



WORLDWIDE SECURITIES SERVICES

OTC Derivatives - Custodian/Fund Administrator View

ISSA

2<sup>nd</sup> July 2007

JPMorgan

### Executive Summary

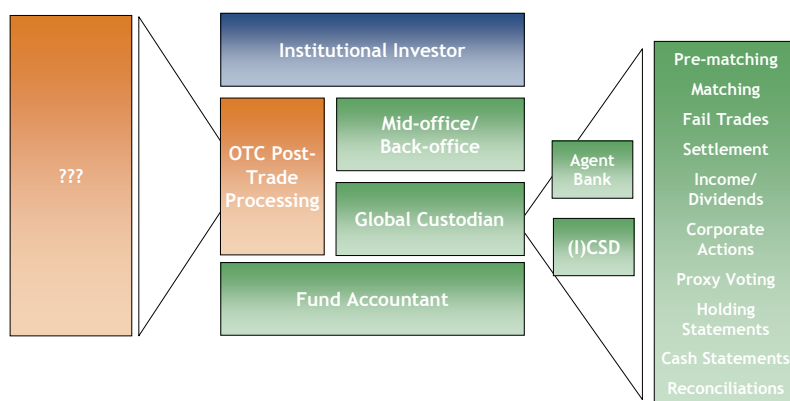
- There remains a considerable amount of debate as to what is deemed “reasonable” when valuing OTC derivatives
- Furthermore there are no clear winners in terms of best practices for the on-going “verification” of these valuations
- In Luxembourg and Dublin, consultation efforts are underway to establish clearer industry guidelines and the results should be published this year
- In the UK, there is no known consultation effort underway and with principles based regulation the responsibility will fall more and more on industry groups
- There is an obvious need for industry groups to help establish a position that can be broadly adopted by all key stakeholders
- In the meantime, the hidden costs of processing OTC derivatives are starting to emerge which have been estimated at “fifty times” the cost of conventional assets

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**Key Challenges - OTC Derivatives**

- “Processing derivatives is just like processing bonds or equities”
- “There is one correct value for a specific OTC derivative”
- “My Custodian will take care of my derivative processing needs”
- “My Fund Accountant will source independent valuations for my OTC derivatives”
- “I don’t need to worry about interfacing to derivative industry utilities”

**Key Challenges – How to manage the position post-trade?**



The efficient division of the post-trade value chain remains ‘work in progress’

### Key Challenges - Operational Issues

- Industry-wide issues:
  - Need to establish 'best practice' especially in the area of verification
  - Infrastructure needed to make this a scalable/controlled process
  - Reliance on counterparty prices where pricing models are unavailable
- Clients:
  - Scalability over the entire lifecycle including collateral management
  - Transaction data quality and consistency across instrument types:
    - All economic trade details required are available on trade date
    - Trade amendments and lifecycle events also need automation
    - Reliance on standard defaults which are subject to change
    - Maintenance of the prime record
  - Consistency of pricing across all funds for allocated trades
  - End-to-end pricing issues - front/mid/back-office and Fund Administrator
  - Attribution of costs - who pays for which aspect of the service?

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### Key Challenges - Operational Issues

- Custodian/Fund Administrator:
  - Support for multiple inbound/outbound communication methods
  - Maintaining pace with new instrument developments
  - Access to consensus data and analytical capabilities
  - Lack of scalable, industrial strength processes:
    - Complexity of managing long-form confirmations
    - Access to data for event/lifecycle management
    - Lack of standard Client-Custodian reconciliation procedures
    - Resolution of realised cash settlement breaks
  - Ability to attract and retain OTC derivatives specialists
  - Need for increased transparency of internal control procedures

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### Key Challenges - Some of the solutions

- Consultation exercises underway will help to raise the debate:
  - AIMA and IOSCO
  - Dublin regulator
- Infrastructure developments:
  - Swapswire
  - DTCC DerivSERV
  - Potential ICSD developments
- For valuations, focus should be on consistency versus the search for absolute truth (which may not exist), so solutions should be:
  - Practical
  - Scalable
  - Mitigate the key risks
  - Represent market standards or emerging 'best practice'
  - Clear about what the price actually represents

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### Appendices

- Appendix 1 - IOSCO principles for the valuation of Hedge Fund portfolios, March 2007
- Appendix 2 - Commission Directive 2007/16/EC - 19th March 2007

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### IOSCO principles for the valuation of Hedge Fund portfolios

- Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund
- The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund
- The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures
- The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness
- The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed

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### IOSCO principles for the valuation of Hedge Fund portfolios (cont)

- The policies should seek to ensure that an appropriate level of independent review is undertaken of the individual values that are generated by the policies and procedures and in particular of any valuation that is influenced by the Manager
- A hedge fund's policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an Independent Party
- The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services
- The arrangements in place for the valuation of the hedge fund's investments portfolio should be transparent to investors

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### Commission Directive 2007/16/EC - 19<sup>th</sup> March 2007

“The reference to reliable and verifiable valuation shall be understood as a reference to a valuation, by the UCITS, corresponding to the fair value..., which does not rely only on market quotations by the counterparty and which fulfils the following criteria:

- The basis for the valuation is either a reliable up-to-date market value of the instrument or, if such a value is not available, a pricing model using an adequate recognised methodology;
- Verification of the valuation is carried out by one of the following:
  - An appropriate third party which is independent from the counterparty of the OTC derivative, at an adequate frequency and in such a way that the UCITS is able to check it;
  - A unit within the UCITS which is independent from the department in charge of managing the assets and which is adequately equipped for such purpose”

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