

ISSA European Funds Roundtable

20 April 2005 at JPMorgan, London

10:00 a.m. - 4:00 p.m.

Participants

- Neil Henderson, JPMorgan Investor Services (& ISSA Board), Roundtable Chair
- Mark Austin, JPMorgan Investor Services
- Campbell Fleming, JPMorgan Fleming Asset Management
- Josef Landolt, UBS (& ISSA Board)
- Urs Stähli, UBS (& ISSA Board)
- Peter Gnepf, UBS (& ISSA Secretariat)
- Heinz Fischer, Credit Suisse
- Stephen Lomas, Deutsche Bank (& ISSA Board)
- John Gubert, HSBC Securities Services (& ISSA Board)
- David Ewings, HSBC Securities Services (& ISITC)
- David Broadway, Investment Management Association
- Jervis Smith, Citibank
- Robert Binney, Citibank
- Frédéric Perard, BNP Paribas Securities Services
- Gary Janaway, Schroders Investment Management

Joining for the afternoon session:

- Simon Cleary, SWIFT
- Max Wright, EMX Company Ltd
- Tony Wood, EMX Company Ltd
- Pierre Slechten, Euroclear/FundSettle
- Bruno Zutterling, Clearstream/Vestima

1. Background and Chairman's Introduction

ISSA and its members were concerned about the slow progress on both the regulatory, distribution, and operational aspects of pan European funds and this was first discussed at the 11th ISSA Symposium in 2002. Progress on the topics was reported at the following Symposium in 2004. The ISSA members requested that ISSA offer its services to promote more rapid progress. It was observed that cross-border funds investments had seen a sharp rise in popularity over the last years, and that this trend would continue. However, it was noted that, as transaction volumes rise, so do the processing risks, the exceptions, the inefficiencies. The compliance burden on custodians related to fund subscriptions has reached a level that becomes unbearable. This is perhaps less so for European funds, but most certainly applies to offshore and non-standardised fund products. There was a strong call on ISSA during last year's symposium to help bringing funds processing more in line with established settlement standards, as we have them in the secondary market for equities.

The London roundtable is an outgrowth of this with respect to the operational aspects. ISSA is prepared to offer a co-ordinating role if that makes sense. Today's meeting will assess status, the speed of change and the next steps and in this context should recommend that ISSA either leave the field to others or play a more active co-ordinating role.

Today's meeting focuses on "plain vanilla" fund products. Complex categories such as hedge funds, offshore and exotic fund products pose additional challenges which need to be looked at separately.

2. Presentation UK Initiatives / Focus Groups

To kick off the discussion, David Broadway gave an overview on current initiatives in the UK funds market, and how IMA (Investment Management Association) plays a crucial role in coordinating the various groups and work streams, both on a national and European level. The slides used are contained in the Appendix.

3. Morning Discussion (vendors not present)

The discussion focussed on three aspects: 1) Current funds landscape in Europe; 2) the need for standardisation and for a communication standard; 3) the need for a common processing platform. Key observations in each area:

3.1 Current funds landscape in Europe

Business models differ widely by market, some examples were given:

- In Germany, Switzerland, the Netherlands and Denmark, fund units are bearer securities. Generally, trades settle in the same way as equities. Processing is efficient, DVP is in place.
- France: DVP settlement at Euroclear France in place, trailer fees processed outside of the CSD. AFG (Association Française de Gestion Financière) and AFTI (Association Française des Professionnels des Titres) are active in streamlining funds processing.
- Portugal: Market dominated by banks' inhouse fund products. STP exists in that respect, but there is hardly any activity in third party funds.
- Italy: Generally fragmented market, rather inefficient processing.
- Luxembourg: Market "manageable" due to a relatively small number of local distributors (about 65). ALFI (Association Luxembourgeoise des Fonds d'Investissement) is currently developing a generic messaging system for all involved parties; many national specifications however need to be accommodated. The push in Luxembourg is to use SWIFT standards wherever possible.
- UK: Very fragmented market, more than 2,000 distributors. Large banks act as "mini clearing houses". CrestCo has no active role as a CSD for funds. IMA has done a good job in liaising between all stakeholder and industry working groups in the UK market (see Appendix).

Main observations: Markets still tend to be domestic. There is neither a pan-European market place for funds, nor a "best" business model. Markets where an open funds architecture prevails, have less efficient processing flows than others. The same applies to cross-border trades as opposed to trades confined to a domestic environment. The Swiss banks seem to have considerably more cross-border volumes than most others, hence they are more faced with cross-border processing inefficiencies.

There is a need for closer interaction between the different parties along the value chain. Improved communication is in the interest of the ultimate investor. Example: Fund managers should make information available to securities data vendors/and or custodians on whether a fund is "in scope" or "out of scope" for purposes of the EU savings tax. If the tax status on a

fund is unknown, custodians will be unable to give optimal tax treatment to clients holding that fund.

3.2 Need for standardisation and for a common communication standard

- An industry wide communication standard is needed. However, the industry would be well advised to question the validity of a business model, before it is "cemented" with new standards. Do we need new communication standards, or should we rather switch to a better business model? - Given today's fragmented, heavily domestically oriented market, the rapid adoption of a single "best" business model for Europe is not a likely prospect.
- Today's UK fund environment is not efficient, but many players profit from its inefficiencies. Ideally, not the business model itself should be up for competition, but rather the way it is serviced. More generally, today's market infrastructures are influenced by vested interests. Every stakeholder is part of the problem; he could however also be part of the solution.
- The cost of building, owning and maintaining multiple links to infrastructure operators such as Vestima, FundSettle, SWIFT is high and is constantly rising.
- One "ecosystem" within which the custodians, the correspondent banks, the transfer agents and the distributors agreed on a common communication standard, would be a vast improvement. However, it is difficult to get a critical mass of early adopters. If a group of significant market players endorsed a certain standard, others would follow quickly and the cost of switching to the leading standard would be less of an issue.
- Continental Europe is supportive of ISO 20022 for funds transactions. Coexistence of ISO 15022 and ISO 20022 will be unavoidable and is acceptable, as long as the functionalities serviced are different. The funds industry should be able to conduct all business in ISO 20022 format, even though custodians would have to support both ISO standards.
- In the UK, EMX is the dominant standard, interoperability with ISO 20022 will not materialise any time soon.

3.3. Need for a common processing platform

- There is a trend (in the UK) towards concentrators who provide one-stop shopping.
- The question was raised whether SWIFT could open up to IFAs (Independent Financial Advisers) and to Fund Supermarkets so as to streamline at least communication across all stakeholders. The IFA's, however, are not interested in maintaining client accounts, as the associated regulatory burden would be heavy.
- The suggestion was made and supported by the French, Swiss and German roundtable participants, that Clearstream Luxembourg, in analogy to Clearstream Frankfurt's role as a CSD for German funds, could become a CSD for all or most Luxembourg-domiciled funds. That way, DVP settlement would be ensured. In addition, CSDs could also take care of funds transfers, and of transactions/position reporting to the transfer agents for the purpose of enabling trailer fee calculations.
- There was, however, a clear preference to not endorse any specific business model but to leave a range of options to evolve. Market forces would gravitate towards the most efficient set-up over time.

4. Infrastructure Operators' Presentations

For full details, refer to the various slide presentations which were handed out in the conference folder (electronic copies are available through the ISSA Secretariat). Some key points only are given below:

SWIFT

- SWIFTNet Funds is available since October 2004.
- The SWIFT product is designed for a "many to many" environment, i.e. it is not tied to any specific business model or processing platform.
- EFAMA (formerly FEFSI) recommends ISO 20022 as the single communication standard for domestic and cross-border funds business.
- In Germany, France, UK and Singapore, work is in progress to develop a national market practice for ISO 20022 fund standards.
- More than 80 market players intend to implement SWIFTNet Funds in 2005.

Euroclear/FundSettle

- Funds business is no longer just retail, institutional investors participate more and more.
- UCITS III will lead to significantly more cross-border investment in Europe.
- Open (or at least "guided") architecture and Funds Supermarkets become widespread.
- All stakeholders are under increasing cost pressure, margins keep shrinking.
- Fund units cannot easily be processed like bonds and equities, because
 - the issuer (promoter) is involved in every transaction
 - securities are not always fungible, they come with rights attached which are linked to specific distribution agreements (applies mostly to "exotic" funds).
- These differences require specific functionality, such as
 - full reporting of all movements between distributor/custodian and fund/TA
 - trade date accounting
 - more complex account structures (lot accounting)
 - adequate treatment of decimals (fractional shares).

While the "typical" CSD/ICSD can not handle all functions along the processing chain (out of scope: order collection and aggregation on the distributor side; investor record keeping and trailer fee calculations on the issuer side), it could offer significant efficiencies to its users by handling order routing, cash and securities settlement, asset servicing and CSD record keeping and reporting, using some of the same infrastructure that is used to process bonds and equities, and by offering a central service that accommodates the particularities of fund units.

Clearstream/Vestima

- A single and liquid pan-European funds market will not materialise for many years. Europe will remain a "multi-domestic" landscape, thus requiring a "multi-domestic" solution.
- Need open solutions accessible to all, plus an automated hub delivering STP to the key participants.
- Use existing domestic infrastructures where they are suitable and efficient.
- Try to align funds processes as closely as possible to those used for other financial instruments.

- Split the value chain into three distinct segments: Order processing, trade settlement, custody; and develop solutions around those clusters.
- Offer a tool (Vestima+) that links existing infrastructure components and participants whether or not they are Clearstream members, and whether or not they want to settle their trades and safekeep their investments in Clearstream or elsewhere.

EMX (Electronic Message Exchange)

The EMX order processing system is the de facto communication standard in the UK market where it has attracted a large funds provider and IFA community. EMX provides functionality for electronic dealing, settlement initiation, reconciliation of holdings, and an automatic audit trail. It has proven successful beyond the UK as well. The system is based on secure internet connections, accessible via standard browser. As it is "lighter", it is better suited to the business needs of small market participants than SWIFT is. The standard is robust, linked parties never had to cope with system upgrades. It is however not compatible with SWIFT standards and interoperability is not planned.

5. Afternoon Discussion (vendors involved)

Some key statements from the discussion following the infrastructure presentations:

- "Everyone seems to be in favour of business harmonisation, provided the target model is one's own."
- How could the cross-border market be made more efficient? Different legal systems in Europe prevent streamlined operating models. There is not one single market model today that could be extended to the entire EU. An analysis could look at each market and determine features that are easy, difficult, respectively impossible to change, and seek room for improvement on that basis.
- Custodians suffer most from inefficient processes. Their clients (i.e. the fund managers) decide where to invest. Custodians should do more to educate the fund managers by making transparent to them what the execution of an investment decision actually entails.
- It is important that the industry arrives at its own solutions. Solutions imposed by regulators - once they perceive the market as inefficient or risk-prone - are not desirable.
- It is necessary to bring more buy-side partners and the transfer agents to the table. The latter category was not present at all.

6. Conclusions and Next Steps

6.1 Roundtable Conclusions

- Discussion was limited to "plain vanilla" funds. Hedge funds and exotic funds were deliberately not covered. It is necessary to address them as well.
- Market models differ by country, there is neither a truly pan-European funds market place, nor an agreed-on European business model yet.
- There is the need for communication standards. SWIFT offers a solution (ISO 20022) which, however, only a few major market participants have implemented to date (among them, from among the roundtable participants, BNP Paribas Securities Services). The UK market is dominated by an alternative standard (EMX) which is implemented but not compatible with SWIFT.

- There is the need for a common processing platform but there is no single best solution and it will be difficult to shift processing volumes to one platform only.
- The leadership role in Europe is with EFAMA. ISSA is considered a viable partner to facilitate and drive progress, due to the fact that its membership mirrors the whole processing chain. ISSA should intensify contacts to the specialist groups in the funds industry.
- Additional experts are needed to tackle specific questions in a targeted manner.

6.2 Conclusions for ISSA

- ISSA should reach out to other relevant industry bodies (EFAMA, ISITC, IMA...) and continue the dialogue.
- ISSA should seek ways to add value to existing initiatives, rather than create a competing forum.
- ISSA to consider an official endorsement of ISO 20022 for funds transactions.
- The categories of hedge funds and complex/exotic funds must be covered as well.
- A small ISSA working group should look at open issues, set priorities and draft a road map for the next 12 months. First concrete achievements must be available by the 13th ISSA Symposium i.e. June 2006. [In the April 22 ISSA Regional Meeting in Budapest, where a summary of this workshop was presented, Omgeo and dwp Bank asked to be included in an ISSA working group.]

Special thanks to Neil Henderson and JPMorgan for having hosted and chaired the meeting.

Peter Gnepf
ISSA Secretariat

Mark Austin
JPMorgan Investor Services

13 May 2005

For more information on ISSA, visit www.issanet.org or contact Peter Gnepf at the ISSA Secretariat in Zurich, Tel +41 44 235 74 21, peter.gnepf@ubs.com or issa@issanet.org

Appendix: Presentation on UK initiatives

UK initiatives/focus groups

IMA - Investment Fund Operations Committee

Composition: Operational heads of fund managers, TPAs and fund platforms, plus infrastructure providers.

Objectives: Advise IMA on strategy/priorities regarding fund operations; including development of standards, consultation, lobbying and liaison activities.

Priorities:

- (i) Order/settlement/reconciliations
- (ii) Client reporting (valuation statements)
- (iii) Transfer and re-registration
- (iv) Commission processing
- (v) Income etc.

Progress: Keen to endorse/promote FPSG recommendations subject to consultation with IMA members. Agreed that single messaging standard desirable in ideal world, but seeking wider industry input on real-world barriers.

Slide 1



UK initiatives/focus groups

ISITC - Investment Funds Working Group

Composition: Custodians; investment operations; fund operations; fund platforms; infrastructure; vendors; consultants; SWIFT Standards.

Objectives: Create viable business model to achieve high rate of STP in funds market - initially for UK, but capable of providing basis for future development across Europe.

Priorities:

- (i) Order/confirmation
- (ii) Settlement
- (iii) Reconciliations
- (iv) Commission processing
- (v) Transfer and re-registration
- (iv) Entitlements (income, corporate actions etc.)

Progress: White paper on order and confirmation published November. Agreed to consider adopting FPSG position on settlement and to work side-by-side on reconciliations and commissions.

Slide 2



UK initiatives/focus groups

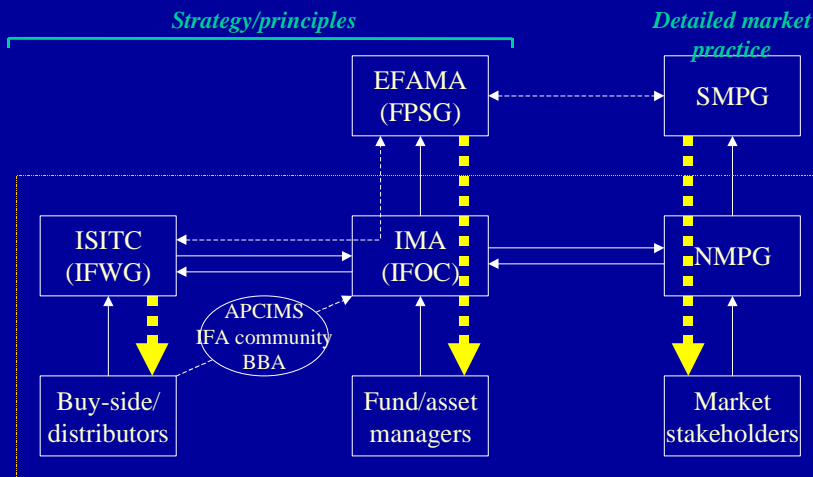
[SWIFT] - ISO 2002 UK Funds Working Group

- Composition:** Currently - fund providers/TPAs, fund platforms.
- Objectives:** Originally - validate existing SWIFTNet Funds messages against UK model.
- Progress:** Completed work on order/confirmation, cash flow reporting price reporting and messages.
Moving on to consider requirements for transfers and re-registration.
- Future:** Proposal to reform as UK NMPG for funds under SMPG umbrella.

Slide 3



UK initiatives and links



Slide 4

