



*Point of View*  
Financial Services

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Data Management Compliance  
*The Right to Audit*

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# The Perfect Compliance Storm: Rules, Short Cuts, and Margins

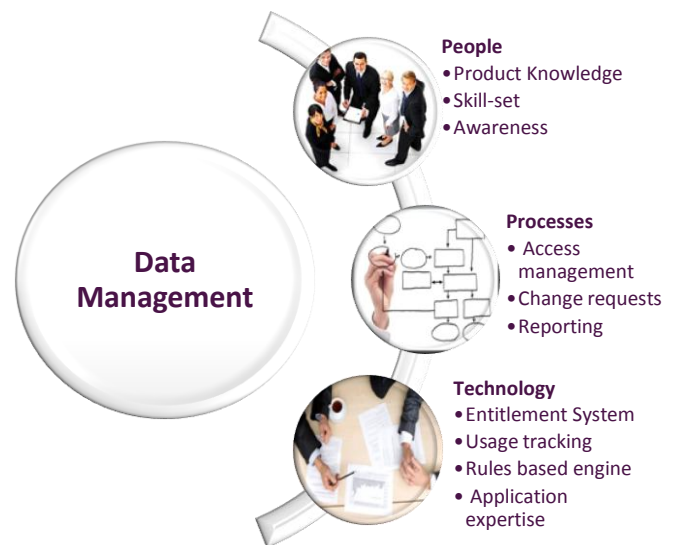
The “right to audit” is a common phrase used in most every Data Vendor or Exchange Agreement (Data Provider Agreements). It is neither new, misunderstood, nor misrepresented. Yet this term has wreaked havoc of late, as it exposes the three modern day plagues causing considerable distress amongst financial services firms - Inconsistent Rules, Technology Short-cuts, and Margin pressures.

Some believe that audits, and the seemingly increased frequency of them, are the problem that is crippling their ability to do business, creating great reputational risk, and causing confusion in the marketplace amongst Investment Firms. Many will go as far as saying that audits are nothing short of a new revenue-generating weapon that Data Providers use to prop up weak product sales. However in looking at the reality of data (both in terms of global access and technology enabling redistribution), ***how audits are being used is less significant than what they expose.***

Whether a consumer firm believes that audits are more frequent or more aggressive is a moot point. If the exposure exists, why wouldn't a Data Provider exploit it? If a firm is prepared to enter into an Agreement to follow the rules, with up to 70 Exchanges globally, than how should non-compliance be treated where controls/reporting are an after-thought? And if as a Data Provider you experienced deteriorating net new sales while your client's knowingly under-report usage, when exactly should a “right-sizing” exercise occur? The point is that the grey area that has

always existed between Investment Firms and Data Providers relating to rules, short-cuts, and margins has become too big. “How big?” in the context of reasonable for the relationship can be debated ad-indefinitum. “How big?” in the context of an audit finding (where gaps and costs are quantified) and Investment Firms are in a very weak position to defend themselves.

Strong governance becomes a critical theme for these firms to minimize their exposure. The people, processes, and technology that touch data within an organization is remarkable. Therefore understanding how they interact, enable, store, and consume data (all elements of the Agreements firms readily sign) is paramount.



The question firms need to be asking is – how are we mitigating the inherent operational and compliance risks of our distributed third party-data enterprise environments where:

- a) Rules are inconsistent across Data Providers;

- b) Technology short-cuts within firms are inevitable; and
- c) Margin maximizing activities (both buyer and seller) are fueling confrontation.

#### **What makes abiding by the rules so difficult?**

- Varied contracts and policies exist
- Contract terms are subject to interpretation (display/ device/usage/ derived)
- User awareness (to T&C's and costs) is problematic
- Reporting and Controls require effective entitlement management, and
- Audit management (operational costs)

### **So many rules, so little time**

The simple fact of the matter is that chasing a global playground of trading and investment opportunities leads to more relationships, across more time zones, having more jurisdictions to understand. Individually, understanding the rules and the requirements are reasonably clear. Collectively, building and managing a system that satisfies the rules for all is dreadful. So it goes that more datafeeds mean more rules to know; more users having different usage requirements of the same data feed mean more complex permissioning systems; And more flexibility expected by people to pay for only what they consume and how they consume it (E.g. real-time, delayed, snapshot) means more sophisticated tracking and reporting capabilities. Worth noting is that the protectionist terms and conditions that everyone accepts in their Agreements have not changed much over the last decade. Again, the change is more with the number of venues they deal with, and the complexity of managing so many while still focusing on individual user needs.

### **Technology Shortcuts**

The rules, their interpretation, and the sheer complexity of managing all the factors to be compliant can be overwhelming. Add to that the pressures of rapidly delivering solutions to business users ("the Agreement was signed two days ago!"), and technology groups will inevitably make one of two mistakes:

- a) Defer development of the necessary controls and reporting component required,
- b) Incorrectly assume the data is "available, therefore I can use it".

These "shortcuts" are a challenge for all firms as they represent where the "innocent" or at least "unintentional" violations regularly occur. In a rush to build and gain the competitive technology advantage, a technology project team is rarely aware of the ramifications that these low-visibility mistakes could have. And it is not uncommon for these issues to go undetected for a lengthy period of time, which regrettably reinforces the misconception that they are providing compliant Data Redistribution solutions.

**Data ownership** - A common misconception amongst firms is that they have purchased the data and associated rights to use and distribute without restriction. Instead of the word "Buy" a better analogy would be "Lease". When a product is leased, the ownership remains with the Data Source. Subscriber can use the product as long as it is paid for and used according to the terms of the contractual agreement.

### **Audit Revenue**

It's ironic but many look at large financial services firms as the victim, unable to defend themselves. "Victim" might be strong, but there is little doubt that Data Providers stand to



gain from exposing the weak controls that persist. Controls that Investment Firms have been reluctant to establish (it's

expensive), and too casual in managing (relying on the "value of the relationship"), are the result of two significant miscalculations: a) that slashing market data costs to preserve their own margins would not be met with some response, and

b) they underestimated how much Vendors knew about under-reported usage. To be clear, we are not arguing that the financial services firms had it coming to them (or that Vendors are completely justified in beefing up their audit staff), we simply think both acted rationally in the context of the current environment. Regrettably, the pendulum has swung too far into a contentious state (audits and legal definitions to guide relationships), forcing firms to take a harder look at their environments and eliminate any "grey" by **getting proper controls in place**.

## Resolving for the Gap

Many firms have made great strides in the last few years to get their house in order.

Unfortunately, it's often *after* they exhausted enormous effort to respond to an unfavourable audit when millions of dollars in rulings are at

stake (remember, audits can be applied retroactively and against the entire firm). So how could Financial Services firms miss this gap, especially in an overbearing regulatory environment? Is it complacency that requires firms to be pushed to that limit before acting? Is it outright disregard for the rules? Market Data Company hypothesizes it's neither, but rather a simple result of not being able to quantify and qualify the operational risk. They do not have the governance and processes to harmonize the **People, Processes, and Technology** that are so integral in measuring their exposure.

In an obscure, and yes unwelcome way, Data Providers are resolving for the gap between the realities of a firm's environment and the Agreements they accepted. Their approach is harsh, but they need to get attention to the scale of the gap (or grey area) which they will all politely point out is "the data client's responsibility to undertake the necessary effort to mitigate breach of their contracts". Debating anything else might get a reduced settlement, but it all comes back to the consumer fulfilling their obligation. No small task, but better to manage it on your own terms than in response to a lengthy, disruptive, and costly corrective exercise that often overshoots the reasonable controls you could have originally made.

An integral governance system is required to understand **who** the consumers are, **what** users require, **how** they access it, and from **where** it is sourced (to tie it all back into contractual commitments for reporting). Absent a credible system, a Data Provider can argue that the reporting is unreliable and controls insufficient – making **all users** on a network **liable**.



## Working with the Market Data Company

Market Data Company works with financial services firms to qualify and quantify the operational risk inherent in a distributed market data system. By studying your current environment against best practices required to sustain strong governance, we help firms realize the benefits of a suitable system of people, processes, and technology relative to their risk. The fundamental aspects of that system include:

### 1. Understanding your contractual commitments

(remember that as a Subscriber you agree to):

- Keep all Exhibits and contracts up to date
- Inform the Supplier of new applications
- Control entitlement and usage of data by an approved system
- Produce accurate current and historical entitlement and usage reports on demand
- Declare accurate entitlements to the Supplier on defined intervals
- Fully co-operate with the Supplier during audits



### 2. Dedicate a team of specialists to perform periodic reviews and action preventative plans

- Pre audit – discovery/ analysis/ recommendation/ implementation
- Frequent mock audit exercise
- Post audit (review/cleanup)
- Supplier audit team – consistent response and analysis



### 3. Engage your Data Provider for clarity

- Dialogue and clarity could clarify or diffuse provocative issues
- Learn about other products/services (often from the same vendor) that could satisfy a compliance issue (e.g. snapshot data)



### 4. Investment in the skill-set and technology required to manage the collective exposure

- Consolidate risk management
- Identify gaps
- Build a system to sustain governance and transparency that envelopes
  - People
  - Processes
  - Technology



***Regardless of the reasons why audits have become so difficult, the onus is on the consumer firm to mitigate the risks of non-compliance for their distribution networks. It is in their best interest to have a firm grasp on how market data transcends the system to not just manage costs, but avoid the reputational risk of a large, unfavourable audit review. The “grey” exists. It’s a matter of understanding how big it is, and how relevant is it to the Data Provider with whom your relationship will be challenged.***

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