDINGS

## Compliance Budget

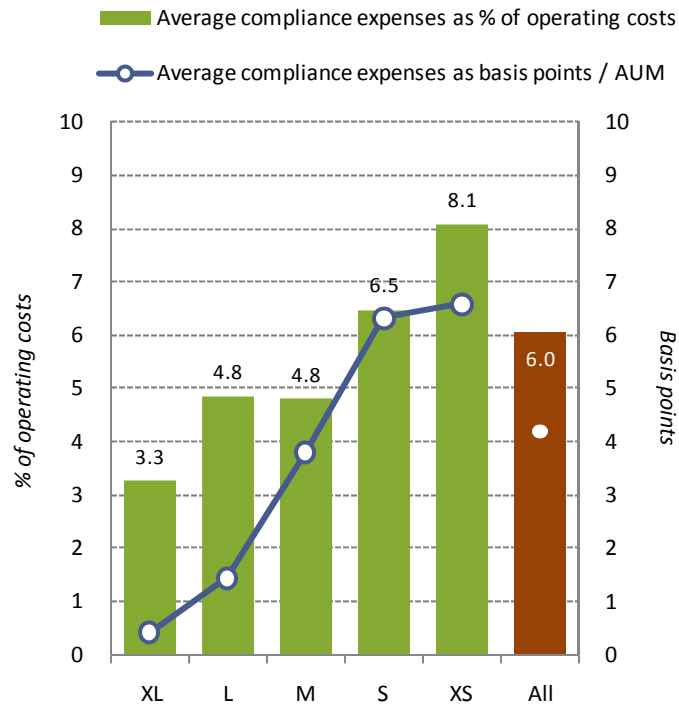
Asset management firms have traditionally enjoyed relatively healthy economics. Profit margins regularly outpaced those at other types of financial services organizations, and market growth generally ensured a steady rise in revenue that offset modest reinvestments in the business. This comfortable status quo was shaken to its core during the recent financial crisis. Plummeting markets and panicking investors meant managers saw assets and fee revenue fall by 50% or more in some cases. The subsequent recovery has been uneven, with asset managers facing the sobering fact that their economics may be permanently altered by a market environment is radically different from the one to which they had become accustomed.

Total operating expenses vary widely depending on the size of firm. Across all firms surveyed, operating costs account for an average of approximately 53 basis points (bps) of AUM (Figure 3). Economies of scale are clearly evident. Operating costs at the largest firms average just over 26 basis points, compared to the 66 basis point average among the smallest firms. Smaller firms may justifiably point to any number of advantages they offer clients over their larger competitors, but generating fee revenue to cover operating expenses that are two and a half times higher is a daunting challenge indeed.

Figure 3: Total operating expenses by AUM peer group



**Figure 4: Compliance budget by AUM peer group**

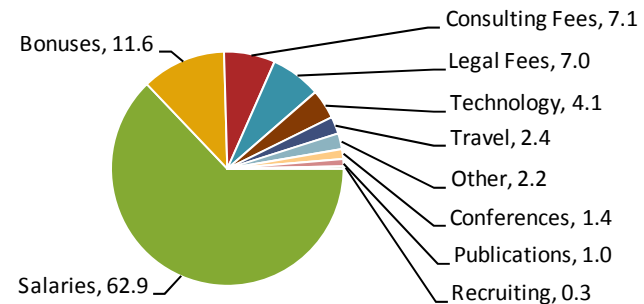


Research, marketing, and technology are just some of the expenses that disproportionately affect smaller managers. Compliance costs another. Compliance budgets range from just over 3% of total operating costs at large firms to more than 8% at the smallest ones, averaging just over 6% across all respondents (Figure 4). Relative to AUM, compliance costs account for 6.6 basis points, a significant number by any measure. Among the largest firms, on the other hand, compliance costs account for a scant 0.4 basis points, amounting to little more than a rounding error.

Compensation costs account for almost three quarters of the average compliance budget (Figure 5), a similar proportion of total compensation to the overall costs at a typical asset management firm. Compensation comprises a larger proportion of compliance budgets at larger firms, not surprising given their more sizable staffs. The largest organizations report spending an average 86% of their compliance budgets on compensation, while compensation accounts for only 62% of compensation budgets at the smallest firms, which are often operating with the skeleton crew.

**Figure 5: Costs as average percentage of total compliance budget**

*Average % of compliance budget*



Perhaps more surprising are the markedly different approaches to compensation between firms of different sizes. Bonuses constitute an average 12% of compliance compensation across all survey respondents, but large firms are more inclined to use variable compensation to pay their compliance staff than their smaller counterparts. This approach is highlighted by the fact that almost 18% of compliance compensation is paid in the form of bonuses at large

firms, while bonuses account for an average of only 4% of compensation paid to compliance staff at small firms

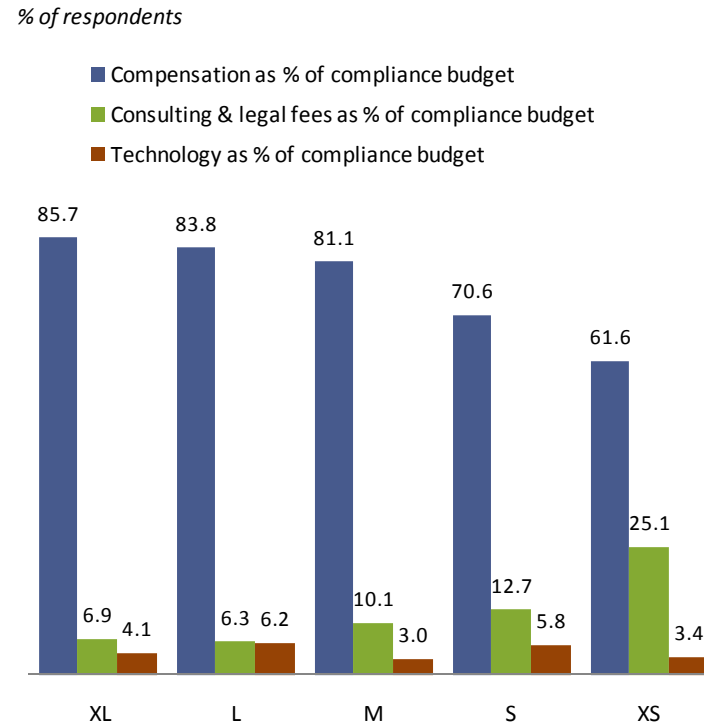
Differing approaches to compensating compliance staff could reflect simple economic realities. On the other hand, they might reflect divergent philosophies. Boutique asset management firms revolve almost exclusively around the central mission of managing client funds. Investment professionals are the stars of the show and typically earn the lion’s share of whatever bonus pool exists. Compliance professionals are more likely to be viewed as operational overhead. Larger managers, like any sizeable enterprise needs to maintain competitiveness on a variety of fronts. Investment performance remains front and center, but a variety of other metrics are typically tracked, with functional professionals rewarded according to their respective contributions. Compliance professionals are more likely to be viewed as potentially valuable contributors to overall corporate performance.

After employee compensation, consultant and legal fees typically comprise the largest compliance-related outlays, with each accounting for 7% of the average compliance budget. Smaller organizations often depend heavily on external consultants, meaning their fees constitute 17% of the average compliance budget at the smallest firms. More likely to be fully staffed, large firms spend an average of less than 1% of their compliance budgets on consultant fees.

At just over 4% of the average compliance budget, technology often represents a small slice, but it rises into double digit percentages at many firms. The level of technology spending is not correlated to firm size. Rather, it is likely to exhibit considerable variability from year to year, depending on the range of compliance initiatives underway, the

state of implementation, and the types of licensing arrangements in place. It would not be surprising if technology spending rose significantly in the coming years, if only to address the many processes still being performed manually. Other drivers of technology investments include continued regulatory change, the coming of cloud computing, the growth of mobile technology, the proliferation of investment products, and a host of other unanticipated changes. In fact, survey respondents report that compliance-related IT is the second-most likely area to see an increase in funding over 2010.

**Figure 6: Key compliance costs by AUM peer group**



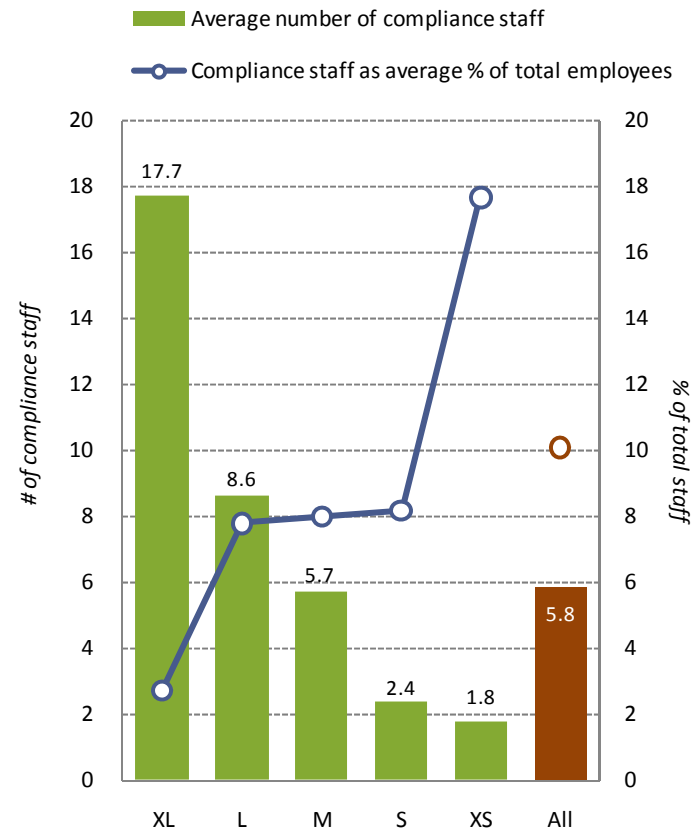
### Compliance Staffing

With compensation accounting for three quarters of all compliance-related spending, efficient and effective staffing is clearly a priority. Compliance staffing is directly related to firm size. Small organizations report an average of two dedicated compliance employees on staff, often augmented by external consultants. This compares to an average of six compliance employees at mid-size firms and fifteen at the largest firms. The average number of compliance employees among all respondents was just under six individuals (Figure 7). Given the critical nature of compliance in the operations of all asset management firms, it is probably fair to say that the smallest organizations are understaffed in this regard.

It is not unusual for senior managers at these firms to wear multiple hats, but the fact that they spend more time than average reading up on regulatory and compliance developments illustrates the luxury enjoyed by larger organizations that are able to hire a greater number of specialists. This state of affairs is likely to persist, as the smallest survey respondents say they are the least likely to increase compliance staff compensation in the coming year.

Compliance staff account for an average 10% of total headcount across all organizations surveyed, but their numbers to vary considerably with firm size. While accounting for an average 18% of all employees at the smallest firms, compliance professionals make up only 8% of overall headcount at mid-size firms and a scant 3% of large firm employees. Compliance activities are highly scalable, however, causing AUM per compliance professional to range from an average of \$190 million at the smallest firms to almost \$9 billion at the largest firms.

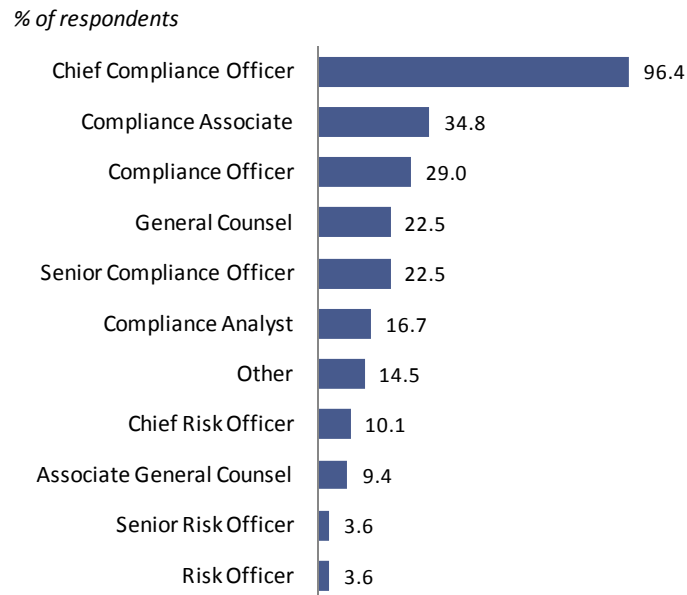
Figure 7: Headcount by AUM peer group



Almost all firms participating in the survey employ a Chief Compliance Officer (CCO), but other compliance-related positions are reported less frequently (Figure 8). After CCOs, other Compliance Officers, Compliance Associates, and General Counsels are the most commonly employed positions.

The breadth of compliance positions employed is correlated to firm size. More than half of all firms with more than \$10 billion AUM, for example, report having a General Counsel, Senior Compliance Officers, and Compliance Analysts on staff. All of these positions are rarely found at smaller organizations.

**Figure 8: Compliance staff positions currently employed**



In light of the recent financial crisis, during which many investors and managers alike found themselves facing risks they had overlooked or not anticipated, it is interesting to note that risk officers remain a relatively rare breed. Full-time Chief Risk Officers (CROs) are employed at only 16% of all firms, with almost half of all organizations choosing to have their CCO play both roles (Figure 9).

**Figure 9: Chief Risk Officer**

Does your company have a full time Chief Risk Officer?

*% of respondents*



Is your company's CCO also the Chief Risk Officer?

*% of respondents*



### Compliance Priorities

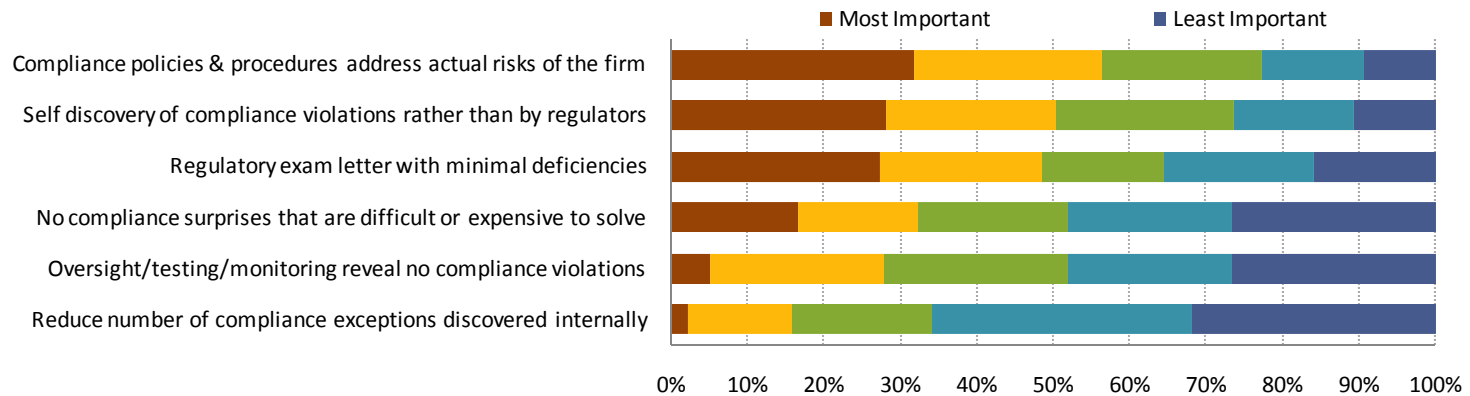
Compliance priorities are hardly uniform among asset management firms, but there is broad agreement on certain things. Ensuring that policies and procedures address actual risks faced by the firm, for example, is widely seen as a top priority (Figure 10).

Minimizing unwanted attention from regulators is also seen as a high priority, whether in the form of self discovery of violations or exam

letters with minimal deficiencies. Reducing or eliminating the discovery of compliance violations via internal oversight, testing, or monitoring is generally seen as less important, likely because most firms would rather uncover and deal with problems rather than not discovering them in the first place. The ranking of priorities is remarkably consistent across firms of all sizes.

**Figure 10: Compliance priorities ranked most to least important**

*% of respondents*



### Compliance Activities and Processes

Compliance professionals at most firms spend the largest part of their time monitoring their organizations for exceptions to compliance (Figure 11). Managing general compliance issues and reviewing marketing materials also account for a significant amount of time. Highlighting the wide array of approaches, activities that are de-emphasized by many firms are named by others as the very ones requiring the most time. Vendor due diligence, employee training, and updating the firm’s risk assessment are all examples of this phenomenon.

Small firms report the most varied use of time among compliance professionals, while large firms exhibit the most focus. Small firms also place considerably more emphasis on the enhancement of professional knowledge by reading compliance-related publications or websites than their mid-size counterparts, while large firms declined to rank it at all. Similarly, mid-size firms are the most likely to report their compliance professionals spending a great deal of time on the review of marketing materials.

**Figure 11: Time spent on activities by compliance personnel**

*% of respondents*



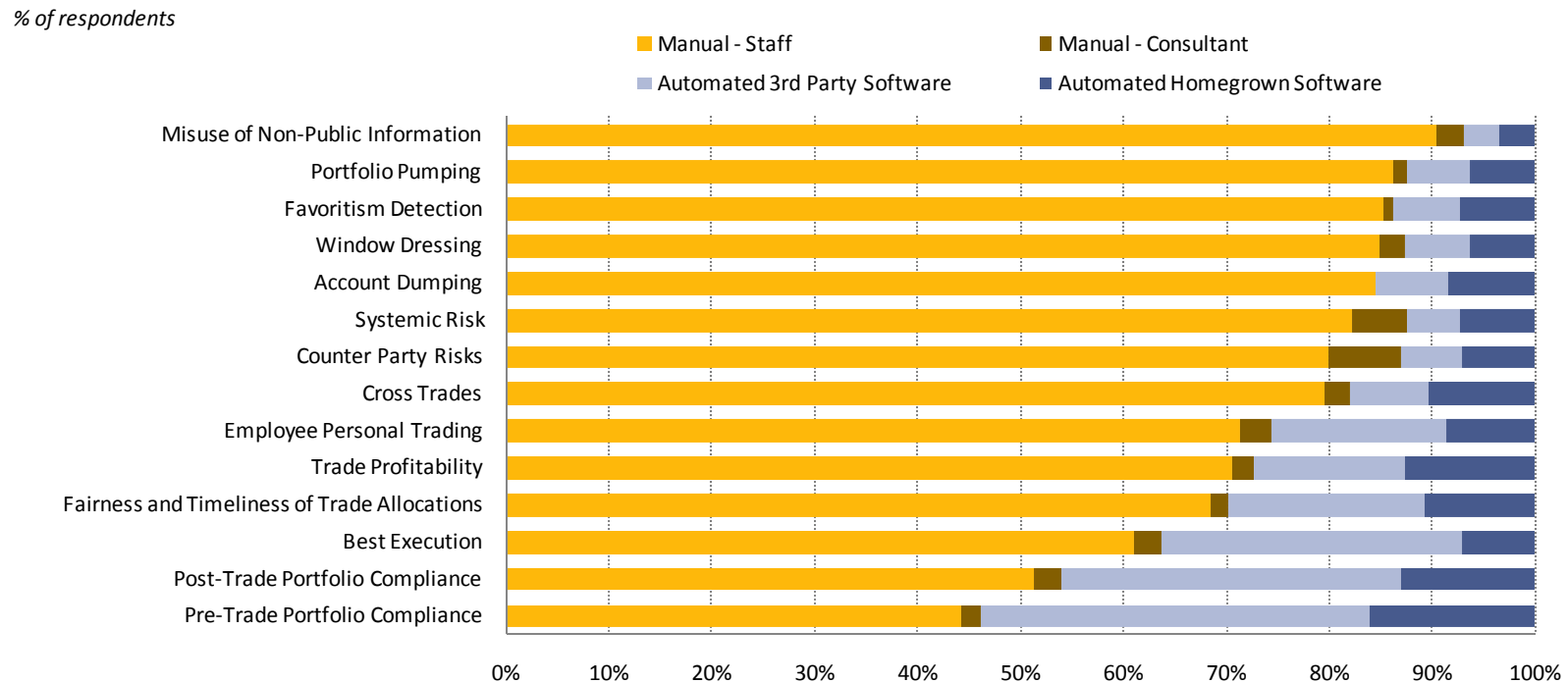
Well into the 21<sup>st</sup> century, the lack of automated compliance processes at asset management firms is striking. Asked to describe how fourteen distinct compliance processes are handled at their firms, a majority of survey participants reported manual processes in thirteen instances. (Figure 12).

At the other end of the spectrum are processes like the ones used to detect portfolio pumping and window dressing, where less than 15% of firms report having automated processes in place. The prevalence of third-party software is directly correlated to the level of automation overall.

Only in the processes used to assess counterparty risk and systemic risk are external consultants used in any significant numbers to perform manual processes.

**Overall this finding represents a material opportunity for money managers to automate these processes through technology based solutions; in turn, significant profit potential could be realized in these areas. Automation could not only provide increased profits but also ensure a higher degree of compliance and enhance competitive advantage during due diligence meetings.**

**Figure 12: Are the following compliance testing/monitoring processes manual or automated?**



Small firms are much more likely to use consultants to perform manual processes, a practice that is virtually unheard of at the largest organizations. The level of automation is also highly correlated to firm size, as is the use of in-house software (Figure 13). To take but one example, employee personal trade compliance is automated at 75% of

the largest firms, which are evenly split in their use of third-party and homegrown software to perform this particular task. In contrast, employee personal trade compliance is automated at less than 3% of the smallest firms.

**Figure 13: Use of manual compliance processes by AUM peer group**

*% of respondents*

	XL	L	M	S	XS
Favoritism Detection	81.3	85.7	85.2	86.7	91.3
Misuse of Non-Public Information	66.7	100.0	96.9	95.0	97.0
Account Dumping	66.7	90.0	85.0	77.8	95.0
Portfolio Pumping	64.3	91.7	91.3	83.3	100.0
Systemic Risk	61.5	92.3	92.3	83.3	96.2
Counter Party Risks	61.5	83.3	96.2	75.0	100.0
Window Dressing	61.5	92.3	95.2	81.8	95.2
Trade Profitability	61.5	42.9	76.0	76.5	88.5
Cross Trades	57.1	72.7	85.0	91.7	95.2
Fairness and Timeliness of Trade Allocations	46.7	56.3	72.7	77.8	82.8
Employee Personal Trading	25.0	64.7	78.9	75.0	94.7
Post-Trade Portfolio Compliance	25.0	17.6	51.5	77.8	77.4
Best Execution	20.0	35.3	69.7	85.0	82.1
Pre-Trade Portfolio Compliance	13.3	25.0	44.8	64.7	65.5

### Compliance Technology

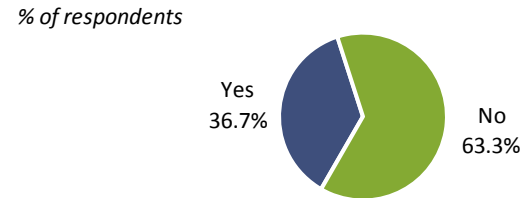
When acquiring compliance-related technology, it is not particularly common for the purchaser to perform a formal ROI or cost/benefit analysis (Figure 14). Only 37% of survey respondents say that this type of analysis is a part of their normal decision-making process.

Vendor due diligence checklists are often extensive. When presented with 18 items that might be found on due diligence checklist, survey participants indicated that they regularly review an average of seven items. Only one in ten respondents says they do not regularly conduct any due diligence on technology vendors.

References, checked by three quarters of those conducting vendor due diligence, top the list (Figure 15). Business continuity, client lists, financial statements, and potential conflicts of interest are all checked by at least half of all firms. Though broadly consistent across all sizes of firms, some due diligence items are emphasized more (or less) by certain cohorts. Large firms, for example, are far more likely to inspect IT security documentation, with 81% saying that such inspections form a part of their due diligence checklist, compared to only 35% of their smaller counterparts.

In addition to the options provided, many survey respondents noted additional items that could be found on their diligence checklists. Onsite visits, for example, were noted by a number of respondents as being an important component of their diligence process.

**Figure 14: When purchasing compliance technology, does your firm perform a formal return on investment or cost/benefit analysis?**



**Figure 15: When conducting vendor due diligence, which of the following are reviewed (multiple responses allowed)**



### Compliance Spending Plans

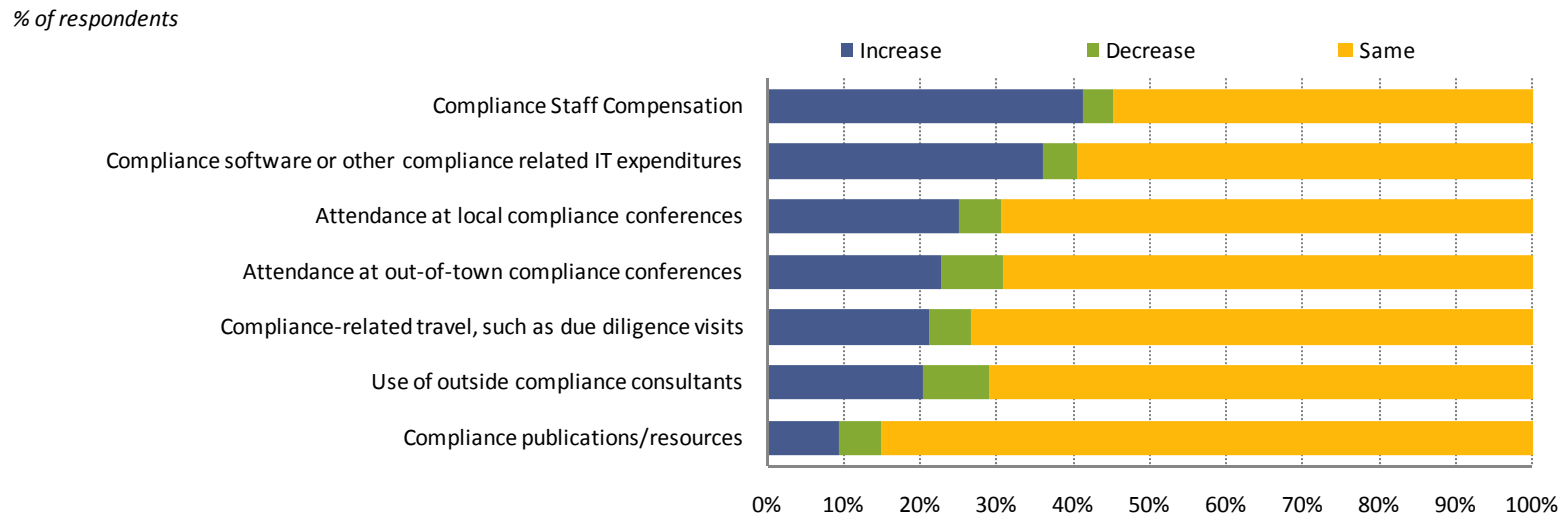
Market volatility, scandals, increased regulatory scrutiny, globalization, product complexity, and technological innovations all contributed to rising compliance costs over the past decade. Spending on compliance will continue to rise at some firms, but it appears to have plateaued at the majority (Figure 16).

Increased spending is most often expected to be in the form of additional compensation for compliance staff. More than 40% of firms say compliance staff compensation will increase in 2010, compared to only 4% who say it will decrease.

More than a third of all respondents say they expect compliance-related IT expenses to rise in 2010.

Changes to compensation and IT spending are relatively consistent across all sizes of firms. In other areas, it appears that small and mid-size firms may be playing catch up. A sizable group of respondents from large firms, for example, say they plan to cut spending on conferences, consultants, and travel. This is almost unheard of among smaller organizations, which are nearly unanimous in their plans to either maintain or increase spending on these areas.

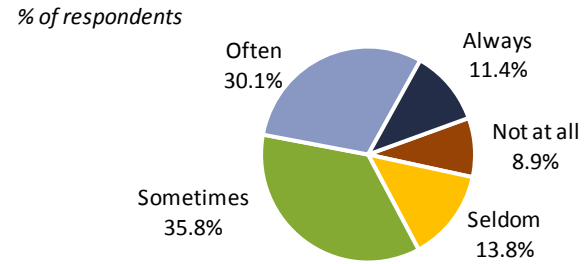
**Figure 16: Does your firm plan to increase, decrease, or keep the same compliance spending in 2010 compared to 2009?**



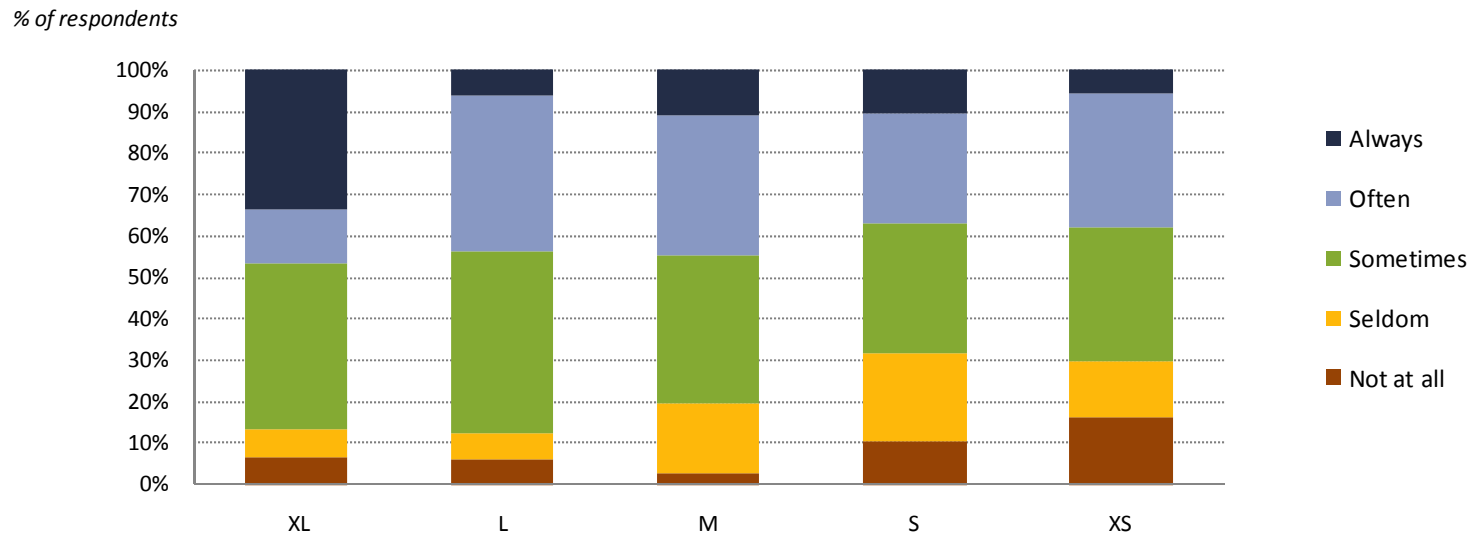
### Compliance as Competitive Advantage

There is a widely held view that compliance is closely linked to overall competitiveness. Over three quarters of all respondents said their compliance program provided their firm with a competitive advantage at least some of the time, with more than half of these saying it ‘often’ or ‘always’ gives their firm a competitive advantage (Figure 17). Less than one in ten says their compliance program provides no competitive advantage whatsoever. The largest firms appear to have the most conviction regarding the contribution of their compliance programs to overall competitiveness (Figure 18).

**Figure 17: To what degree do you feel your compliance program gives you a competitive advantage?**



**Figure 18: Compliance program’s contribution to competitive advantage by AUM peer group**



## CONCLUSIONS

Given recent events, it would be surprising if compliance took a lower profile in the years to come. Spending may slow in some cases, but various regulatory initiatives, client pressure, and competitive necessity will ensure that compliance will become a more – not less – prominent area of attention for business executives and investment professionals alike.

Outside of the largest global organizations, the survey revealed that dedicated compliance staffing is often quite thin, with a median of only two compliance professionals per firm. A typical staff consists of a Chief Compliance Officer and a single associate. Staff sizes grow quickly in tandem with asset size and business complexity. The number of compliance professionals can often climb to double or even triple digits at firms with more than \$20 billion of assets. The good news is that there are economies of scale.

It is reasonable to expect increased hiring of compliance staff across the board. It will be particularly interesting to see how many firms refine their definition of Chief Risk Officer and create a separate and distinct role from that of the Chief Compliance Officer. Dedicated risk officers are still somewhat rare, but may become more commonplace in the wake of the recent financial crisis during which it became abundantly clear that many people, businesses, and governments did not fully understand the risks to which they were exposed.

***Although compliance-related compensation costs will rise, the more significant change will be driven by technology adoption. There is a potentially significant opportunity to improve profitability through the judicious application of technology to compliance-related processes, and forward-thinking firms will dedicate resources to this proposition. Third-party solutions will proliferate and gain traction. Quantifying the benefit of replacing a manual process with an automated one is relatively simple. Equally important, if less obvious, is the benefit of an improved client experience, whether the 'client' in question is a pension plan or the SEC.***

There will be no shortage of excitement in the coming years for compliance professionals in the asset management industry. There are likely to be many new regulations to learn and processes as well as technologies developed to accommodate them effectively. Change of this sort is often perceived as a challenge to overcome, but competitive managers will view it as an opportunity, leveraging a proactive approach to compliance as a source of advantage in a competitive and volatile market environment.

# ABOUT

## *Financial Tracking, LLC*

Financial Tracking Technologies, LLC is the proven leader in reducing costs through automated compliance software with modular features. The SEC is a client. Its solutions enable positive assertions and proof that internal controls exist. Companies using its technologies include government regulators, investment managers, mutual funds, hedge funds, fund of funds, broker/dealers, trust banks, plan sponsors, private equity firms, public companies and value-added resellers. Clients no longer endure the arduous and daunting tasks of data gathering and analysis and are the **“First to Know™”** when compliance exceptions occur. Additional information can be found at [www.financial-tracking.com](http://www.financial-tracking.com)

## *IA Watch*

IA Watch is part of a portfolio of specialized information services wholly owned by United Communications Group. Run by its founders, UCG is independent from suppliers, consultancies and other organizations. IA Watch is the place [www.iawatch.com](http://www.iawatch.com) for authoritative answers to your toughest compliance questions. It harnesses the best journalistic and research expertise to create the most comprehensive information tool for compliance professionals working in the securities industry. IA Week, published by UCG, is a general circulation weekly focused on regulatory and compliance issues in the investment advisor community.

## *The Author*

Steven Unzicker provides research and consulting services to financial services organizations. Surveys form a cornerstone of Steve’s work, which is focused on helping clients identify, understand, and exploit key industry trends.

Over the past fifteen years Steve has been asked to design strategic plans, advise on transactions, re-engineer business processes, optimize product lines, and formulate compensation plans. Clients include mutual fund managers, institutional managers, hedge funds, family offices, banks, technology vendors, fund services companies, recruiters, and industry associations.

Prior to becoming an independent consultant, Steve was Director of Research with the Business Strategy Group at CRA RogersCasey. Previously, he managed the strategy consulting group at Investment Counseling, a boutique consultancy focused on the asset management business where he played a pivotal role in the development of Competitive Challenges, a ground-breaking annual study of best practices in the asset management industry. He began his career in the asset management industry with Morningstar.

Steve earned his MBA from London Business School and a BA in Far Eastern Languages and Civilizations from the University of Chicago. He can be contacted at (415) 259-8071.

## CONTACTS

If you would like to learn more about the compliance survey, please feel free to contact any of the following individuals:

Carl Ayers, Publisher, IA Week, 301-287-2435

Hugh Kennedy, Group Publisher, United Communications Group, 301-287-2213

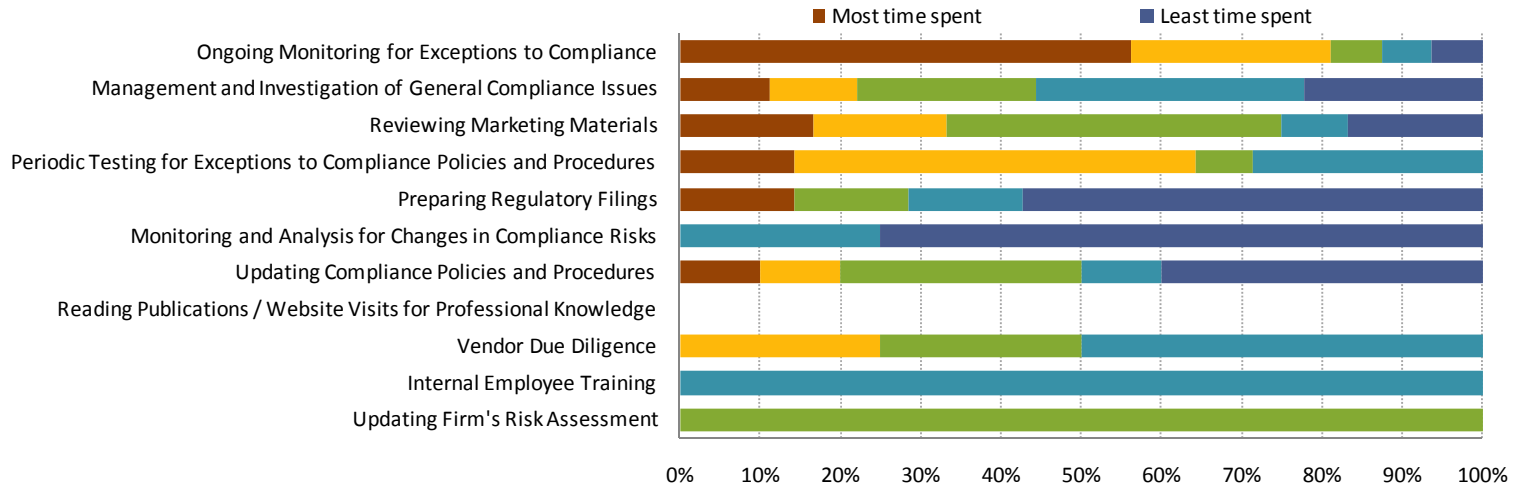
Tony Turner, Principal, Financial Tracking, LLC, 203-340-2356 x804

Mike Ryzak, Global Business Development, Financial Tracking, LLC, 203-340-2356 x803

# APPENDIX 1: LARGEST (XL) FIRM DATA

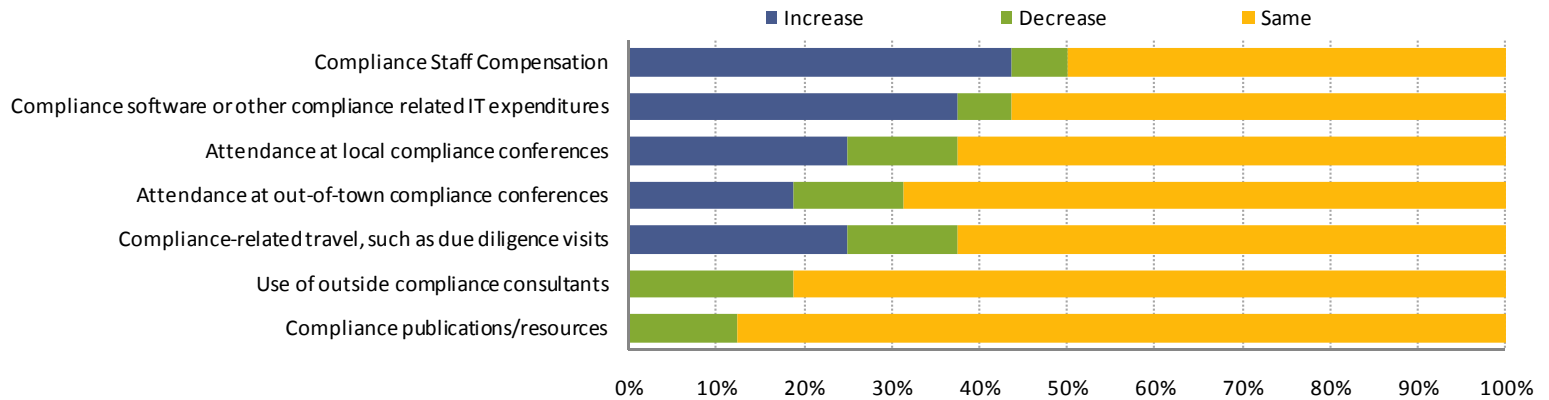
## Time spent on activities by compliance personnel

% of respondents



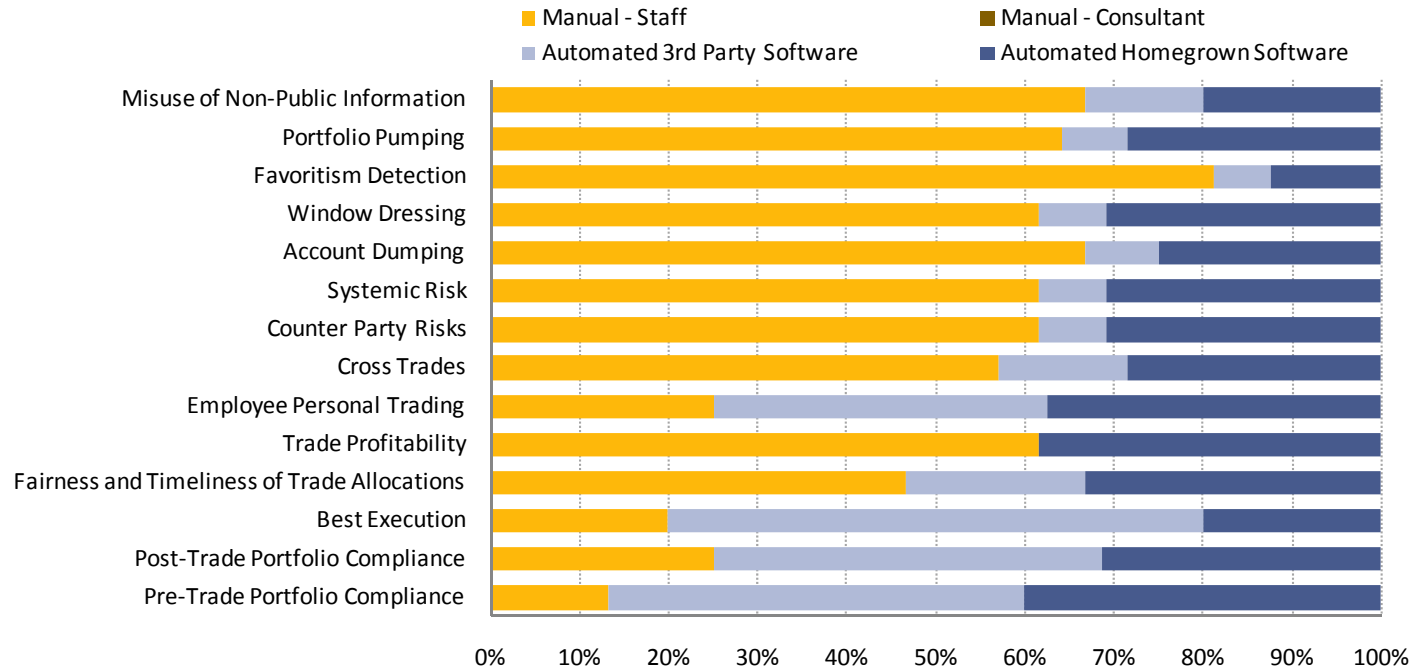
## Planned compliance spending in 2010 compared to 2009

% of respondents



**Are the following compliance testing/monitoring processes manual or automated?**

% of respondents



**Do you have a trading relationship with a vendor that provides best execution analysis?**

% of respondents



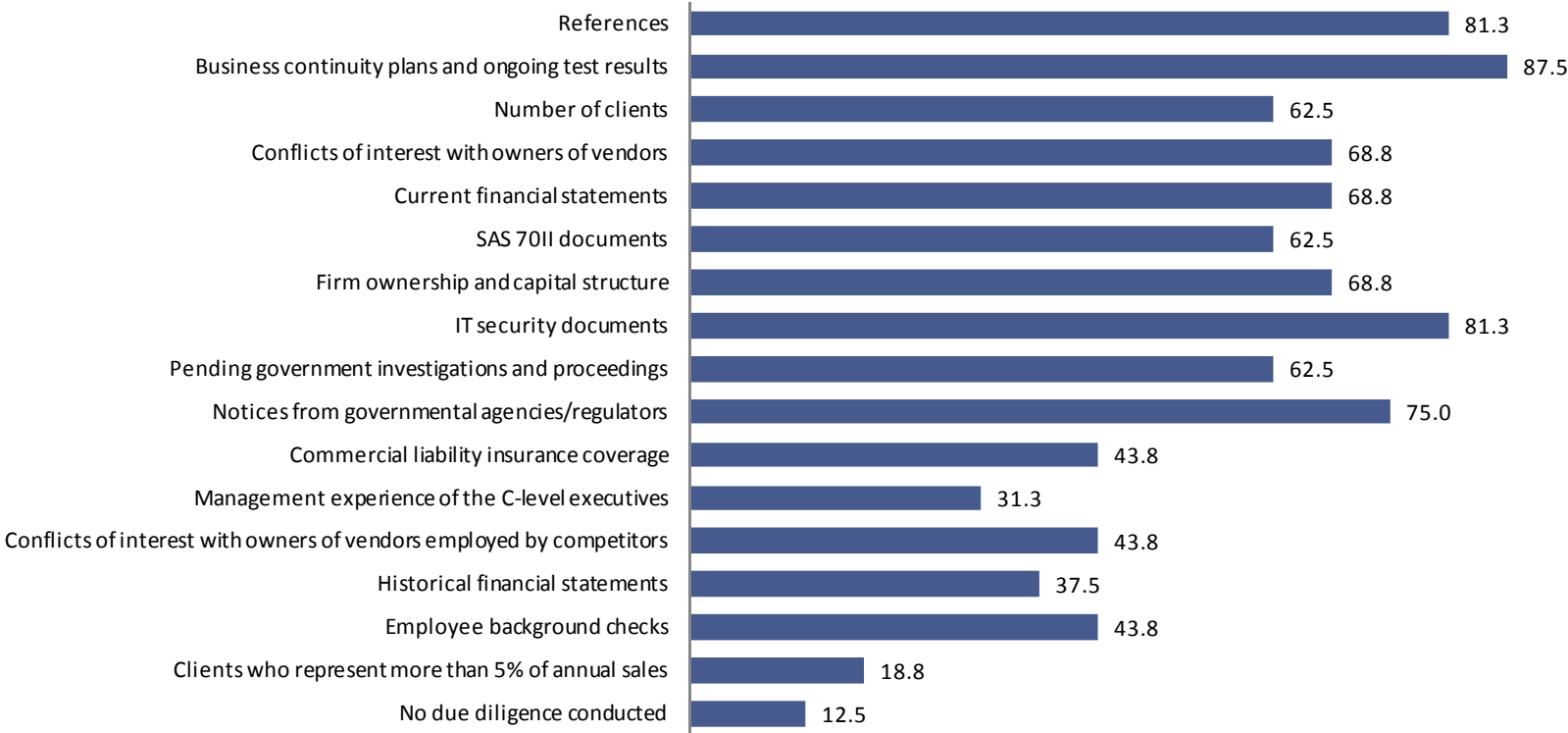
**Are you considering limiting the BDs with which your employees may hold accounts?**

% of respondents



Items reviewed when conducting vendor due diligence (multiple responses allowed)

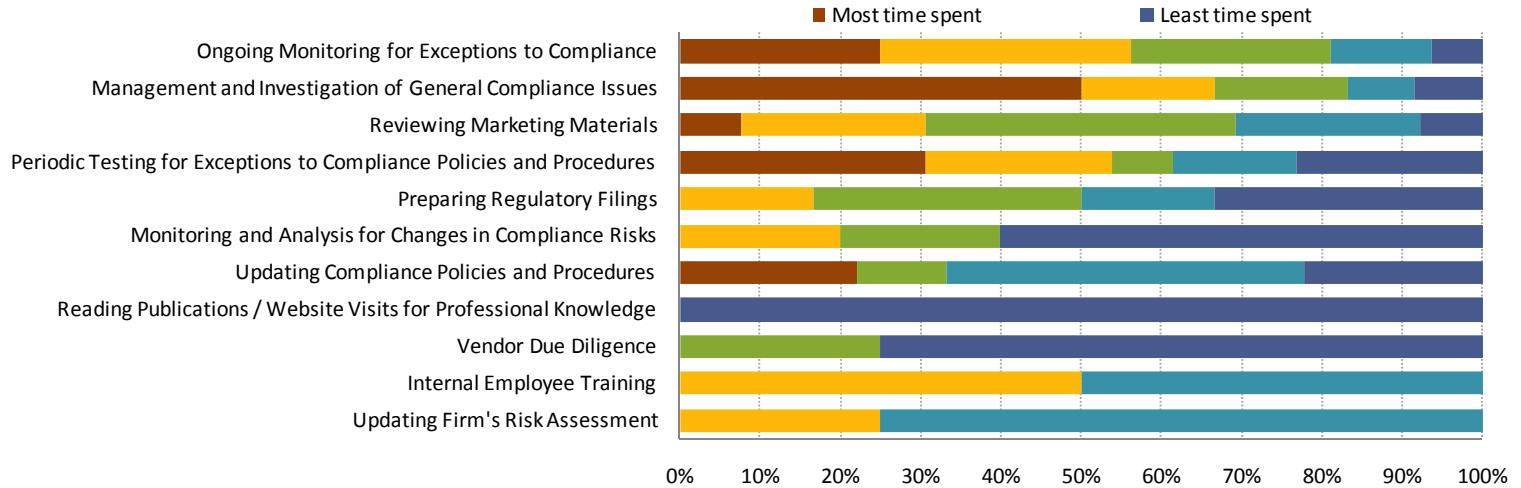
% of respondents



# APPENDIX 2: LARGE (L) FIRM DATA

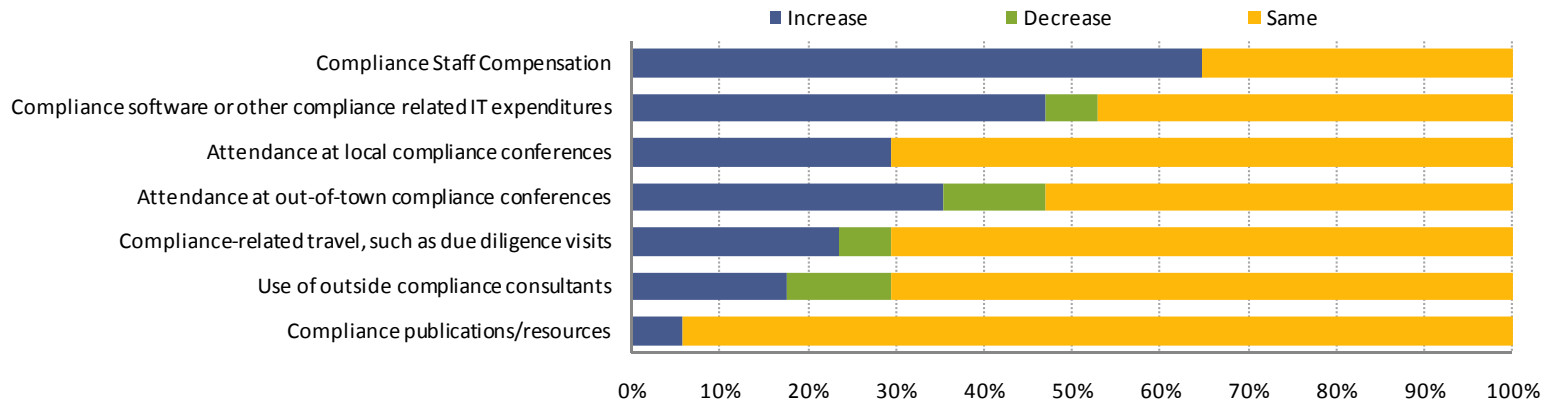
## Time spent on activities by compliance personnel

% of respondents



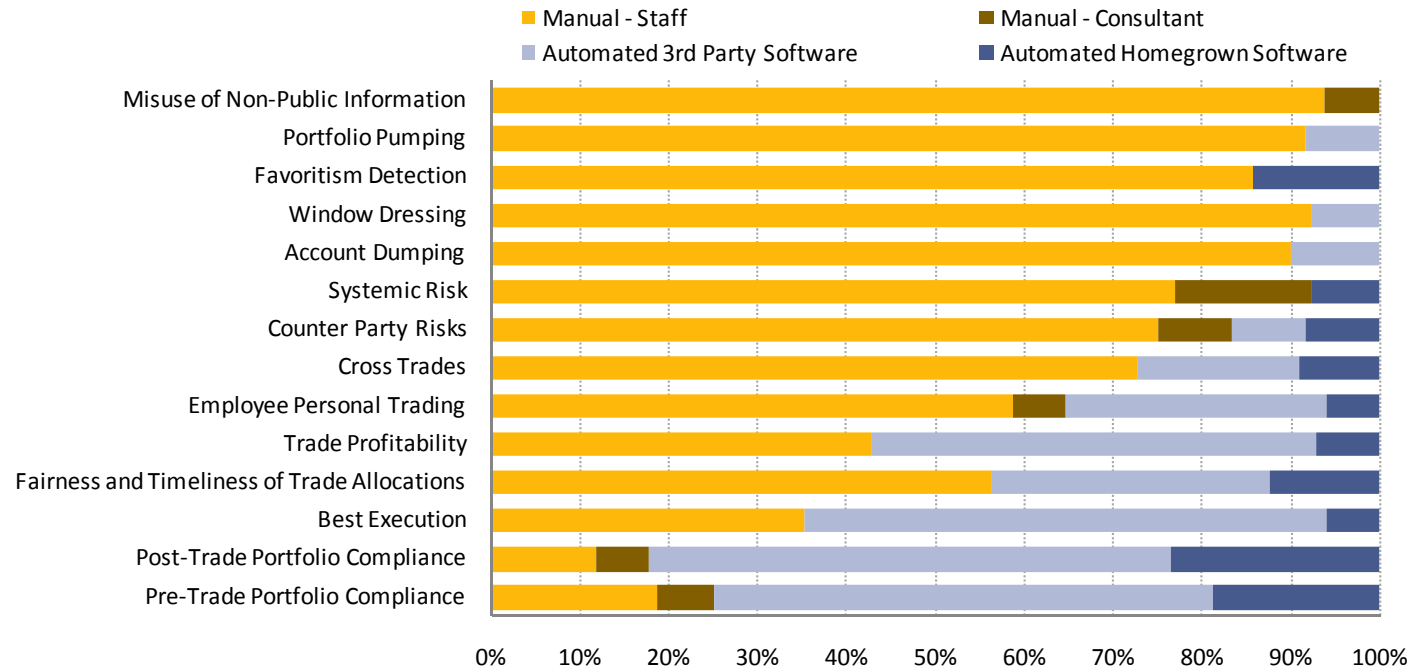
## Planned compliance spending in 2010 compared to 2009

% of respondents



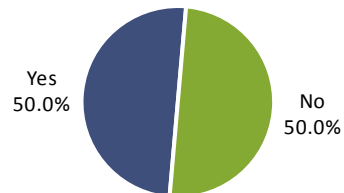
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% of respondents



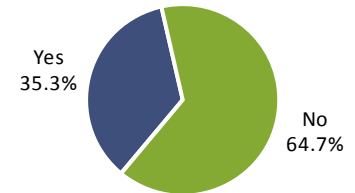
**Do you have a trading relationship with a vendor that provides best execution analysis?**

% of respondents



**Are you considering limiting the BDs with which your employees may hold accounts?**

% of respondents



Items reviewed when conducting vendor due diligence (multiple responses allowed)

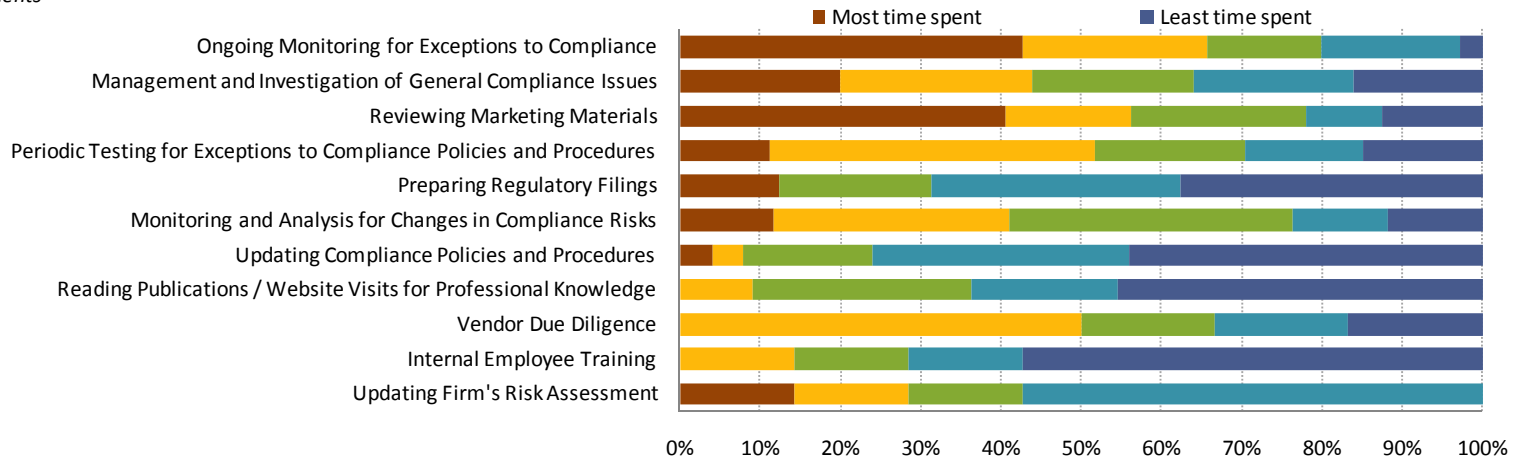
% of respondents



# APPENDIX 3: MID-SIZE (M) FIRM DATA

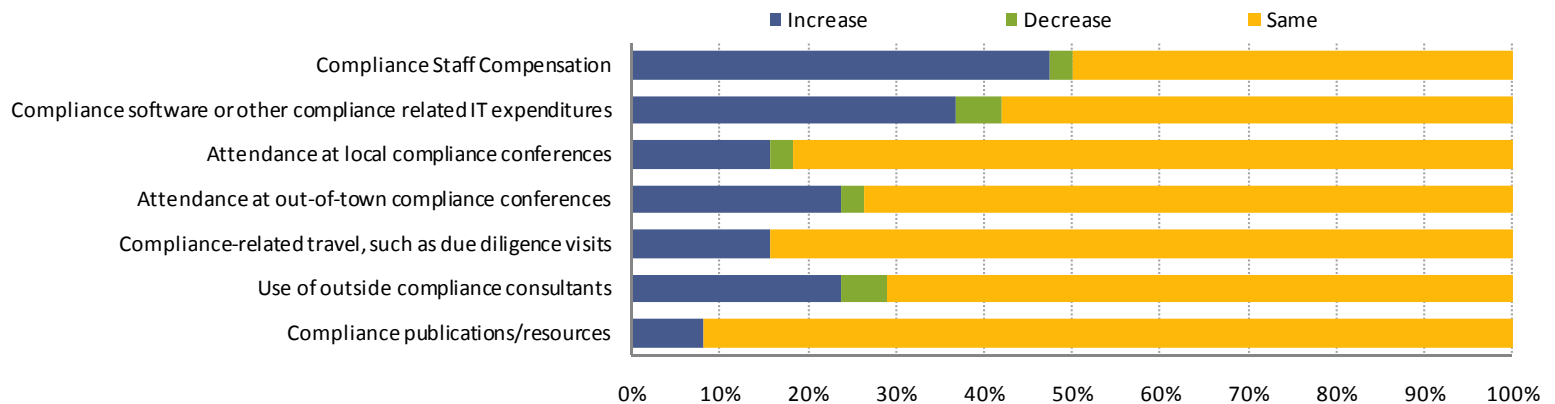
## Time spent on activities by compliance personnel

% of respondents



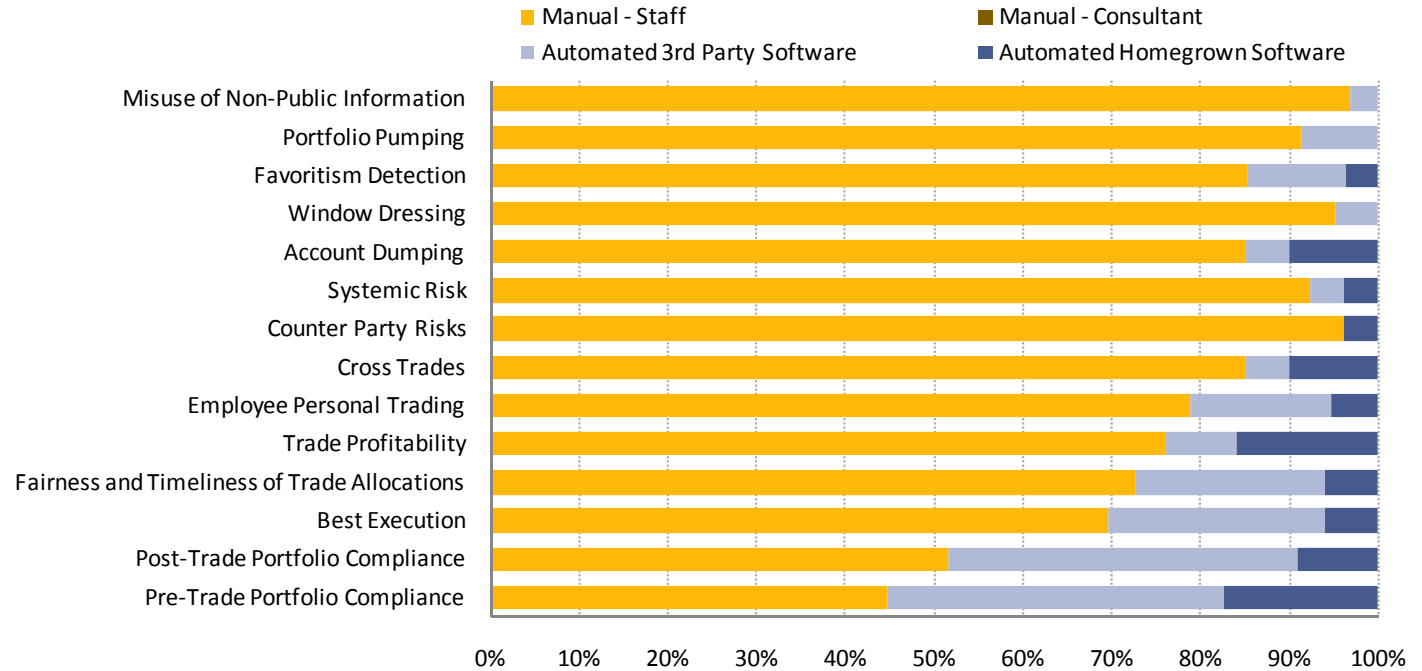
## Planned compliance spending in 2010 compared to 2009

% of respondents



**Are the following compliance testing/monitoring processes manual or automated?**

% of respondents



**Do you have a trading relationship with a vendor that provides best execution analysis?**

% of respondents



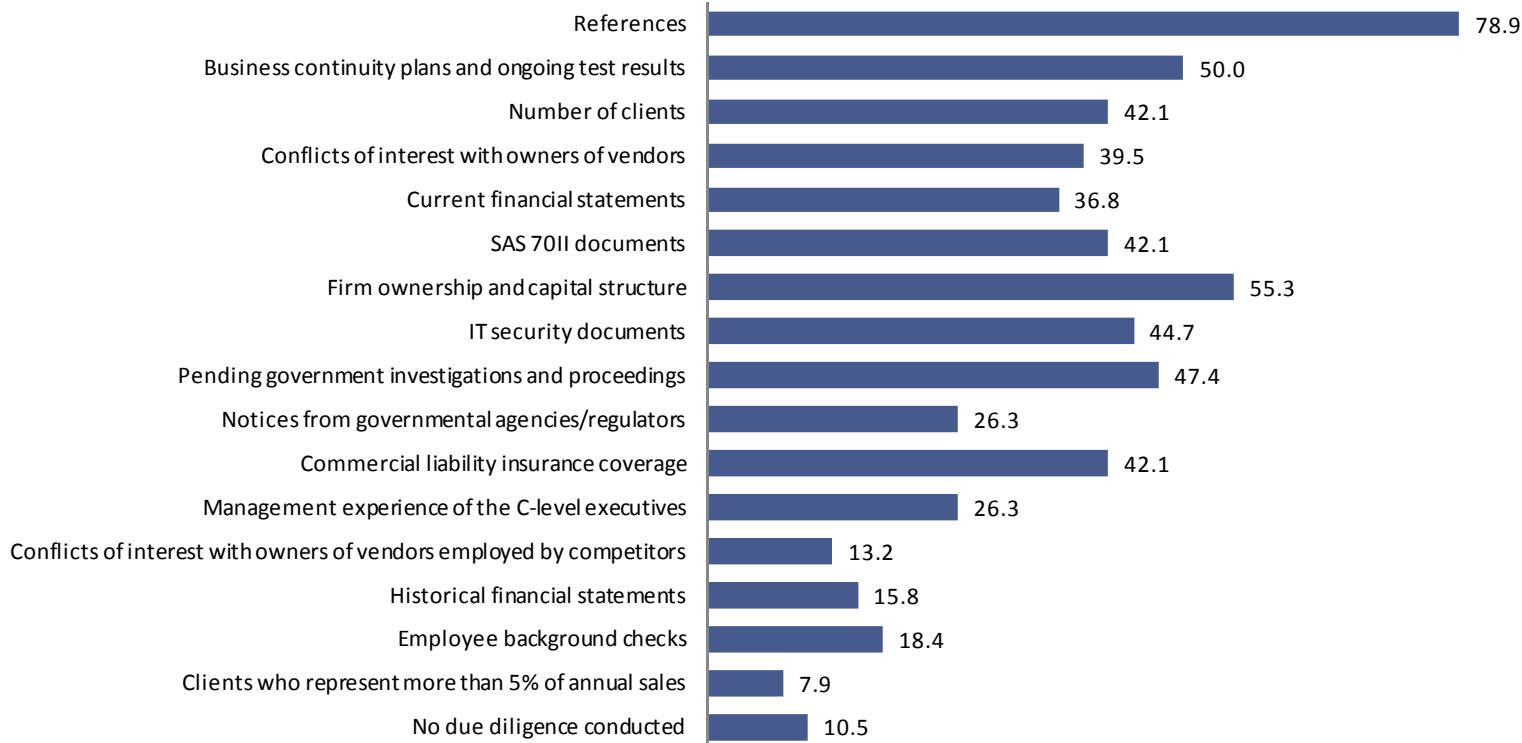
**Are you considering limiting the BDs with which your employees may hold accounts?**

% of respondents



Items reviewed when conducting vendor due diligence (multiple responses allowed)

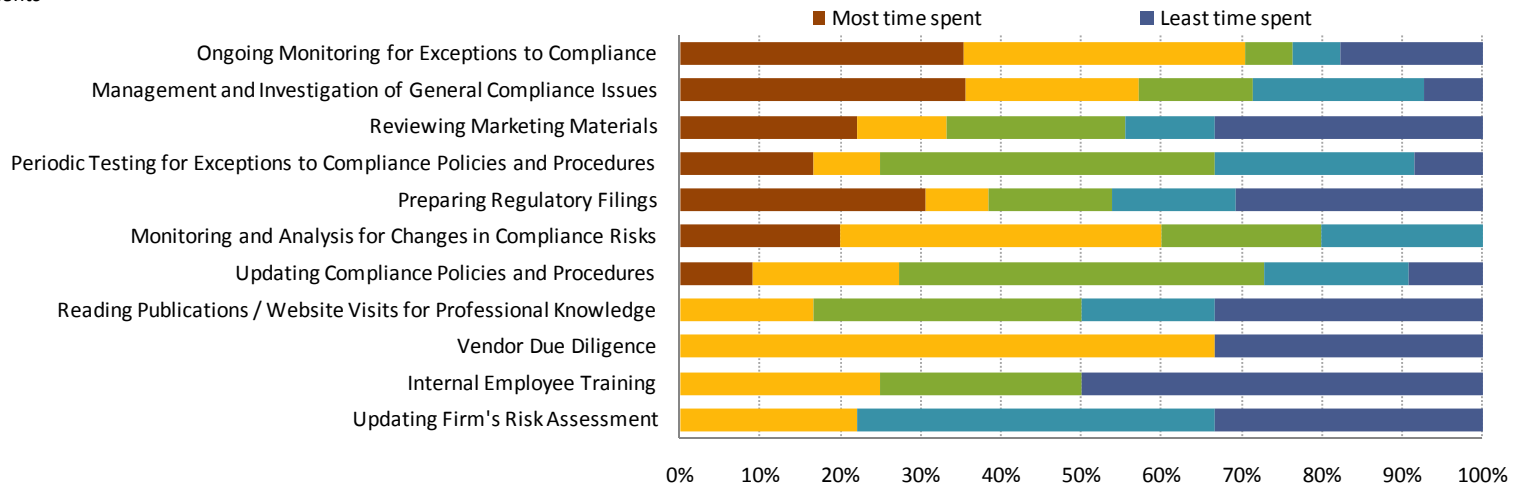
% of respondents



# APPENDIX 4: SMALL (S) FIRM DATA

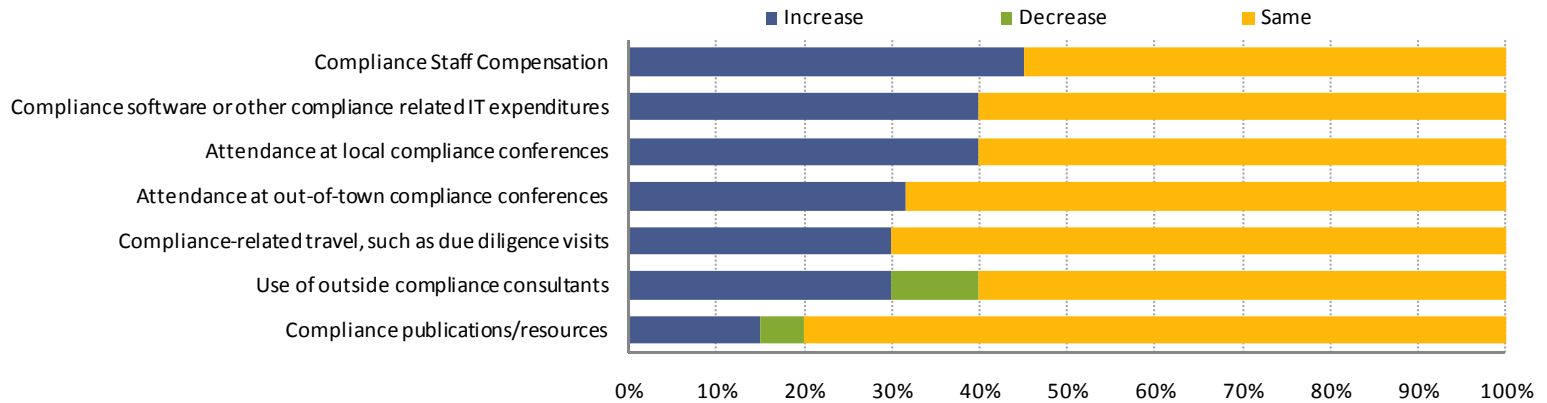
## Time spent on activities by compliance personnel

% of respondents



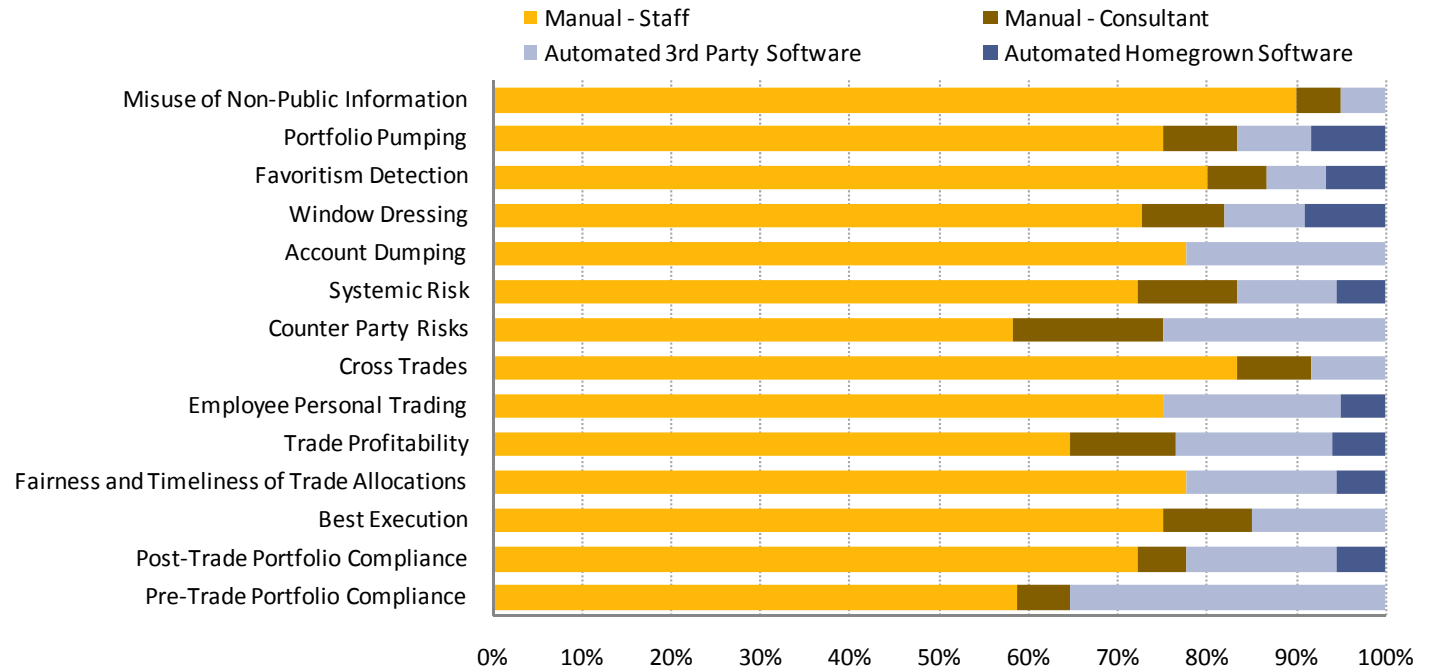
## Planned compliance spending in 2010 compared to 2009

% of respondents



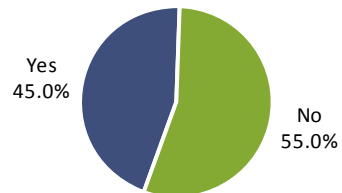
**Are the following compliance testing/monitoring processes manual or automated?**

% of respondents



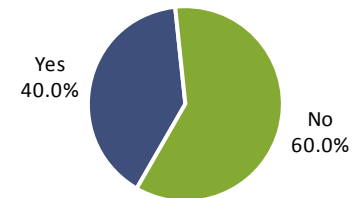
**Do you have a trading relationship with a vendor that provides best execution analysis?**

% of respondents



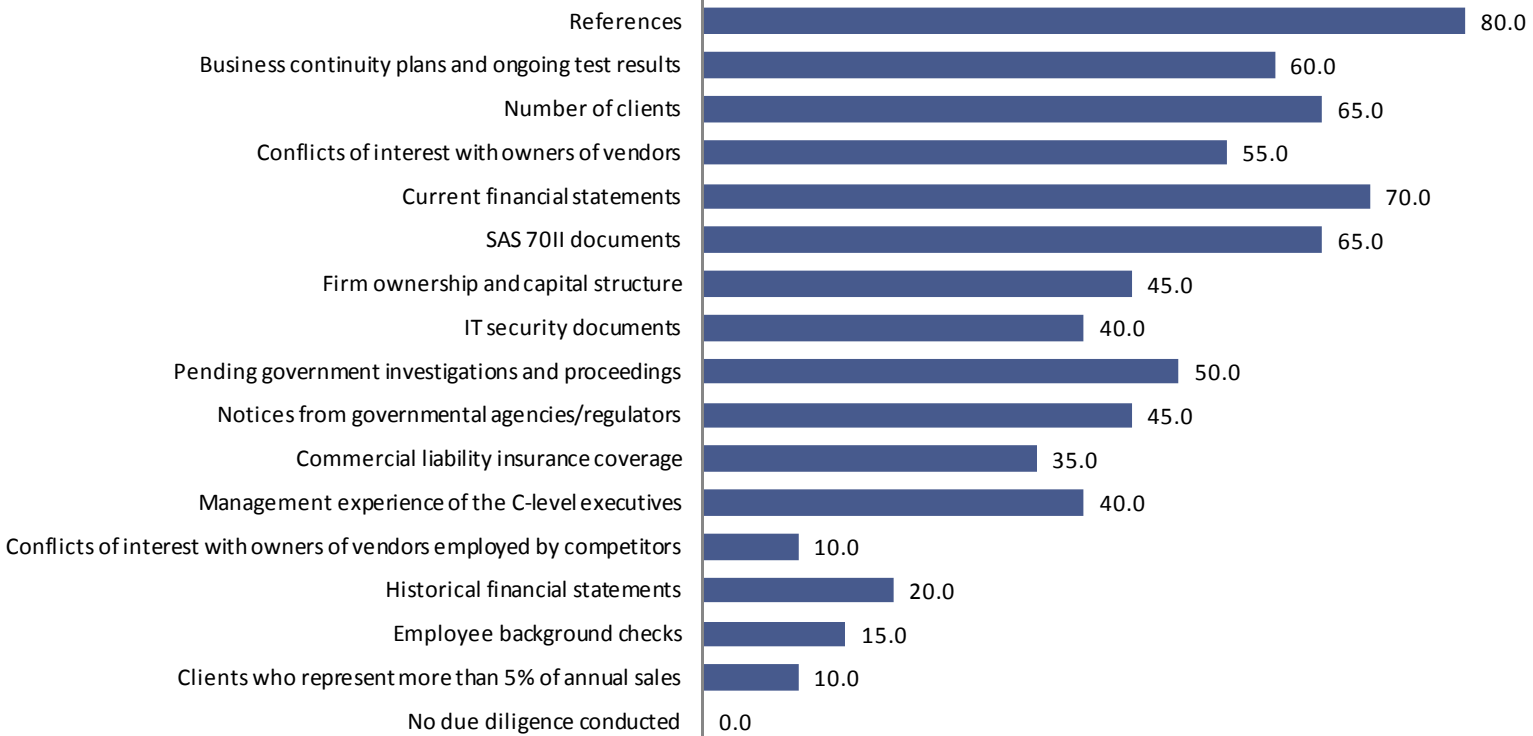
**Are you considering limiting the BDs with which your employees may hold accounts?**

% of respondents



**Items reviewed when conducting vendor due diligence (multiple responses allowed)**

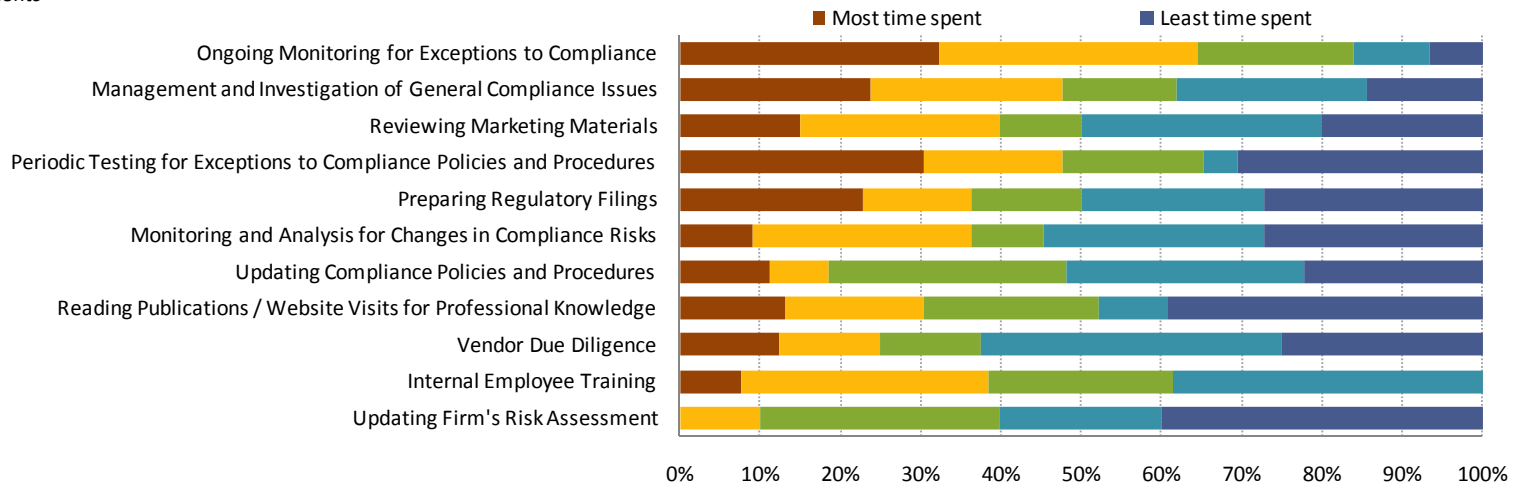
% of respondents



# APPENDIX 5: SMALLEST (XS) FIRM DATA

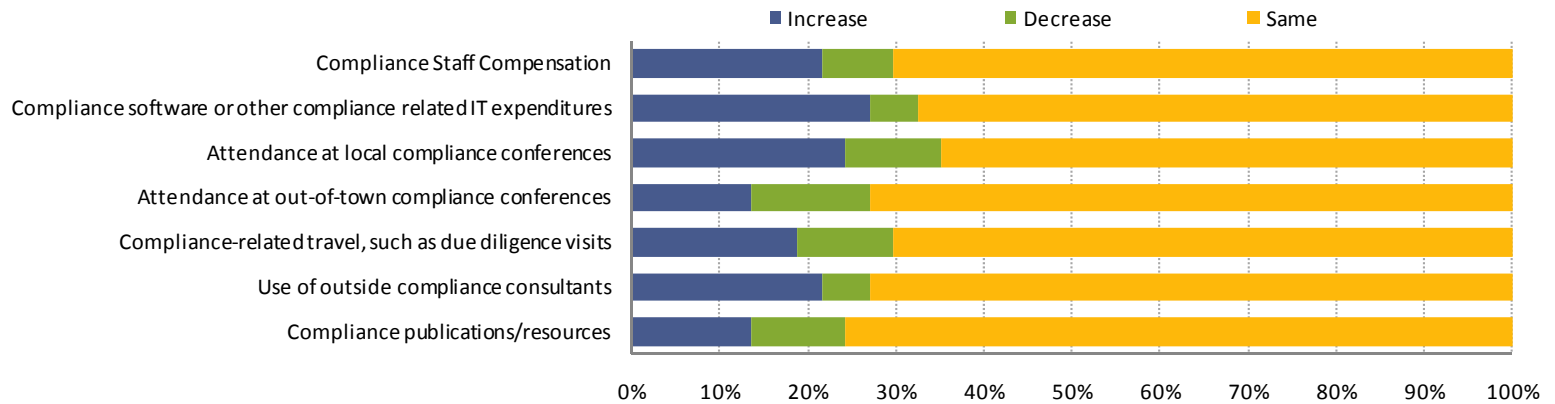
## Time spent on activities by compliance personnel

% of respondents



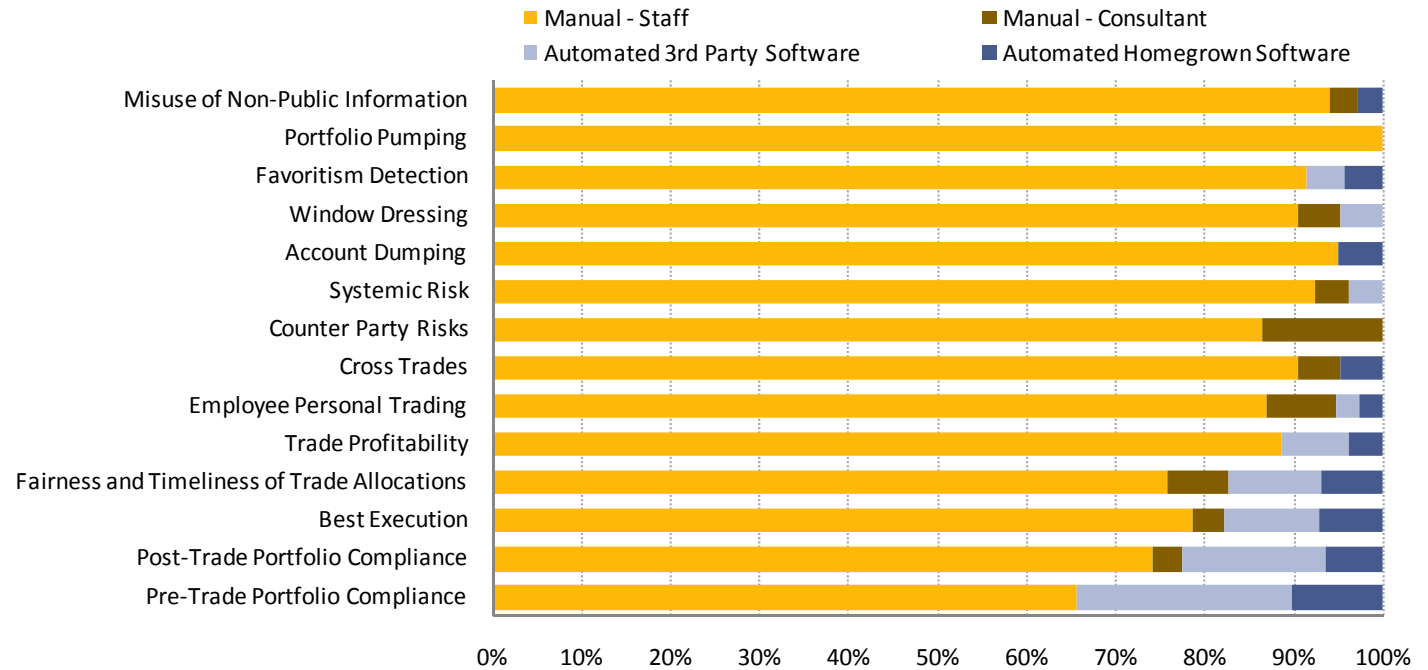
## Planned compliance spending in 2010 compared to 2009

% of respondents



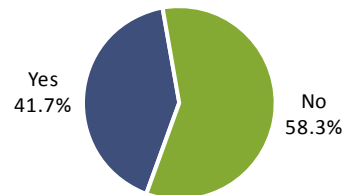
**Are the following compliance testing/monitoring processes manual or automated?**

% of respondents



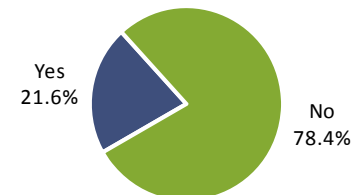
**Do you have a trading relationship with a vendor that provides best execution analysis?**

% of respondents



**Are you considering limiting the BDs with which your employees may hold accounts?**

% of respondents



**Items reviewed when conducting vendor due diligence (multiple responses allowed)**

*% of respondents*

