

Knowing Your Clients Too Well?

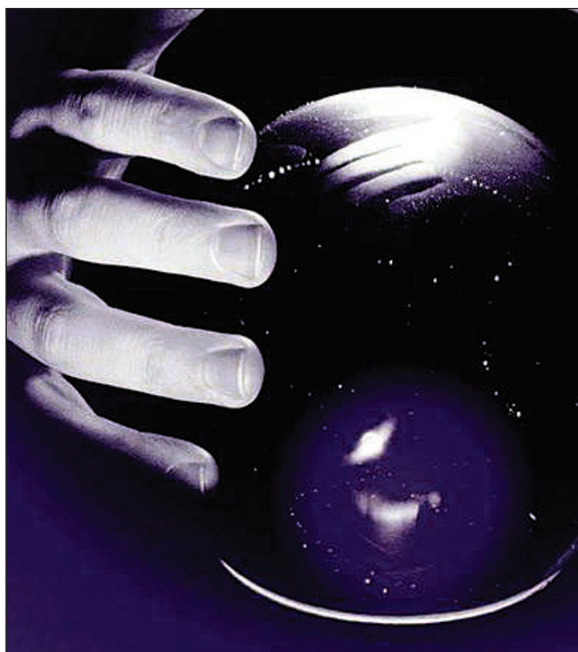
The latest service offerings combined with marketing technology may give brokers an opportunity to anticipate a customer's next trade. **By ROBERT STOWSKY**

As trading margins get thinner, brokers are looking to generate revenue by providing institutional clients with new services that include portfolio valuation, risk assessment and what-if analysis of potential trades. Like the platforms provided by Bloomberg, Reuters and Thomson among others, these brokerage solutions give investment managers access to state-of-the-art technology, while minimizing the cost of added staff and infrastructure.

Unlike those platforms, however, brokers also have an interest in being able to predict market activity, as well as sell other investment products to their clients. Add to this the pressure on brokers to provide their clients with timely trade offerings, or indications of interest (IOIs), and questions should begin to arise about how services are managed and how client information is protected within the brokerage firm.

Portfolio valuation and risk services, usually provided through a Web portal, require the investment manager to enter information that, under most circumstances, is the most guarded data of all: the actual holdings of the portfolio. What-if analysis combines the information on what is currently held in a portfolio with what the manager is thinking of buying or selling. All of this information is placed in the broker's computer system while the requested results are being calculated.

It becomes easy to see the potential conflicts of interest, depending on how long the data is stored on the broker's system and who has access to it. For example, portfolio managers don't want their broker's proprietary trading desk knowing that the portfolio managers are considering buying, or selling, 100,000 shares of IBM. It is doubtful that the same portfolio managers who use these services would be inclined to fax or phone the very same information to a living person, who happily enters it into a Web browser.



Up-Selling, Cross-Selling and Front-Running

Most online consumers have had the experience of visiting Amazon.com and being given a list of items that have been determined, based on previous purchases, to be of interest. Known commonly as database marketing, consumers are presented with what are considered up-sell or cross-sell opportunities from the vendor's perspective. In the case of an up-sell, the consumer is presented with an opportunity to purchase something with more features—that is also more expensive—than an item he or she already owns, or is thinking of owning. In cross-selling, consumers are presented with an opportunity to purchase an item that either complements something they own, or an item that the vendor thinks will interest them, based on their previous purchases.

The same technology behind this type of targeted marketing, which is also responsible for a number of the coupons and special offers received by mail, can just as easily be applied to the investment industry. If brokers know their clients' portfolio makeup or risk profile, they can offer custom-tailored risk management products with an assortment of features available at various premiums. Brokers are also beginning to look at this technology to examine their clients' trading patterns, in order to provide them with better quality IOIs. Along with quality of execution, a num-

ber of investment managers score their brokers on the quality of IOIs, or how many broker-initiated offerings result in an executed trade. As these scores are used to negotiate commissions, brokers are eager to increase their ability to accurately target these offerings to their clients. For investment managers, this creates the dilemma of not wanting their brokers to know what they're going to trade, while at the same time expecting their broker to provide them with timely trading opportunities.

From a regulatory perspective, a different dilemma is presented by a broker's ability to predict a client's future trade. The practice of front-running, that is, brokers holding their customers' orders, until completing orders for their own accounts, for the purpose of taking advantage of the market's reaction to the customers' orders, is clearly prohibited by law. Regulators may find themselves wrestling with whether it is still front-running if brokers trade on their own accounts in anticipation of an order that they have predicted will be received from a client, based on the client's previous trading patterns.

Isolating Sales from Trading

Such questions may raise the need for brokers to figure out how they can create an institutional sales organization with the controls in place to keep customer information from reaching the trading desk. This would be a much more complicated task than the separation of research and investment banking business units that the brokerage industry recently was called upon to do.

One possible approach is the one Morgan Stanley has adopted for providing independent market indices through its Morgan Stanley Capital International (MSCI) business unit, of which it is a majority shareholder. The MSCI indices are among the most popular benchmarks that institutions use to measure portfolios against. Together with minority shareholder Capital Group Companies Inc., Morgan Stanley has been able to keep the internal information within MSCI well out of reach of its other businesses. If this were not the case, Morgan Stanley would have an unfair advantage in possibly knowing ahead of public announcement when a change in an MSCI index is made. Such index changes usually result in investment managers rebalancing their portfolio holdings to track the changes in the index. Having prior knowledge of what securities their clients are going to buy and sell to rebalance would be, by all accounts, an improper use of this information.

Recently, MSCI announced its intention to purchase Barra, a provider of portfolio and risk management solutions to the investment industry. Barra's Web-based product BarraOne gives investment managers the ability to model, construct and monitor their portfolios on Barra's

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computers, using a Web browser. It is not hard to see the day when Barra customers are offered the option of having Morgan Stanley propose custom strategies for hedging their portfolio risk as an added service. Such services would need to be isolated from the trading desk until the decision is made to execute a strategy on the customer's behalf.

As for creating IOIs based on a client's trading patterns, a completely automated approach may be needed. Such an automated IOI system would need to store both the client information and rules for how IOIs are targeted to specific managers. The broker's trading desk would not have access to this information, but would have the ability to enter available offerings, which the automated IOI system would route to an investment manager. Should investment managers decide to trade on an offering, they would do so electronically, with the broker's IOI system routing the trade to the appropriate desk. Such a system would help prevent clients' information from getting into the wrong hands.

Technology and Governance

Today's investment industry finds itself under fire for improper governance of its business practices. Technology presents a number of opportunities for brokers to provide services to their institutions that will improve the management of portfolios and risk. Before these technologies are implemented, brokers need to examine their organizations and make the changes necessary to avoid any opportunity for impropriety. Just as technology can accelerate, or amplify, good organizational practices, it can also do the same for poorly planned business processes. ●

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