
ISSA has done substantial work in the mutual funds and the OTC derivatives area – in the latter for the first time. How high are those topics on your personal problem agendas? Are they the right issues, given the core competence of ISSA? And are they also at the top of your list, or rather somewhere down in the "miscellaneous" category?

Markus Ruetimann: The OTC derivatives work stream clearly is our number one priority. The amount of inquiries we are receiving from regulators, fund distributors and investors on asset pricing or the valuation verification process, have increased manifold.

Therefore, it is not only a defensive approach of Schrodgers to participate in this very valuable ISSA work. It is also an offensive way of protecting the industry from inappropriate interpretation of how these processes work, or perhaps do not work. There is a lot of confusion and there was a lot of learning, even among the working group members and the sponsors themselves. Achieving a common terminology and achieving consensus on what is of key importance and what is not, was crucial and is very high up on our priority list.

As far as we are concerned, we participated in this effort not only for the sake of the valuation process. It was also groundwork for the decision process for Schrodgers on where we are going to spend money in our IT architecture. We identified seven components in the lifecycle of an OTC derivative – this is just our internal interpretation. All seven elements have a huge amount of manual intervention, and all seven are supported by a different system solution. Therefore scalability and all the goals we talked about yesterday are simply not achievable yet. In reality we do not have interoperability yet in these processes but we must get there.

The areas examined in the Fund Working Group are also high on our priority list. Schrodgers works with more than 9,000 fund distributors all over the world. The data management element, be that for distribution agreements, for the transfer of holdings, for retrocession management etc. is absolutely horrendous. Therefore, for systems and commercial considerations, it is a very high priority.

Where is the industry with regard to the EFAMA Fund Processing Passport?

Edouard-François de Lencquesaing (EFL): The Fund Processing Passport (FPP) is a collection of some 100 data elements describing a fund. The EFAMA approach was to rely on national market initiatives to put pressure on the fund managers or fund promoters to compile the FPPs for their fund range. That is the first task and we have some 2,000 FPPs available right now.

The second step is to create a concentrator at national level to collect those FPPs. Different markets have found different solutions. Some markets have more than one collector (for instance Luxembourg with KNEIP and CCLux). There are also collectors covering more than one market (for instance the UK and Denmark are both covered by FundConnect). In France, they are building an Internet-based portal, where distributors can access all fund managers to obtain their fund passports. So there will be different solutions for making the FPPs accessible. The theory was to have one collector per market, but reality works differently.

The third step is to distribute the FPPs globally. This requires an industrial-strength process. A common language is a key element. SWIFT can play a major role here, in providing an ISO standard message for the FPP. That is however not enough. We also need an agreed market practice for the full FPP

maintenance cycle. We need to have more discussion in the industry about the process and to define a sound business case to deliver the service. Cost certainly is an issue. Who pays for the FPP cost? However, the FPP process will not only impose additional cost on the industry. Hopefully it will make costly and inefficient old ways of collecting fund data redundant and thus reduce the total cost in the end. Cost considerations are the reason why we want to re-use existing infrastructure in a more efficient way.

Where does the US have solutions? In both areas, funds and OTC derivatives, the US are ahead of Europe. That does not mean that all US solutions work in Europe, but we should know what is there and look into it. What can the working group exponents learn from other parts of the world?

Janet Wynn: In the OTC derivatives area, a number of industry initiatives are in motion at this moment. ISSA would be welcomed in contributing to them. It is commonly misunderstood that the so-called "FED Initiative" is dealer-driven. On March 27, 2008, a group of trade associations submitted a public letter to the Federal Reserve Bank of New York, confirming their commitment to streamlining the processing of credit and equity derivatives. The associations are ISDA (global), the Managed Funds Association (US hedge funds, buy-side), SIFMA's Asset Management Group (US based asset managers), and the Asset Managers Forum (US operations experts). That group has an OTC derivatives best practice initiative with several working groups underway. The ISSA recommendation would be very much welcomed by that group because it addresses an area they have not focused on to date. Their current focus is on trade confirmations and collateral. Generally, there has been an active educational effort underway in the US, driven by both the dealers and the buy side firms.

The Operations Management Group, a very senior group of OTC derivative operations professionals from the sell side and the buy side, has sought repeatedly for representation from the asset manager community in Europe. They have struggled to find a trade association to speak up. That might be an opportunity for ISSA.

ISDA is currently reviewing improvement initiatives in the OTC derivatives confirmation and novation space. There are also discussions on industry interoperability platforms and vendor solutions.

Where does the ISSA work on OTC derivative price verification stand in comparison with rest of the world?

Jon Lloyd: Asia is entirely untapped as far as our group's work is concerned. We looked at the US regulations and found them less prescriptive than the UCITS regulations in Europe. I assume that what we have done is pretty unique.

With regard to funds, what is the world's view on the "many-to-many versus hub" issue?

Tim Connelly: The biggest difference between the US and the European fund market environment may be the distribution fees, the lack of transparency in Europe about them, and the difficulty that creates for firms in Europe to move towards a centralized and cost efficient operational platform.

In the US, the shareholder servicing fee is 25 basis points for all funds and everyone can get it. In Europe, everything is individually negotiated. That creates a tangled web of market participants' behavior, driven by many factors and criteria, which bogs down the whole system. It seems to me that ISSA would be well served to make some declarative statement that we would want more transparency or harmonization with regard to trailer fees.

The trailer fee management issue is extraordinarily difficult if it is different per distributor you are working with, and even per investor and per fund family. I suspect that most funds would applaud this in a sense that they could be assured that nobody else would offer 90 basis points if there was an agreed industry rule of giving 50 basis points and everyone played by the rules.

Right now the conversation in Europe with intermediaries or banks is "We would love to outsource and lower our cost, but what sort of trailer fee arrangements do you have, and how does it work with you?"

So my suggestion is: not trying to get this issue standardized by means of an ISSA recommendation on trailer fees will make most other efficiency improvement initiatives quite elusive.

Would ISSA be listened to if we made a declaration on trailer fees, given that we are most likely attacking the excessive profitability of a large part of the European funds business?

Tim Connelly: I am not sure that in any of our conversations today, ISSA will be able to control the outcome. But you can start to contribute to a dialogue that hopefully will be picked up by other parties.

EFL: There is a cultural issue to this. If we had raised this point ten years ago, nobody would have listened. Today, because of all the cost and risk involved in the funds arena, all the different components of this industry are now aware of each others' problems. This is already a big achievement. Now they are starting to listen to collective contributions calling for convergence. It is the right time for ISSA to accompany this movement. EFAMA already has a working group dedicated to streamlining the trailer fee issues. In France, the local fund market association created a document on distribution fee conventions, which contains ten pages of recommendations. ISSA can help achieving convergence, mainly by comparing different markets' experiences and leveraging know-how. Doing comparative analysis of gaps and deriving conclusions will help.

If we look at fund order routing and "many-to-many versus hub" solutions: What is the preference of the people in this room? We have a cross section of the market here today!

Frederic Hannequart: Automation and scope are the two big issues for the industry. In the area of funds, we should be quite humble in expecting the infrastructures to solve the problem. I will come back on this point.

Scope means that we need more funds to be processed inside the infrastructure solutions, be it one or the other. There the FPP can help, because there will be more information on more funds easily available and that will facilitate the process. Here we have the unresolved question of liability, the responsibility for the funds data base. Who owns that data base, and what happens if there are errors, losses and claims as a result?

On automation: It is important to automate and all infrastructures are pursuing this as it will make processing cheaper and less prone to error. But the degree of automation in the infrastructures will depend to a big extent on the degree of automation of the market participants. If a fund promoter insists on working with the fax, well there goes the automation...

So, the infrastructures are right to work on automation and scope, but that will only address a part of the industry-wide problem. We heard yesterday about the new trends and challenges that come from the pension funds or the newly emerging wealthy investors in Asia. I wonder how fund order routing compares as a priority with those challenges. Priorities are defined by the market, not by the infrastructures. Looking at the big picture, other issues seem to be more pressing, for instance on the fund accounting and fund valuation side. The infrastructure should continue on the road it is traveling, but we should keep things in perspective and acknowledge that there are other priorities competing against ours.

What is the role of the data vendors in the funds processing area?

Jean Sonnevile: Two comments. First a general remark on the "scope" which Frederic Hannequart just mentioned. SWIFT makes it now easier for potential users to become accessible. SWIFT Alliance Lite is a new solution targeted at the "fax users" such as the smaller fund distributors in Asia which Dean Chisholm also mentioned yesterday.

But now on funds and the FPP: SWIFT was involved from the start with the EFAMA working group that developed the FPP. So we now have the format for those data. That was the first step. We are now transforming the format into an ISO 20022 message. That is the second step and it should be completed in the third or fourth quarter of this year. Thirdly, we need an agreed market practice for the FPP

maintenance cycle. It is not enough to have a form in a standard format that you can send over the SWIFT network – or a different network. You need an end-to-end market practice. We started a working group together with EFAMA and, as Edouard mentioned, ISSA could have a role in it. It should be fairly easy to come to a result as this is a new business. There are no vested interests that hinder the process. A couple of meetings should be sufficient, so the third quarter of this year could be a realistic target.

Coming back to a remark made earlier today: Few fund managers are already aware of the FPP, or it is not at the top of their priority list. When we talk to the international fund managers we hear the same. They heard about the FPP, but when asked about their planning to produce FPPs for their full range of funds, most of them mention the first or second quarter of next year. It is not a top priority. So you should realistically expect mid-2009 to have most FPPs available "somewhere".

And in that context, we are thinking about the ultimate solution for the FPP which Edouard also mentioned. The ultimate solution is one single central European fund database. In the interim, we will have a virtual one. We are currently talking to the industry to find out if it would make sense for SWIFT to have the FPPs centrally stored, similar to the BIC database we maintain. The advantage to the fund managers and the distributors would be that they only have to go to one place to either deposit or access the FPPs for the whole world. And most importantly, at some point in time, you can integrate the fund buying and selling messages with the fund processing data you have in the FPPs. If you put them together at the source, your order could be checked automatically against crucial FPP data such as the order cut-off time. This would yield substantial efficiency gains and add more value than just having the FPP database as such.

50 million trades times the savings from 50 Euro to 12 Euro would be a substantial savings to the industry and a significant contribution to increase a fund's performance. What precisely has to be done to achieve it? What is the exact deliverable to achieve that?

EFL: It is indeed important to define precisely what has to be done. The first condition is to make sure that we have all fund data which we need for processing, and that we make those data accessible in an efficient way to all parties who need them. That is the FPP and the ISO standards issue.

A second condition is to immobilize - if not dematerialize - all funds registered for distribution in Europe and bring them into the same paperless, automated processing logic that we have for the conventional securities business. We need to move away from fax processing. This should be possible; it has been done in several markets, at least domestically. That will reduce cost very significantly. As far as the hub costs are concerned, in the Euroclear France proposal, the hub cost is indicated at approximately 1 Euro for the hub function.

More importantly, for each step in the processing chain – account opening, settlement, registration, custody, etc. – we need to define a best practice in the same way as has been done in the securities market. For each step we should define short, 1-2 page terms of reference. That should serve as guidance for IT to expedite process automation. And it should allow the function to be processed in an automated way, irrespective of the order route. Whether we send the order to a transfer agent, to a domestic market hub or to a pan European hub should not matter from a process automation point of view. All of this has to be based on ISO standards and common market practice. That should be feasible if we agree that we have the same problems and the same priorities on our tables.

Tom Abraham: Fund order placement and processing in the UK is very much paperbased. The cost indication of EUR 40-50 seems very low. There is a huge reliance on faxes, exception processing and clerical follow-up. The same is true for transfers from one custodian to another.

EFL: Convergence is hard to achieve in the fund world. That is why we need shortcuts. Shortcuts are our existing infrastructures, SWIFT, a common language based on ISO standards, and last but not least our IT vendors' involvement. We heard yesterday that the industry should rely more on using components produced or operated by external parties. If more market participants turn to using external components that will facilitate operational convergence over time. The IT vendors then become part of the convergence team: If more of their clients ask for the same thing, then convergence is happening!

Pierre Yves Goemans: A remark on many-to-many versus hub models: The issue is not so much the operational model, but the lack of STP. Once we have implemented standards and automation, then the spaghetti network is less of a problem, at least technology-wise. In the end, irrespective of the operational model, we will just have a flow of a transaction from the investor to the fund and then back from the fund to the investor. IT-wise, the processing model does not matter much. Cost savings will materialize once we can link the different functions, i.e. order routing, settlement and asset servicing. The current cost is coming from the lack of STP and integration between those three functions, and that is where the hubs we are building are helpful. Account transfers and commission payment streams still remain an issue, but the main obstacle is the need for manual intervention from order routing to asset servicing.

JP Marson: This last point gives me the opportunity to link to a point raised yesterday, about liability. The linking of the different stakeholders in the funds business raises many questions concerning liability. The vertically integrated or STP model does not make those issues go away.

The same is true if we are discussing tax models or OTC derivative valuation. We need to be careful that in whatever model we build, we are conscious of where the borders of liability are. In our industry, the asset servicing provider always acts as an agent, not as a principal. We should always remember that. For instance, in the area of valuation, we have a long standing battle between the asset manager and the asset servicer. The asset manager makes the decision to buy a certain instrument, so he should be liable for the correctness of the valuation. There should be no case to shift this duty to the asset servicer and make him responsible for finding a reliable source for valuation.

The same thing applies to the G30/ISSA tax model. If we are in an intermediary chain, we need to be aware of what position we hold in the liability process. This is a tax legal issue, but it can also be extended to pure legal issues. In the discussion about The Hague Securities Convention there is also the question of what party in the intermediary chain carries what degree of liability. Same with collateral management: Where do you have the right to take some assets as collateral, being sure that the assets are legally within reach at the point in time you actually may need to reach them?

There is a whole set of liability issues in whatever process we are looking at. Please consider that in all your thought processes when you recommend models to improve efficiency. Who will be liable for what always has to be clearly defined upfront!

Taking this point up, how do the models you propose change the liability structures in your processes?

Patricia Brown: This is one of the issues where governments and business still have not come to a common view. Governments are aware that they cannot impose liability on the intermediaries. But they worry about this and they are reluctant to acknowledge it. But we have to get there, because the system will not work without it.

It is easy to maintain liability if you are getting a certificate of residence. You can look at it, and if you are satisfied that it is correct, pass it up. It is much more difficult if you have to rely on somebody down lower in the chain to exercise judgment. So, in practice, you have to relieve intermediaries at the top of the chain from having to assume liability for processes that they cannot control because somebody else performed them at the bottom of the chain. That is easy to decide intellectually, but government officials swallow hard before they can accept that.

Jon Lloyd: We need to attack the issue at two levels: One is the valuation level; the other is the operational process. Custodians cannot be liable for the valuation itself, but they are responsible for the process of getting valuation from various sources to be used for the Net Asset Value calculation. We are not creating a precedent in the OTC derivatives world in terms of changing the liability for the valuation. But we are creating an additional operational process. Custodians are paid for doing that and they should accept liability for operating their processes efficiently. That is consistent with everything else a custodian does.

By being proactive, we are definitely minimizing the regulatory risk or exposure. We interpret our understanding of the regulations and we propose – based on our understanding – the best way to meet

the requirements.

Reputational risk: Our clients are using OTC derivatives in their funds. If the proverbial widow or orphan invests in that fund, and the OTC derivative does not behave in the expected way and causes the fund to lose a lot of value, there is nothing a custodian can do about it.

EFL: In the fund world, liability may change when the scale of risk changes. If we take the Fund Processing Passport: Before we had the FPP, all fund managers were able to provide by phone or fax all the data that are now contained in the FPP in a structured format. Those data simply had the status of commercial information. If there was a problem, the counterparties had a commercial way to solve it, because the fund managers controlled a limited number of distributors. Now, when you disseminate FPPs all over the world and the fund managers are faced with large volumes of open architecture trades, they get frightened of the magnitude of the risk. So the risk changes from a commercial risk to a legal risk and now you have new questions on the table. Two different attitudes now emerge: some use the liability issues as a pretext to hold up progress, some try to find a positive way out and match liability with each step in the processing chain.

We have to be pragmatic. We need to progress step by step and we should not try to fully answer every imaginable question before taking the first step, because progress will never happen this way. We should find creative solutions along the way.

Another example is in the area of the transfer agency business: TAs can be a major risk for global custodians. In theory, a global custodian could refuse to do business with a particular TA if they are not comfortable with that firm. In practice, this is not an option because the custodian's client needs the order processed and there is no alternative TA to the one appointed by the fund. The risk is the same a global custodian has with any subcustodian. But in the conventional securities world, there is usually choice among subcustodians and voluminous Service Level Agreements are negotiated to describe and mitigate those risks. You do not have that in the TA environment.

The fund processing hubs could help here by performing a robust due diligence process on each TA on behalf of all hub users, award a quality label to those TAs that meet certain criteria, and share that information with the hub users. That is another way to minimize risk and increase efficiency in the industry.

The next ISSA Symposium will take place in 2010: In your respective initiatives, which three tangible steps should be achieved by then?

Chris Gilbert: First, high level best practice recommendations, by the end of 2008. Second, adding detail to certain areas, such as the format of the investor self-declaration, the reporting, authorization and compliance process, by the end of 2009. Third, we should be able to start the implementation and monitoring process by 2010.

Question from the floor: What is the enforcement mechanism that makes you think you can reach those ambitious targets?

Patricia Brown: To get people to agree on something, you need leverage. We now have a confluence of events: In Europe we have the implicit – some countries would say explicit – threat of enforcement action from the EU Commission against processes they think discriminate against foreign intermediaries. We are getting attention from European countries we might not have gotten five or six years ago.

Then, because of cross-border merger activity, you suddenly have large groups of investors in one country finding themselves holding shares of a company in a different country and the withholding tax processes do not work efficiently. For instance, after Banco Santander acquired Abbey National, the UK tax authorities had to provide 1.5 million certificates of residence with respect to that merger. That is not sustainable, and the tax authorities on both ends know it. This is the beginning of convergence and this opens opportunities to influence and expedite the process.

EFL: First, the FPP issue is part of the past in 2010: FPPs for 40,000 funds are up and running and they found their distribution channel. Maybe a SWIFT-like depository controls their distribution through perhaps four or five secondary providers in Europe; with a bridge in place to DTCC to access the US equivalent to the FPP.

Second, we have terms of reference and common practices for each fund processing function. That will help us to remove paper from the order processing cycle and automate it to the extent possible. In particular, we have common account identifiers on fund or transfer agent level to identify the distributor and thus facilitate the commission payment function.

Third, two or three domestic fund hubs are up and running, possibly in the UK, France and Germany; besides the two existing hubs that already provide pan-European coverage.

Jon Lloyd: The clear target is to make OTC derivatives as easy to manage as conventional assets such as equities and fixed income instruments. DTCC is doing a lot to move into that direction. If the DTCC trade information warehouse becomes a de facto CSD for OTC instruments, that would be a material shift in the efficiency we can establish in this part of the value chain. Three things need to be improved:

- Same day trade confirmation needs to be a target. This is work in progress.
- Buy side settlement, through a mechanism like CLS, done through DTCC.
- Automated reconciliation of positions, cash flows and corporate events.

As soon as these are done, we will have a seismic shift in the industry as regards cost and efficiency in the OTC space.

Closing comment by John Gubert

If you think of those agendas and if you think back – if you belong to those ISSA members like me who attended many ISSA symposia – to the agendas we had in the past, it is striking how different they are now. This shows, as we also heard yesterday, how complex our industry has become.

We have had three working groups who have been looking into very specialized areas. Each is a tough challenge. But this is very mission-critical work and I would like to thank them for doing it. It takes an incredible amount of work to just define what the problem is, and then being able – in a sensible way across the value chain – to work towards a solution that is acceptable to all interest groups. We no longer have either/or solutions. We have to move towards consensus because sectarian solutions will not work. We are moving more and more into environments where there are different interest groups. Some are in this room today, others are not. Our experts have achieved to bring together this whole value chain input. And they demonstrated a willingness to concede in some areas to come to consensual (not lowest common denominator!) solutions. Our speakers and their working groups are to be congratulated on having achieved that.