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Australia and New Zealand Banking Group Limited ABN 11 005 357 522 Item No. 53590 07.2005 W74147
Let the changes begin...

This edition of Investor Services Journal is published amidst of a host of regulatory directives, which have focussed the attention of our industry. Only days ago, for example, the member states of the European Union enacted a savings directive for financial services providers. The European Union Savings Directive will have a long term impact on investors and securities services providers.

The EUSD places an onus on the paying agent, or custodian bank, of the investing entity to disclose information on all of the investors within a fund to the regulator, or pay a withholding tax. However, an investing entity who is also the paying agent does not want regulatory reporting to detract from the primary role of generating returns for clients. The potential to outsource this function to a third party custodian or administrator suddenly makes more sense than it did several years ago.

While regulation places securities service providers in the driving seat, the requirement for these businesses to have state-of-the-art data management systems in place has intensified. Putting this requirement into perspective, when Europe’s Market and Financial Instruments Directive (MiFID) is tabled at the end of this year, banks and broker dealers will be able to bypass the stock exchanges by transacting directly with each other via their own system internalisers. While this may sound good in theory, the reality is quite different...

According to MiFID, banks and broker dealers have to keep record of every client or end investor behind a transaction, the origins of the security traded and the location and details of the issuer of the security. This static data, which should be readily available to the EU regulator, is considered the most basic form of data, which should be “scrubbed” and “polished” to satisfy regulatory conditions and to ensure the longevity of financial markets.

Apart from MiFID, Basel 2 places a similar onus on banks and broker dealers to meet certain operational efficiency and capital adequacy targets to minimise the likelihood of counterparty default. Basel 2 requirements will separate those who have sufficient capital to cope and those who do not. Those who do not will have two choices: exit the market or consolidate.

While MiFID and Basel 2 will test the staying power of financial institutions, let us not forget the standards recommended by the Committee of European Securities Regulators and the European System of Central Banks. In effect, these standards may recommend that banks and trading parties generate an amount of collateral, which some may fear, could be double the value of the security traded. Trading institutions who do not possess this collateral may be forced to outsource the requirement to a large bank, which has the collateral to support all their trades. Similarly, not all banks have sufficient collateral to support every single trade, which may prompt them to pool their available resources with other banks.

Apart from pending collateral obligations, banks are also entering into partnerships with other banks in order to access foreign markets. The recent custody alliance between RBC and Dexia is an example of the transatlantic partnerships that are no doubt the shape of things to come.

Janet Du Chenne - Editor

ESSAY COMPETITION 2005: Investor Services Journal recently celebrated the winner of the ISJ Essay Competition 2005. From New York, a part time student at NYU Stern - Sara Grillo’s winning essay on Hedge Funds is published in on page 59. Our thanks to Accenture and HSBC and our congratulations to Sara. JDC
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jpmorgan.com/investorservices
Letters to the Editor

Write to
Janet.DuChenne@ISJforum.com

To offshore, or not to offshore?
The primary objective of offshoring is to reduce costs. Whatever is said when talking about quality in the Business Process Outsourcing space, it is still all around cost and it will be for some time to come. What any institution undertaking offshoring is seeking to accomplish, is the same task but with a less expensive labour supply. To answer the question of whether you can do that, you first have to answer a series of other questions. This is not linear: it is just that offshoring is a function which does not automatically guarantee that your costs will be lower. There are calculations that you have to go through. Firstly, what is the nature of the function? Can you find qualified people offshore to undertake it? If you can, then would it be acceptable to the organisation and to the end client to offshore the function? Is it the case that there are qualified people available, but the fit from a cultural or language standpoint isn’t there? This involves a lot of discussion around intangibles and a couple of missed steps could erode the economic advantages very quickly. Additionally, you need to consider the view of the regulators. The regulator in your home market might not want to see the jobs move away and may try to prevent that from happening.

“The regulator in your home market might not want to see the jobs move away and may try to prevent that from happening”

We expect STP rates to reach 90 per cent by year-end 2005 among transfer agents processing transactions on FundSettle. This is a huge leap from only two years ago when STP rates barely reached 50 per cent. Can we then conclude that fund-transaction processing has become highly efficient? Absolutely not there is still a long way to go.

“While the fund distributor leg of each transaction settles with STP rates of 100 per cent, it has taken transfer agents longer to realise these benefits”

STP is not only about order placement and confirmation (or dealing); it also includes cash settlement, reconciliation, corporate-action processing, NAV collection, data integration, and more. This is precisely why we are working actively with numerous industry organisations and working groups to standardise and automate the entire spectrum of back-office processes to offer a truly STP fund-processing environment.

Sébastien Chaker, Director, Investment Fund Product Management, Euroclear

Double-checking
(From Christophe Lentschat)

Propelled by the wave of scandals affecting the industry during recent years and the need to restore investor confidence, compliance and supervision issues have risen to the top of the agenda for most investment managers. This trend has been concurrent with regulatory initiatives at local or at European level, most notably reflected in the content of the UCITs III directive and the way it is being implemented at member state level. Much emphasis has been given to the use of risk management techniques as a tool to be used by management companies for the supervision of investment mandates.

(Continued on page 88)
A passion for results

In our business – as well as in yours – results are everything.

We are especially proud of ABN AMRO Mellon’s lead position in the 2005 R&M Global Custody Survey, in which pension and fund managers ranked us first among global custody providers in Europe.

Results like these best demonstrate our commitment to clients and the industry – and confirm that when you choose ABN AMRO Mellon, you are choosing worldwide expertise second-to-none.

Call us to find out how we can help you achieve the results you want in 2005 and beyond.

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Custody & Outsourcing

Sweden’s SEB merges banking units

Sweden’s SEB Group is merging its Enskilda Securities investment banking subsidiary with SEB Merchant Banking, its investment and commercial banking arm. Under the new arrangement, SEB will pull together all its equity operations into a new unit called SEB Enskilda Equities, which will be headed by Stefan Carlsson, previously deputy chief executive at Enskilda Securities. Bjorn Jansson, currently head of equity research in SEB’s trading and capital markets division, will continue in his existing role in the merged entity. The new equities unit will form part of the bank’s trading and capital markets business, headed by Anders Johnsson.

London - Dexia and Royal Bank of Canada (RBC) have reached an agreement to combine their institutional investor services businesses in an equally owned joint venture to be named RBC Dexia Investor Services (RBC Dexia IS), pending regulatory and other approvals. The new company, with approximately US$1.8 trillion in client assets under custody (representing combined parent AUC), will rank among the world’s top 10 global custodians and will offer a complete range of investor services to institutions around the world. Under the terms of the joint venture agreement, RBC and Dexia, through its wholly owned subsidiary Dexia Banque Internationale à Luxembourg (Dexia BIL), will each own an equal share of the new company, resulting in net tangible equity of EUR500 million. RBC Dexia IS, a holding company that will be headquartered in London, U.K., will provide strategic direction and management oversight to the operating companies (see page 98 for the full story).

Milan - Italian bank UniCredit and Germany’s HVB Group have joined forces to become one of Europe’s banking groups. The combination will be effected through a 5:1 exchange offer to HVB shareholders. The transaction will consist of three voluntary share-for-share offers by UniCredit for HVB, including subsidiaries Bank Austria and BPH, subject to regulatory approval by Italian authorities. The offers for Bank Austria and BPH will also comprise a cash alternative. UniCredit will offer five UniCredit ordinary shares per each HVB share. The transaction will make the combined group a leader in Central and Eastern Europe (CEE), with close to EURO1 bn of estimated annual pre-tax synergies fully realised by 2008, of which over 90 per cent resulting from lower costs and the remaining from increased revenues.

Funds & Administration

London - International Financial Data Services (IFDS), the international transfer agency joint venture between State Street and DST, has completed the consolidation and fund merger programme for the open-ended fund transfer agency activities of F&C Asset Management (F&C). F&C has consolidated its UK open-ended fund range transfer agency servicing with IFDS. The new consolidated business will operate on an outsourced basis with IFDS providing investor and distributor services on behalf of F&C to retail and institutional investors, financial advisors and distributors.

STP & Technology

London - ADP Wilco, a subsidiary of Automatic Data Processing, Inc., has launched a SWIFT Service Bureau for banks and asset managers in Switzerland. The service enables access to the SWIFT network for the full range of SWIFT messages including securities, treasury, derivatives, payments and cash management, all in a serviced data centre environment.

London - CheckFree Corporation has acquired Accurate Software, a provider of reconciliation, exception management, workflow and business intelligence solutions. Based in the UK, Accurate will become part of CheckFree’s Software Division to focus on operational risk management solutions for banks, securities firms and corporations. CheckFree purchased all of the outstanding shares of Accurate for approximately $56 million in cash, subject to certain post-closing adjustments. The acquisition was completed on 30 April 2005.

London - FT Interactive Data, the operating subsidiary of Interactive Data Corporation and a supplier of financial information and analytical software to global markets, has developed a new European Union Savings Directive (EUSD) data module as a tool to help customers impacted by the Directive. The data service can be delivered directly into the client’s existing system. Council Directive 2003/48/EC, commonly known as the EUSD, is scheduled for implementation from 1 July 2005 to prevent cross border tax evasion.

London - Reuters DataScope, the complete back-office solution from Reuters, has entered into a strategic alliance with AIM Software, an international data management solutions provider. Reuters DataScope will provide real-time and historical reference data for equities and fixed income via AIM Software’s data management platform GAIN DataDesktop, which enables the automatic processing of financial markets’ data. GAIN Light Reuters is the basic version for the processing of Reuters data.

Securities Lending

London - Richard Steele of JPMorgan Worldwide Securities Services was elected the new Chairman of the International Securities Lending Association (ISLA). A securities lending veteran of almost twenty years,
Steele has served on ISLA’s Executive Committee since 2001 and was elected Deputy Chair in 2003.

London - State Street has entered into an arrangement with Data Explorers Limited, providers of an independent securities lending performance measurement service, to offer the Performance Explorer product to State Street’s securities lending customers. Performance Explorer is a secure, Web-based service that allows customers to better understand their securities lending performance by comparing individual results against the aggregated data of a broad, customisable universe of industry peers.

Market Infrastructure
Amsterdam - Netherlands’ central securities depository, Euroclear Nederland has launched a new corporate-actions service for clients with assets held in custody by the CSD. The service is intended to improve the way clients manage voluntary corporate actions. Effective immediately, Euroclear Nederland’s clients will be able to indicate their choice of a cash or stock-dividend distribution for all dividend declarations with such a voluntary stock option attached to it.

Dubai / Kuwait - A new association for central securities depositories in Africa and the Middle East has been created. The unveiling of the African and Middle East Depositories Association was formally announced at the recent Eighth Conference of Central Securities Depositories (CSD8) in New York.

Vilnius - Vilnius Stock Exchange, one of six exchanges within the OMX Exchanges grouping, has launched the common Nordic trading platform SAXESS for trading on the cash markets. SAXESS is already in use at the stock exchanges in Copenhagen, Stockholm, Helsinki, Riga and Tallinn (all exchanges owned by OMX) as well as the stock exchanges in Oslo and Iceland. SAXESS was launched to realise the vision of an integrated Nordic and Baltic securities market.

Regulation
London - The Financial Services Authority (FSA) in the UK has set its final rules and guidance for implementing European requirements on product disclosure information for consumers in relation to collective investment schemes that hold a UCITS certificate enabling them to be marketed in other countries belonging to the European Economic Area.

www.isjforum.com
In the U.S. equities market continues to be the most robust and dynamic in the world, and now Fimat will give our institutional clients the ability to fully utilize these products when implementing the most complex investment strategies.”

Fimat Canada has launched an interdealer brokerage (IBD) business called Toronto Capital Markets Group (TCMG). The Group will focus on government bonds, swaps, forward rate agreements (FRAs), repos and futures and options.

Securities Lending

New York - EquiLend, the global equity and fixed income securities lending platform announced the expansion of their core trading platform to include portfolio auction capability. EquiLend

AuctionPort provides the ability for lenders to host and conduct blind and open auctions of portfolios on behalf of their clients. “EquiLend AuctionPort provides another route to market and distribution model for our clients,” Dirk Pruiss, President and CEO states. “Many of our clients view auction capability as a platform “must-have.” As with most functions, this view is driven by the needs of the lender’s clients who are looking at exclusive auctions as another route to market.”

STP & Technology

New York - Xcitek, a provider of market data, corporate actions software, and consulting services, has launched a new web-based information management service which allows financial institutions to identify, track and ultimately collect from positions held in the ever-expanding list of securities class actions. Xcitek Class Actions™ brings together Xcitek’s vast database of securities class actions, daily case updates and web-based software, to enable investors to identify and track relevant cases.

Watchlists and portfolios can be created to drive user-defined reporting including email alerts, upcoming filing deadlines, and daily lists of new or updated cases. The service includes information and features to assist in the process of claiming and collecting funds to which they are entitled.
Custody & Outsourcing

Singapore - Niche market broker-dealer and custodian, Swiss American Securities Inc. (SASI), a member of Credit Suisse Group, has turned its attention to winning new business in the Asia Pacific market. The institution has hired Richard Surrency, a veteran of the securities industry in the region, to aid business development in several key territories. SASI has served clients in Asia Pacific for more than 10 years, and is eager to increase its client base in the region. Richard joined SASI in October 2004 as Vice President of Sales, following roles as Vice President EMEA and Vice President Asia Pacific with RBC Global Services. His experience of the Asia Pacific market extends over many years. Raised and educated in Hong Kong, he has worked for Reuters Hong Kong and managed operations for Thomson Electronic Settlements Group across Hong Kong, Australia and Singapore. SASI differentiates itself from competitors in the region through its service offering, comprising custody, brokerage and securities lending. These services can be delivered in a single package to maximise cost efficiency. SASI will focus on serving small and medium private banks, online brokers and specialist divisions within larger tradition-al banking groups in core markets of Singapore, Hong Kong, Taiwan, Malaysia and Australia. Surrency believes SASI’s positioning is ideal for Asia Pacific investors.

Shanghai - Norway’s DnB NOR is planning to convert its representative office in Shanghai to a full-service branch in line with the Group’s existing international branches.

“The purpose of this move is to provide the expanding Nordic business community in China as well as international and local shipping companies with a full range of banking services,” said Espen Lund, project manager for the new branch and head of DnB NOR’s representative office in Shanghai. The decision to establish a full-service branch in Shanghai in line with the branches in Hamburg, Helsinki, Copenhagen, London, Singapore and Stockholm was made at a joint meeting of DnB NOR’s Board of Directors and Supervisory Board on 14 June 2005. An internal project has been working on the matter since February, and the aim is to establish the branch as quickly as possible. “We need the approval of Kredittilsynet (the Financial Supervisory Authority of Norway) before we can send our application to the Chinese authorities. In China, decisions on such matters take around 14 months, so we don’t expect to open the branch for ordinary banking services until the autumn of 2006," said Lund.

STP & Technology

Bangalore - Capco, the global financial services consultancy and IT solutions provider, and i-flex® solutions, an IT solutions provider to the global financial services industry, have created an alliance which leverages joint competencies to help financial institutions better measure and manage their enterprise risk. Through the alliance, Capco and i-flex intend to leverage their collective strengths in operational risk thought leadership, consulting, and product development, as well as their extensive global sales and delivery networks. Following the agreement;
- i-flex will acquire the intellectual property rights for Capco’s Operational Risk Tool Suite – ORTOS – and i-flex plans a two pronged approach for its use. It will merge the modular tool with its Reveleus Risk Analytics to create a complete Enterprise Risk Management suite. i-flex will continue to sell and implement ORTOS independently and Capco will serve as its reseller and distributor through its global sales network.
- Capco will be i-flex’s preferred Operational Risk consultancy partner. Capco and i-flex Consulting will collaborate to offer consulting in Operational Risk strategy, product selection, implementation and process advisory services.

Securities Lending

Hong Kong - The Pan Asia Securities Lending Association (PASLA) has appointed Sunil Daswani, regional manager for Securities Lending in Asia for Northern Trust Global Investments (NTGI), as its new chairman. Daswani, who re-located to Hong Kong from London in October 2004, will serve as Chairman for one year, having been elected by the executive members of PASLA. He replaces David Timpany, who also worked for Northern Trust and has since retired.

Market Infrastructure

The international derivatives market Eurex and Osaka Securities Exchange (OSE) have signed a Memorandum of Understanding (MoU), in which the two exchanges agreed to explore means of co-operation in order to extend the global reach of both exchanges. Under the terms of the MoU, Eurex and OSE have agreed to share information with a view to furthering the distribution of financial derivatives in Asia and Europe. “With the Memorandum of Understanding we formalize our longstanding relationship with the OSE. The MoU will be an important step towards bringing European and Asian market participants closer together and help Eurex to extend its reach into the fast growing Asian market," said Rudolf Ferscha, CEO of Eurex.
RBC & Dexia join forces

“We will focus on achieving long-term growth by providing institutional investors with an integrated proposition of global custody, fund and pension administration, transfer agency and related services”

Dexia and Royal Bank of Canada (RBC) have reached an agreement to combine their institutional investor services businesses in an equally owned joint venture to be named RBC Dexia Investor Services (RBC Dexia IS), pending regulatory and other approvals. The new company, with approximately US$1.8 trillion in client assets under custody (representing combined parent AUC), will rank among the world’s top 10 global custodians and will offer a complete range of investor services to institutions around the world. Under the terms of the joint venture agreement, RBC and Dexia, through its wholly owned subsidiary Dexia Banque Internationale à Luxembourg (Dexia BIL), will each own an equal share of the new company, resulting in net tangible equity of EUR500 million. RBC Dexia IS, a holding company that will be headquartered in London, U.K., will provide strategic direction and management oversight to the operating companies.

Marc Hoffmann, CEO of Dexia BIL and member of the Dexia Executive Board, will be Chairman of RBC Dexia IS. The CEO of the new company will be José Placido, currently Executive Vice-President of RBC Global Services, who is responsible for institutional investor services. Operations will be conducted mainly by RBC Dexia Investor Services Bank in Luxembourg and RBC Dexia Investor Services Trust in Canada and their respective subsidiaries and branches around the world.

“RBC Dexia IS clients will benefit from the size, product breadth and high touch client service of two well-respected and well-financed global banks,” Hoffmann said.

Placido added: “We will focus on achieving long-term growth by providing institutional investors with an integrated proposition of global custody, fund and pension administration, transfer agency and related services. Our local presence on four continents will provide the scale and expertise to meet the needs of global asset managers.”

The transaction is expected to close by early 2006. The new structure will have 3,500 employees and operations in 15 countries. “During the transition period, we will maintain consistent, uninterrupted service to our clients,” Placido said.

“RBC Dexia IS is expected to continue producing growth and value for both parent companies by using greater scale to attract new business, improve operational efficiency and generate synergies resulting from cross-selling,” Hoffmann said.

ISJ questioned Rob Wright, managing director, Global Fund Services, RBC Global Services about the merger:

Q Comment on specific areas you would like to develop as well as new avenues that have become open to you as a result of the joint venture?

A Over time, the new company will offer an expanded range of products and services as well as greater geographical reach to better meet the ever-changing business requirements of clients. One of the first things we’ll be able to take advantage of is added strength from a multi-jurisdictional perspective, meaning we’ll be better positioned to sell to clients on a cross jurisdictional basis, whether that is throughout Europe or the Australia/Asia region. We also see tremendous opportunities in the area of outsourcing in the 15 geographies where the new company will have operations. In addition, we see some specific opportunities to bring Dexia’s transfer agency capabilities to the UK market through their well known subsidiary, First European Transfer Agent (FETA). And of course there are additional opportunities for us to cross-sell some of our established services into the Dexia client base, such as securities lending, and our suite of Benchmark analytical products.

Q Which European markets will you focus on in light of the partnership?

A Going forward, our focus will be on expanding our business base in each of the countries we’re currently represented in, so future organic growth in each of those geographies will be a key focus. We see definite opportunities for growth in both France and the UK, two of the bigger markets in this industry. And of course, because of the combined strength and capabilities of the two companies, there will be opportunities for us to enter new geographies in the future. We’re also looking to augment our traditional services with an ability to service hedge funds in Europe, as well as introducing our proven pension capabilities into the European theatre from RBC Global Services’ strong Canadian platform. Leverage those capabilities in Europe is something we view as a great business opportunity.

Q Will systems be integrated and products renamed in order to reflect the new entity?

A Over time, we will assess our systems with a view to retaining best-in-class applications and developing innovative new features. Identifying specifics can only happen upon the closing of the deal, which we expect to take place sometime in early 2006.
Asset Control's Total Data Management® offers you the most efficient data management available at the lowest operational cost. It is achieved through two, seamlessly interconnected steps.

One step is the consolidation of in-house sources and vendor feeds that are critical to your proprietary processes and competitive edge. For this important internal data, our AC Plus solutions have been successfully implemented at leading financial institutions around the globe.

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It is up to you what to outsource and what to keep in house. Either step is a good place to start. You can easily extend one to the other, leveraging the benefits of both.

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Having lived in London and New York, Brown Brothers Harriman Partner, Andrew Tucker knows life on both sides of the Atlantic.

Currently chairman of BBH’s European subsidiaries he speaks to ISJ about the group’s strengthened resolve in the European marketplace...

A New League

When leaving London for the Big Apple, many emigrants long for typical conversations about the English weather and Premier League football, leaving them eager to return to their home country in a few years time.

But when Andrew Tucker traded these past times for Central Park and views of the Manhattan skyline in the late 1970s, little did he know that his stay in New York would last for over 25 years. Oxford-educated Tucker began his career in 1976, when he joined Barclays Bank.

Despite these significant inroads into the UK financial services industry, Tucker became frustrated with the government of the day, citing events such as the Coal Miner’s Strike and the “three-day-working-week” as the cause of his displeasure. He decided to leave London and immigrated to the US.

Tucker's US career began with BBH, which was looking for Spanish-speaking professionals for its Latin American trading desk. With a major in Spanish at University, Tucker became the ideal man for the job. “The fact that I was “slightly exotic”, helped in persuading BBH to hire me,” he says.

Tucker’s first BBH role was executed from New York and involved extensive travel to Latin America. “This was a dream job, considering I had studied Latin American history at University,” he says. “It was fantastic to travel to these countries, having read novels by Latin American authors such as Marquez, and combine it with a job at the same time.”

Several years later, Tucker moved on to BBH’s commercial banking unit in New York and then onto the Investor Services unit in 1995. From the moment he joined Investor Services, Tucker was heavily focused on BBH’s European business, covering the region from New York.

Owing to the growth of the European business in the 1990s, Tucker and his colleagues began to appreciate the value of a physical presence in Europe. This mutual appreciation heralded Tucker’s return to London in 2003.

Since his return, Tucker has strengthened BBH’s European operations by endorsing new executive positions, including those of Jeffrey R. Holland as head of European Sales and Relationship Management, Laura Hoult as head of Client Solutions, William Rosensweig as head of Private Account Services and Wendy Brooks as head of Human Resources in Europe.

Europe will continue to play an integral role in the development of BBH’s Investor Services business line. The first European office location to focus on custody was Zurich, which was established in 1968. A presence in London, Luxembourg and Dublin then followed. “Europe has always been an important part of our global custody business, but particularly in the last five to seven years, we have seen significant opportunities outside the US, including Europe and South East Asia,” says Tucker.

“These regions have provided better opportunities from a growth perspective than those in the US, our home market.”

Growth Opportunities in Europe continue to abound following Tucker’s London move and the strengthening of the management structure in the region. But this process is by no means finished. “We have a couple of other sen-
ior hires we will be announcing fairly soon, designed to bolster our European management infrastructure and to decrease our reliance on head office for so many functions,” says Tucker.

Tucker is involved in crystallising BBH’s administrative infrastructure in Europe, including human resources as well as the legal and financial units. “Instead of relying on the US for these functions, we have locally-developed capabilities which are closer to hand and which provide a better insight into how things are done in Europe,” he says. “Laura Hoult, for example, has been part of our client solutions division for a number of years. She has moved from Boston to London, further enforcing Europe’s importance to BBH. These hires are part of the true globalisation of our business.”

BBH has had a significant impact on the European markets where it has a presence. These locations include the traditionally offshore markets such as Dublin and Luxembourg, and the private banking markets in Switzerland and the UK.

“Funds and private banking are our two main areas of focus, making it logical that our first four offices are based in those countries,” says Tucker. “We continue to penetrate other onshore markets in Europe, including Germany, Italy and France, by analysing client demands in those markets. Our aim is to ‘onshore’ into the major European markets.”

Outsourcing

As an expert in global custody, Tucker testifies to an evolution of the word outsourcing. “All asset management and beneficial owner businesses are looking at how they can improve the efficiency of their processes, from start to finish. Many of these businesses believe that full outsourcing to a third party provider is the appropriate strategy to pursue. Others, who probably outweigh the former category, prefer modular solutions. They have observed certain risks associated with full back office outsourcing, including a lack of control.”

BBH is a major proponent of component based outsourcing. “We often speak of our product Infomediary, as a component tool of the outsourcing puzzle,” says Tucker. “Infomediary, and other component-based products we are currently building, are intended to aide specific functions within an asset manager’s middle and back office. We think this is a better approach to outsourcing than executing a full lift out of the asset manager’s middle and back office. The types of outsourcing deals where employees leave work on Friday as employees of ABC Asset Management and return on Monday as employees of XYZ Corporation are not scaleable. These deals are difficult to manage and do not necessarily address the fundamental problems that asset managers face. Asset managers’ problems are largely centred on data management. Infomediary, which assists in this area, is a component-based outsourcing approach.”

Tucker acknowledges there are a number of custodians, which are beginning to espouse the idea that component outsourcing is a viable alternative to a full lift out. “A lot of asset managers worldwide are looking at how they can improve the efficiency of their middle and back offices,” he says.

Despite the different approaches to outsourcing in certain geographies, Tucker avoids suggesting the market for outsourcing is more established in the US than in Europe. “I would make the argument that in Europe, particularly in anglo saxon countries such as the UK, outsourcing is more established than in the US,” he adds. “Fund administration, for example, is an outsourced service that has been offered by global custodians for about 25 years. The outsourcing of the institutional and individual segregated managed accounts business is still fairly new. But the jury is still out on the outsourcing of SMA businesses.”

While investor services providers continually promote the virtues of value added services when bidding for custody mandates, Tucker maintains that every single service offered by the custodian should be considered value added. “It appears that custody is the core, increasingly commoditised product, around which custodians offer an array of value added services” he says. “But I believe custody in itself should be a value added service. BBH has a philosophy of ensuring that the custody, safekeeping and settlement services remain core and that our client service remains at the highest levels that we can sustain. There are commodity elements to custody, safekeeping and transaction processing. But if you get them wrong, then everything else about the service delivery starts to fall apart. Custody, settlement and safekeeping are key parts of the asset manager’s business. These functions enable them to know where their securities are, that their dividends are collected, that corporate actions are being acted upon, that taxes are appropriately processed and that trades are settled on time. If you treat these services as commodities you run the risk of not giving them the attention they deserve. As a result, the quality of your client service deteriorates and clients will be unhappy.”

BBH sells value added services as third party services for institutions, which may or may not be custody clients. “You don’t have to be a custodian to be a foreign exchange or securities lending provider. Increasingly, particularly in the US, trustees and fiduciaries of assets are saying ‘just because you happen to be a good global custodian, does not imply that you should get all of my foreign exchange and securities lending business,” says Tucker. “The institutions should competitively tender for

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all of these services among the best possible providers, including third party providers. The securities industry is moving towards the direction of unbundling their services, for reasons, at least in the US, that are regulatory driven. Apart from regulation, the unbundling of services can help institutions establish if they are getting the best value for money for their shareholders’ assets. We strive to bring value to every service we offer, including custody, fund administration, performance measurement, securities lending, foreign exchange and cash management. Cash management is intricately linked to the provision of custody services because the delivery of cash follows the delivery of securities.”

STP
While the tendency of financial institutions to outsource certain component-based services is dependent on the type of financial institution, the same can be be

efficiency and improving STP rates,” says Tucker. “The issue is: who is going to pay the costs of this efficiency?”

The debate on costs has fuelled two camps of thought in the securities industry. The first camp is discussing the value of industry-led initiatives like the ill-fated GSTPA while the other camp promotes commercial solutions like Infomediary as a means of dealing with the costs of STP. Commercial solutions are provided to investment managers, for example, which outsource their entire back office to custodians. “The custodian bank will attempt, with their own technology, to improve the mess that is handed over to them,” says Tucker.

Through the delivery of commercial solutions, Tucker remains confident that total STP will become a reality. “The STP rates of our clients’ trades is in the high 80 per cent range,” says Tucker. “The remaining 12 per cent of messages are not automated, but 50 per cent of those messages are repaired online. About four per cent of those messages is sent to us by fax. The message is then re-keyed into our processing systems. We have worked with our clients by providing economic incentives to automate their processes with us. This commercially-led approach to STP will probably solve the STP dilemma, not the industry-led consortia like GSTPA. Even Omgeo has had difficulty in signing people to Transaction Flow Manager. For whatever reason, people generally tend to avoid industry-driven approaches. It appears that bi-lateral approaches between service provider and client are the best way to solve some of the current STP issues.”

Clearing and Settlement
Service providers’ quest to relieve financial institutions of some of their STP headaches is not limited to commercially led initiatives. The fragmented clearing and settlement infrastructure in which they operate also impacts heavily on the entire industry. “I’m sure over time there will be some consolidation of the European central securities depository environment,” says Tucker. “There are flashes of consolidation among the stock exchanges, although relations between the Deutsche Borse and the London Stock Exchange serve to enforce that consolidation may not be as easy to achieve as one might think. The role of the global custodian is to insulate its clients against the infrastructure predicament so that the asset manager does not have to worry, from a connectivity and processing perspective, whether two CSDs merge or not. We are insulating them from that process.”

Are their benefits to consolidation? “Conceivably yes. The creation of one CSD and one exchange for Europe will presumably result in lower costs for the users. It can take several years to establish one system. But the resulting lower costs will be passed down to the end consumer, in this case the asset manager and broker dealer user of the clearing and settlement this infrastructure. These asset managers may even choose to disintermediate from their custodians and connect directly to the stock exchange and the CSD. In the US, for example, asset

“We continue to penetrate other onshore markets in Europe, including Germany, Italy and France, by analysing client demands in those markets. Our aim is to ‘onshore’ into the major European markets”
managers may prefer to interpose a settlement and custody institution between themselves and the DTCC. They don’t want to bother with the inefficiencies that come with dealing with a communally owned utility. The DTCC is often hailed as a model to which Europe can aspire. But European’s should be careful what they wish for. In the US, custody and settlement agents play a significant role as intermediaries between the client and the DTCC. Our scale helps us address the quirky nature of the DTCC that individual users don’t really want to deal with. We insulate our clients from changes that are introduced by the DTCC, allowing them to focus more closely on other key aspects of their businesses.

Consolidation

As custodians take advantage of the commercial possibilities resulting from a fragmented clearing and settlement industry, they continue to acquire specialist expertise, particularly in the hedge fund area. Particular examples include the acquisition of Forum Financial by Citigroup, Barings Financial Services Group by Northern Trust and Hemisphere by Bisys. Tucker expects there will be further consolidation in this arena, but to a lesser extent in the global custody industry. “This industry consists of a dozen custodians that are truly global, as opposed to institutions who are in the custody business in one part of Europe,” he says. “There may be further consolidation in this area, but I am hard pressed to see what the combinations are going to be. You may see more strategic alliances. This is one way for an American global custodian to permeate the German, French or Italian market. This option is better than starting the operation from scratch, which is incredibly difficult to do, or purchasing an entire bank for example. I can see further alliances between the US custodians and local players in Europe, allowing the local player to benefit from the technology, expertise and infrastructure of the American or European global custodian and to offer superior services to the local market place. I predict further consolidation among the fund administration houses and other institutions who are involved in particular segments of the business.”

Transformation

As securities services providers take on the challenges of a constantly evolving industry, SWIFT has encapsulated these challenges by choosing “Transformation” as the theme for this year’s Sibos event. Commenting on this theme, Tucker says: “SWIFT always has to worry about transforming itself. Speaking at last year’s Sibos event, JPMorgan CEO Heidi Miller pointed out that although internet is safe, reliable and free, institutions are still paying millions of dollars (for SWIFT membership). Although this comment was fairly tongue-in-cheek, SWIFT has to think about how it can transform itself for the next generation. The utility is working on a number of initiatives in this area. Europe itself is in the midst of transformation in the securities processing arena. But despite these grandiose themes, SWIFT usually covers the basic issues of how can we agree on global standards that permit better efficiencies in the business?” Third party mutual fund processing has been very high on the business agenda. Even if you accept that the best solutions are commercially driven, it is extremely difficult to mould what BBH does with its clients and what JPMorgan does with its clients and get them to collaborate on standards. That was the reason SWIFT initially did not allow investment managers to join. All of the banks had developed their own proprietary workstation technologies to get their clients onto. They did not want their investment manager clients to divorce themselves from those proprietary workstation technologies and go onto SWIFT, as the link between these investment managers and the bank supplying the technology would be broken. This is a classic example of the co-operation (competition versus collaboration) in the industry. Everybody talks about collaboration, industry initiatives and standards, yet the competition is ever present. Banks believe they are doing very nicely by not having their clients participate in a standard. If clients adopt a standard, the grip banks have on these clients is loosened!”

As BBH continues to build on its European presence, the investor services provider looks set to benefit from fragmentation in the clearing and settlement environment and the popularity of commercially-led solutions to address certain STP issues.

Andrew J.F. Tucker
Partner
Brown Brothers Harriman

Relationship Management and Marketing - Europe
Andrew J.F. Tucker is a BBH Partner resident in London. Andrew has been associated with the firm since 1978.

He has held several positions in the bank including Managing Director in charge of the Commodities & Futures Banking Department in New York and Department Head of International Banking. Andrew is currently responsible for the bank’s Investor Services business in Europe. He is a director of the bank’s European subsidiaries in Dublin, London, Luxembourg and Zurich.

He is a member of the firm’s Risk & Credit and Investor Services Executive Committees. He was appointed Partner in January 1998. Andrew is a graduate of Trinity College, Oxford University and attended the New York University School of Business Administration.
Billions of messages flow between financial institutions daily, and any misinterpretation of the data they contained could result in billion dollar losses.

**Like the** attention afforded to most second division football clubs in England, data management was historically viewed as a low ranking, back office function in the securities industry. As such, the investment allocated towards ensuring its proper and efficient management was minimal. Thankfully, there appears to be a change in the mindsets of securities organisations as they become more aware of the monetary risks attached to badly managed data. Service providers have been equally active in providing solutions to meet the reference data needs of these securities organisations. As an important provider of services to the industry, the Depository Trust & Clearing Corporation launched the Global Corporate Actions (GCA) validation tool to help financial institutions manage their corporate action announcements.

Commenting on the origins of the tool, James Femia, head of the DTCC’s global corporate actions business, says: “We have taken the area of corporate actions, which is an area of reference data, and have made it an important issue. We have targeted what is the most problematic, high risk, high exposure area in corporate actions and have focused on delivering solutions for the securities industry.” The DTCC has a fully operational service with a number of clients on board. Although global corporate actions has been a major focus of the DTCC for the last two years, the organisation did not enter commercial mode with the service until about eight months ago. “We were managing a portfolio on behalf of our clients, providing a monitoring and report service for about 900,000 securities that are issued and traded all over the globe. We created about 900,000 corporate actions announcements for customers in 2004.” The DTCC has created over 300,000 corporate actions announcements since the beginning of 2005. The organisation’s global corporate actions validation service is supported by customer centres in New York, London and Shanghai.

**Risk**

With over 300,000 corporate actions announcements in this year alone, the DTCC is no stranger to risk awareness. Femia explains: “Everybody who thinks corporate actions thinks risk, but nobody has been able to quantify the risk. About a year ago, we commissioned economics consultancy firm, Oxera, in the UK to undertake a risk modelling project. They conducted a series of interviews with market intermediaries and analysts and were able to provide some risk-quantifying numbers.”

The first risk Oxera identified was back office risk, which could result from the mishandling of a corporate actions (i.e somebody in the back office doing something wrong). Depending on the size of the investment bank or broker, this mishandling could result in losses of tens of millions of Euros from a single action. “Losses like these are rare, but not unheard of,” says Femia.

Further risks occur when the tender price of a security is higher than its actual trading price. Even if the difference between the tender price and the actual trading price at the time is only EURO 2, an investor who holds one million shares of this security may be exposed to the tune of...
EURO 2 million. “A discrepancy of this nature can result when an individual misreads the information or does not process the trade in a timely fashion,” explains Femia.

The second type of risk Oxera identified impacts the front-office trading desk and occurs when traders or investment decision makers act on incorrect or incomplete information, taking positions, or not taking positions, hedging or not hedging, against the corporate actions. As a result of not being made aware or acting improperly, they make “sub-optimal trading decisions”, which may incur losses of between EURO 1.8 bn and EURO 8bn. “The cost to our industry may result from a person not being aware of a corporate action or acting incorrectly on information,” says Femia. “There are hosts of trading decisions that may or may not have been made, based on poor information.”

Buyside
As the potential for loss in the corporate actions space intensifies, buyside institutions are growing more aware of the benefits of using a third party to help with their data management. “Two years ago we developed the corporate actions service for a core constituency of DTCC, namely global banks and broker dealers,” says Femia. “Today we are finding there is enormous interest from buyside firms, including the hedge fund marketplace and the investment management community. Even institutional end users are being approached by major insurance companies.”

In addition to corporate actions, institutions are showing an increased awareness of risk management, as a result of Basel 2 and operational risk implications. “You cannot mention corporate actions without using the word risk in the same sentence,” says Femia. “A trading desk’s strategies may be impacted by a corporate action event. Not having access to timely and quality information could have a significant impact on the trading desk. Risk management is clearly the driver behind why we got into this space. By streamlining the data source so that there is only one feed, we have provided customers with near-realtime access to information.”

Clients of the DTCC’s GCA validation tool include UBS, Credit Suisse First Boston and JPMorgan Securities. “We continue to work with the Securities Industry Association in the US to drive towards standardised views and outputs of corporate actions information and getting information from the original providers in an electronic and standardised format,” says Femia.

Consulting
In 2003, the DTCC worked with financial services consulting firm Accenture to launch the GCA validation tool. “We engaged them to help us build and launch the service,” says Femia.

Accenture has been actively assisting several securities institutions with their migration strategies concerning the management of their market and reference data over the last decade. Firms typically start their journey with disparate data “silos”; they need to centralise control over the management of their data before they can contemplate the benefits of outsourcing their data management architecture, and that requires metrics. Associate partner Dr Anthony Kirby, whose career includes work with SWIFT, Merrill Lynch and Deutsche Boerse, recalls when the securities industry began to campaign for automation and STP in the mid-1990s. “The thinking at the time was that metrics were vital. If the current state and the goals could not be measured, how could the transition towards improved efficiency and effectiveness ever be managed?” he says.

“While at SWIFT, our aim was to work with members to help them facilitate STP for payments and securities. At that stage we didn’t realise the dependency of these members on their reference data. The burning question became, ‘how do securities institutions identify the securities they trade in a unique way, how would they identify their counterparts to the trade process, and would they cope with other forms of data, such as classification or non-structured data?’ Today, this devil in the detail represents the basic DNA feature within any of the messages exchanged over the SWIFT network.”

The background to reference data was the cost of this detail to the securities industry, which represents an estimated $ 6bn every year. Dr Kirby explains that sell-side firms could be spending upwards of $40 million to $70 million per year, according to CSFB in maintaining and improving on their systems. “45 per cent of all rejected STP rates are the result of poor reference data,” Kirby adds. “A lot of people used to think of reference data as a quick return on investment, but nowadays it is more about regulation and forensics. Regulations such as the Patriot Act, Know-Your-Customer and anti-money laundering provisions mean that you have to demonstrate that you know the customers you are transacting for. You have to know who owns whom and the legal structures of the entities you are doing business with.”

Increased regulation also stipulates that entities with parent-and-child relationships have to be identified in addition to the funds relating to that entity. There is currently no industry standard for this data, apart from the de facto standards available through key suppliers such as Dun & Bradstreet and Omgeo. “A broker dealer may spend money on collecting the data, loading it, taking it in various formats and harmonising it so that it can be processed, before cleansing and scrubbing it to create a golden record,” says Dr. Kirby. “The data has to be compared with your counterpart’s data, and of course there are various vendor feeds you have to take information from in the first place. These are immediate costs to the firm, but there are other areas where costs might be incurred. These include delayed data resulting in failed trades, hidden costs from volume sensitivities (or latency) and even impacts on...
capital adequacy. But the good news is that some of this can be measured! The bad news comes from the less quantitive aspects. If your firm receives a fine for violating the KYC procedures, for example, the fine may not hurt you as much as the damage to your firm’s reputational risk. This impacts on a securities institution’s ability to retain existing clients and to prospect for new clients.”

Savings
Apart from the reputational benefits, well-managed reference data can also contribute to savings through improved customer service and better operational controls that allow firms to cross leverage, through cash and derivatives products. “For a bank the biggest benefit of reference data management is the reduction of reputational risk,” says Dr Kirby. “Even for the smaller fund managers the benefits can easily equate to savings of up to half a million dollars a year, and if that detracts form a fund’s performance, it’s worth considering. If your fund suffers through an incident such as missing a key date for corporate action processing, naturally that’s an example they won’t want to repeat”, he adds.

But in order to realise these savings, the portfolio manager of a buy side firm must interact with the entire reference data flow. “Firms should consider a hub and spoke approach to have the right reference data available to the process at the right time, which is a model in common usage among entities who manage supply chains in the corporate world”, says Dr Kirby. “The information they have in the front, middle and back office should always be on call. You should be in a position to execute a trade and manage the risk, service the asset and move on to making the next trade. You should have access to the relevant market, reference and classification data to enable you to do that, which is why Accenture refers to these market leaders as right-time enterprises.”

RDUG
As founder of the Reference Data User Group (RDUG), Dr Kirby has focussed his efforts on deeper discussions about the value of correct reference data, merging the fruits of the Group’s White Papers with like minded associations. For example, RDUG has crafted an industry initiative with FIX, ISITC and FISD to focus on the Markets and Financial Instruments Directive (MiFID) in Europe. “As far as MiFID is concerned, we’re also doing a lot of work with bonafide industry associations such as the London Investment Banking Association and the Investment Management Association in the UK. RDUG has also coupled its efforts to the important work being done by the European Banking Federation, the European Securities Forum and the European Central Securities Depositories Association around harmonising corporate action processing,” he says.

Once they have fully understood the fragmented nature of reference data, many securities firms have tried to convert their fixed costs into variable costs by handing over the management of reference data to a supplier. “This may presuppose that you know what your costs are, but an even more important issue is questioning: what is your business basis?” asks Dr Kirby. “A fund manager who is in the business of generating good returns for their clients not only makes the trades but is on the hook and responsible for ensuring that they are settled too. They may well decide they’re not in the business of maintaining systems or funding standards changes. For example, they may well decide they’re not in the business of doing fund accounting. There are functions that are core to their business and functions they can hand over to a third party.”

Outsourcing accounted for more than one third of Accenture’s net revenues during fiscal 2004. “We understand how to take a journey, albeit a longer-term one, helping firms migrate from having disparate systems through a logical or physical control architecture, and finally towards business process outsourcing,” says Dr Kirby. “The key point here is control over your data and your transactions, which enables you to monitor your trading and operations, to realise the value of these functions to your firm. This control not only comes from getting data from a particular source and knowing that data is cleansed and made available for distribution. It comes from realising that clean data forms the basis for information, which in itself forms the basis for knowledge, context and meaning”. The co-ordinated frameworks afforded by reference data management can be likened to air traffic control. “Firms need to build that air traffic control before they can ever contemplate outsourcing,” says Dr Kirby.

The aforementioned GCA Validation Service, is in use at nearly a dozen major financial firms globally, with more firms testing in DTCC’s pipeline. “The aim of DTCC’s GCA service is to analyse corporate actions and make information available per different types of corporate action event for the benefit of firms that could handle large volumes of data, including UBS, JP Morgan and CSFB” says Dr Kirby. “A number of firms are also analysing instrument data, including pricing data, post-trade securities master and instrument data. This is a two to three year process for hedge funds, universal banks and custodian banks. Accenture is helping firms manage, cleanse, scrub and distribute their data in this area before they make their journey towards outsourcing non-core operations.”

Client Relations
Once the data management solution has been implemented, the level of interaction between client and provider is extremely high. “This is a trust business,” says Dr Kirby. “We help firms address key issues such as fiduciary responsibility, risk and liability from a technology and operations perspective. It is important for the client, who is contemplating outsourcing, to build metrics. Accenture’s work with its clients helps build awareness of the differen-
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Reference Data Management

Firms should take a hub and spoke approach to reference data

Known to staff in the back office (the official place of listing and trading is not specified to the back office). Thus, data is transacted in a specific location, which may be unequally need to identify client counterparty data for regulatory or settlement purposes, they may need corporate actions information for trade processing. Data management is a continuum that more organisations should pay attention to.

Awareness

Despite its impact on data management, regulation has not always ignited the necessary action. “The problem is one of perception,” says Dr Kirby. “About 10 years ago the distribution of power in the industry was more dispersed. The top 10 broker dealer firms today probably account for 60 to 70 per cent of the volumes across various asset classes. Every firm believes it has the edge over the competition. Gone are the days when you had 100 people in a room, all agreeing they have a common problem to work on, to create common standard. When it comes to industry initiatives, operational representatives might believe in common approaches whereas people in different functions may well regard certain classes of reference data as an area of competitive advantage and therefore pride themselves on being adversarial. Right now, some of the larger firms believe they have the better mousetrap and their information handling—such as prime brokerage or fund administration spanning areas such as alternative asset class processing and credit risk hierarchies—gives them the competitive edge. A way around this could be for industry approaches not to commoditise too much of the added value of data management too quickly.”

This problem has become noticeable when it comes to devising commonly-accepted solutions for business entity data. In January this year, RDUG met to discuss the separation of basic data such as the company name and the legal entity hierarchy from areas such as cross referencing and standing settlements. “This is the only way to get people round the table,” says Dr Kirby. “The common pain is basic data, but we are not going to standardise all of the hierarchies, because this is an area for competitive advantage. To get a common solution we have to think intelligently about what a standard is. A standard has to be reinforced by a network. Unless the standard is put together in a network context so that a lot of people can use it en masse, it is not a standard in practice.”

Cost

Basic information can be supported by charging at a cost, says Dr Kirby. “The contention is whether people believe that instrument data, in common usage, is something you should charge for or a source of competitive advantage,” he says. “More firms need to be aware that data management is often a non-value-added process, especially with regulatory pressures and operational risk issues on the horizon. The step from there towards designing future flexibility to meet the needs of a constantly changing environment is not too far a stretch, provided that a business case showing the ROI makes sense and provided the firm builds adaptability into their rules-based processing,” he adds.

In June 2003, RDUG published a white paper on instrument data. The paper concluded that ISIN was insufficient
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“Many institutions intuitively feel that data management should be kept inhouse because the handling of data is key to their competitive differentiation”

Reference Data Management

in describing a security in a unique way. “Reference data needs to be unique and precise,” says Dr Kirby. “ISIN is insufficient for this purpose and extra qualifications are required. We are talking to LIBA, the Financial Services Authority in the UK, the UK Treasury and CESR about how this critical component is going to be treated in practice. We are expecting there to be concrete references to instrument data within these discussions. Between now and Fall 2006 we expect to see a standard emerging for business entity data, although whether this will be sufficient for firms hoping to respond to directives such as the Capital Requirements Directive is debatable. You can only do this if you know the instruments you are describing.”

Regulation

One of Europe’s grandest projects is the creation of a single market for financial services. The 1993 EU Investment Services Directive (ISD) provided for “Home and “Host” state regulators whereby regulated entities where able to “passport” themselves into another European country and sell financial products and services without re-authorisation. The ISD allowed for core services – dealing, arranging or managing certain financial instruments (excluding derivatives) and non-core services such as giving advice on ISD instruments.

The Financial Services Action Plan in 1999 highlighted a need to upgrade the ISD to reflect the way markets operate and to make ISD flexible enough to respond to further market developments. The March 2000 Lisbon convention stressed the importance of a single financial services market for Europe and revising the ISD was deemed to be a crucial part of the drive towards a single EU market for securities. Under ISD II, harmonised rules applying to all firms operating within the EU would be applied and the removal of artificial barriers to easy cross-border trading for all asset classes (including derivatives) would be enabled.


Under MiFID, investment firms are allowed to provide services throughout the EU on the basis of home country supervision. MiFID was originally scheduled for implementation by all 25 Member States of the EU by 30th April 2006 but has been delayed until 30th April 2007. Key objectives of MiFID are to provide a degree of harmonisation needed to offer investors a high level of protection and to ensure a high quality of execution of investor transactions by imposing a “best execution” obligation. The aim is to provide framework for regulating the order execution arrangements in European financial markets while enhancing transparency on the depth of liquidity and to uphold the integrity and overall efficiency of the financial system. MiFID removes rules in some parts of the EU where all trades had to take place on an exchange (the concentration rule).

“The Directive will afford investors the best price and high quality execution,” says Kennedy. “Brokers will have to show investors they executed at the best price possible. Best execution varies with the cost of a transaction, the security and the range of assets you are trading with.” MiFID recognises and formalises multilateral trading facilities. Whereas the primary market for securities would have been the domestic stock exchange, the concentration rule no longer applies. “All that is required is best execution for the customer,” says Kennedy. “But trades no longer have to go through the exchange; clients will have the option of going through a systematic internaliser such as a big investment bank.”

The changes brought in under MiFID are the latest in a series of regulatory changes that the market has had to adapt to. The process was kick-started by the initial Giovannini report, which focused on the existing clearing and settlement landscape. The report on the current European Clearing & Settlement landscape analysed and identified 15 barriers for cross border clearing and settlement. “The Giovannini II report elaborated a strategy to overcome these barriers for cross-border clearing and settlement with deadlines for completion,” says Kennedy.

“The Giovannini report identified a variety of issues that would have to change in order to realise a single European market.”

The market has also had to prepare and implement changes such as those required under the US Patriot Act to conduct due diligence (Know Your Customer) and have anti money laundering (AML) programs in place. These have complemented the Sarbanes-Oxley Act, which requires improvements in corporate governance and reporting principles. The EU directives have been introduced to ensure investor protection for collective investment vehicles as well as a directive regulating the contents of prospectus’s from issuers and a directive for harmonizing the tax treatment for paying agents to recipients to stop avoidance of tax payments on interest on debt instruments. The Transparency Directive looks to establishes minimum requirements in relation to the disclosure of periodic and on-going information about issuers.

The situation is further complicated by the introduction of the Basel 2 accord in 2007 which aims for a closer match between the capital that banks hold and the risks they take. The Basel 2 accord relates primarily to the calculation of regulatory capital for market, credit and operational risk.

In Charge

The introduction of MiFID will put trading firms in charge of publishing their own prices. The directive will result in an expansion of trade execution venues. Trading entities must make public their pre-trade and post-trade
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Reference Data Management

information. Traditionally, the trader would trade through an exchange, which posts all the information relating to that trade. Under MiFID, the trading entity now has responsibility for pre-trade and post-trade publication.

“This has a number of implications for the business model of any investment bank,” says Kennedy. “If they choose to become a multilateral trading facility, they need to post their prices before a trade and show the prices a trade has been executed at. These firms have to figure out a way of publishing prices to the market place.”

MiFID is requiring institutions to have a clear view of all the data in their systems, including who they are trading with and what they have traded. Kennedy explains: “Thanks to Basel 2 and MiFID, institutions need to understand their business and their business flows like never before. Historically in this business, nobody put money into back office systems. They were necessary evils. It was always cheaper to buy a product and set up a separate system for different types of products. As a time-to-market approach, this was fine,” he said.

“Nowadays, the bigger players are beginning to realise all the information they need is flowing through their systems, but they need to take a view on how they can get intelligence out of their system. People have lots of data, but very little information. As liquidity and program trading in the front office have reduced the spreads of the standard trade and as the volume of trading has increased, we can no longer afford to have out-of-date back office systems, they have to be brought up to the 21st century. Increasingly firms are looking to develop enterprise data management solutions to solve their problems.”

Despite MiFID’s system changing implications, it is still unclear how it will drive the market. While MiFID has the force of law, market practitioners are only now beginning to work through the implications on how MiFID will affect market practice. “The big investment banks may say they have their order flow and could quote their best price and publish both pre- and post-trade information,” he says. “But for mid-to-niche providers, they don’t really want to get into the business of being a data provider too. Smaller players may think that if they push all their business to the exchange, they can always show their customers best execution. This could lead to fragmentation in the market, between the big players with pools of liquidity among themselves and all of the smaller players attracted to the regulated market.”

MiFID may also complicate the management of reference data. Kennedy explains: “If I’m trading Vodafone on the London market, I don’t care who I trade with because I know the security is Vodafone, I know the issuer is Vodafone itself, the official place of listing is the London market and I know that when I buy and sell the security through my broker, I’m buying a bog-standard product. However, if I have to differentiate between Vodafone trad-
ed by one system internaliser versus Vodafone traded by a different system internaliser, there will be one more factor to add in to my security identifying world. This complicates matters. Doing this requires technology that allows you to uniquely describe a particular asset. If you are trading through an exchange that’s fine, but if trading through systematic internalises it may be different.

Under MiFID, multilateral trading facilities will have to publish pre and post trade data at reasonable cost. “Institutions who run these systems realize they need a strategy for managing data,” says Kennedy. “Data needs to be checked and validated as data is the basic input before you can attempt any best execution or value at risk calculations, required by MiFID and Basel 2. Anyone who hasn’t implemented a data management system may be driven out of the business.”

Centralised Approach

According to Ger Rosenkamp, CEO of Asset Control, many securities institutions have accepted that a centralised approach to data management is the most efficient. “They are not only reacting to regulation, but realise that a centralised approach also provides long-term benefits,” he says. “The financial justification for investment in this area is driven by regulatory pressures. Similarly, many institutions intuitively feel that data management should be kept in-house because the handling of data is key to their competitive differentiation. The truth is that core technology in data management involves gathering information from internal and external sources. These institutions have to build a model to cover the different types of instruments. They have to verify data, make the data match and resolve distinctions. The distinction from one bank to another, may be in the rules they use for handling the data or in how they prioritise their sources. But the basic problems are the same. There is a huge benefit in going to an outside vendor because they can cover all that is required in the data management process. Asset Control has had products in production for 11 years and has never stopped developing these products. This involves a huge amount of data modelling and integration of vendor feeds. If you work with a vendor, you can assume the vendor is continuously expanding its products to meet the needs of its customers.”

Asset Control was built as a comprehensive data management environment, to support the operational framework of capital markets institutions. The core technology was built to link all the different data types within these institutions. “Because the system was built as a universal data environment, it is fully auditable - if a regulator questions the data point i.e. why an institution is using a certain value for classification purposes, institutions can drill down into Asset Control and into the history of that value. Institutions are buying our solution to replace legacy systems. At the same time regulators are demanding absolute transparency.” As the demands of the regulator intensify, securities institutions realise the time to act, to ensure their data management is state-of-the-art, is nigh. Data management is also increasingly central to risk management, which the front office cares deeply about.

“Anyone who hasn’t implemented a data management system may be driven out of the business.”
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As a pioneer of the data management revolution, GoldenSource’s Michael Meriton has worked relentlessly to extol the virtues of effective data management to the front, middle and back offices of financial institutions.

ISJ speaks to Meriton about changing attitudes towards data management.

Power Source

What a difference a year makes. Or, in Financial Technologies International’s (FTI) case, what a difference six months can make. In October last year, the company launched its integrated data management solution suite under the GoldenSource brand name. So fitting was the product’s name within a data cleaning and management context that FTI decided to apply the name to the entire company, which it did in February this year. The transformation from FTI to GoldenSource was steered by Michael Meriton, the company’s dynamic CEO. Commenting on the success of GoldenSource to date, Meriton says: “The GoldenSource product can be described using the analogy of an Intel chip powering a Hewlett Packard. It has been overwhelmingly received by large banking institutions, which are using its data management applications, standards and tools to power their downstream systems” he says. “We are working very closely with a number of large institutions and look forward to many more successes in the near future.”

Other factors that have added to the success of the GoldenSource solutions include the increased attention being focused on reference and transaction data management, the basic arrangement of securities, issuer and counterparty data that affects a financial institution, by upper management echelons in these institutions.

EDM

GoldenSource is currently one of the founding sponsors along with IBM, SunGard and BearingPoint of the Enterprise Data Management (EDM) council, comprising top investment bank executives. The inaugural meeting of the council was held in June 2005 in New York, GoldenSource’s city of origin, and follow up meetings will take place minimally twice a year. Meriton has been encouraged by the senior-level management attendance at these councils. “Whereas data management has typically been about mid-managers trying to rally the flag around the value of managing reference and transaction data, this council of senior executives is helping to steer the industry so that best practices can be adopted and companies can start deploying these data management concepts to the benefit of their overall organisations.

“There is a general recognition by the securities industry that enterprise data management is at the forefront of every major opportunity and challenge in the industry”

Recognition

As one of the inaugural sponsors of the EDM council, Meriton bears witness to something that has the ability to impact an entire firm demands the attention of the highest level executives.”
the change in attitudes towards enterprise data management as a source of competitive advantage and a means of complying with regulatory changes. "There is a general recognition by the securities industry that EDM is at the forefront of every major opportunity and challenge in the industry," says Meriton. "This industry runs and survives on data. If the data is poor, then the industry and its participants suffer from it, whether it is in the form of regulatory penalties or an inability to serve their customers or launch new products. Conversely, as the industry begins to rally around data management standards and evoke those throughout their firms, it helps them to improve their business operations, better respond to regulatory and compliance needs and take advantage of opportunities that are occurring in the market, such as the European Union initiative known as the Markets and Financial Instruments Directive (MiFID)."

**MiFID**

As one of the most crucial regulatory changes impacting the securities industry, MiFID will affect the way trading institutions need to determine best execution. This translates into a major data challenge for these institutions. On the other hand, MiFID is also perceived as an opportunity for banks to internalise order flow resulting in cheaper and better margins. "At the heart of executing these trades is transaction and reference data, which make it possible to validate best execution and publish post-trade information back to the market," explains Meriton. "MiFID is another major push towards companies’ need for data management systems in order to execute and to document best execution. In this sense, other regulatory pressures such as Basel II, Sarbanes Oxley and the rules surrounding Know-Your-Customer and Anti-Money Laundering have also played an important role."

As a result of these directives and other market drivers, GoldenSource and co-founding sponsors IBM, SunGard and BearingPoint have found getting C-level executives in a room to discuss how they can best execute within a global marketplace has proved fairly painless. "This is an exciting time for sponsors of the EDM council, which has been well-attended by executives who want to help," says Meriton.

**Background**

Meriton’s data management cause is rooted in his former tenure as president for Checkfree Corporation’s Financial and Compliance Solutions (CFACS) group (today part of the Checkfree Software division), a role he executed for three years, before GoldenSource persuaded him to take charge at the beginning of 2002. Before Checkfree, Meriton ran a start up business in the ERP sector, selling and implementing BAAN ERP software. Prior to this venture, Meriton spent six years with vendor Dun & Bradstreet, a global business information provider, where he managed the software divisions in North East America, including New York, Boston and Washington DC. “Over half of my career has been in financial services, in the provision of application-based solutions to large scale banks and brokerage firms,” he says. “What attracted me to GoldenSource (then FTI) in 2002 was the fact that the financial market did not possess any enterprise data management systems. At the fundamental execution level, the needs of the securities industry do not differ greatly from those of a traditional manufacturing company. Where the fundamental difference lies is that within the trading of securities data can change in real-time. If you drill down the data of the trade process, there is not only the concept of an order, but also a counterparty with whom a firm in a trade transacts. There is also the security or product being traded, that may be very complex and is probably changing real time in price from the moment it is traded to the point of settlement. This dynamism within the trade is what makes the securities industry fundamentally different from any other industry.”

**Integration**

Despite the complexity of data within the securities industry, Meriton believes it is possible to achieve a level of data integration. The first step, he says, is an EDM or common data management system across the enterprise. “Large global banks cannot simply throw out their existing compliance, risk and regulatory systems they have built or acquired,” explains Meriton. “These systems run on data. Cleansing and purifying that data at the source level before transacting can ensure principles that the firm is running off quality data.”

Enterprise data management involves taking all data needed to run a business, standardising it, cleansing it and putting it into a trusted repository, to which applications (that need the data to transact) can connect. “EDM is about tackling your data issues by cleaning it up and putting it into a trusted source first. Then, instead of using a local security master or customer counterparty master to facilitate a trade, I can connect my trade application so that it goes to the trusted source to get the prerequisite source data. Thus, when a trade is executed, you are assured of a clean result because the trade itself is operating off trusted information.”

Today, most institutions’ trading systems host security master data, customer master data and counterparty data. The latter is received from a variety of sources, including Reuters, Bloomberg or a stock exchange. “Invariably some portion of security reference data is inaccurate,” says Meriton. “Instead of taking security information from a dozen different sources, which may have quality issues, the trading firm can consult the trusted source first or in this case the security master.”

"Like most things in life, all parties tend to respond better to pain than they do to opportunity"
The security master can contain data provided by Bloomberg, Reuters, Telekurs and FT Interactive, to name a few providers. Together with the proprietary data of the institution, the security master data is cleansed, compared, quality assured and enters a trusted repository. Subsequently, any risk or compliance system converges into one trusted source in order to create a trade, conduct risk analysis or respond to a regulatory need.

**Trusted Source**

The creation of a trusted source of data, according to Meriton, represents a fundamental shift in how companies manage their data. “They are putting it to the forefront before they execute and make management decisions,” he says. “They are constructing EDM platforms inside their firms. In addition to security master data, customer data, counterparty data, transaction data and position data equate to over 90 per cent of the data you need to power any major system in an organisation today, whether you are a global bank or global investment manager. If you can control that information upfront you have fulfilled the first major step towards integrating your business at a data level.”

The EDM concept is still hot-off-the-press and it is currently being invoked at the major securities firms. In the last six months, financial institutions have moved from an early adopter phase to mass adopters of EDM solutions.

**Organisation**

As an EDM solutions provider, GoldenSource is seeing firms not only implementing EDM platforms but also organising their businesses to support it. “One of the other strong indications of an industry going through transformation is evident in the creation of new types of positions within certain companies that never existed before,” says Meriton. “Global banks have created the data management office (DMO), which is headed up by a Chief Data Officer (CDO). This office has acquired its own staff because the firm has recognised that data is a key asset in determining how the business is run. Accordingly, the firm realises it should staff and give organisational priority to constructing a data management office that in turn becomes a service and a data utility to the rest of the bank.” In fact, a total EDM strategy for financial services companies includes both implementing EDM platforms and leveraging third party Managed Data Services (MDS). Providers such as SunGard are on the leading edge of offering this type of EDM service as the industry recognises that certain public data is better distributed by an MDS.

“EDM, Meriton says that global banks face dire consequences if they neglect it. “Like most things in life, all parties tend to respond better to pain than they do to opportunity,” he says. “The risk of penalties that could apply as a result of the damage to their brand is substantial.”

But these penalties are not isolated to large global banks. Japan’s Aozora Bank, for example, endured difficult market conditions during the 1990s. After being acquired, the bank was renamed Aozora and implemented an ambitious growth strategy. “Aozora’s CIO and CFO are firm believers in establishing a sound EDM environment as the foundation for growth and acquisitions,” says Meriton. “If you acquire businesses that can’t control their data, you run the risk of incurring costs, poor customer service and losing visibility and control of your overall parent company business.”

Aozora has recently gone live on the first leg of the GoldenSource platform, known as GoldenSource Counterparties. Aozora has six different counterparty masters, a dozen different customer masters and security data provided by Reuters and Bloomberg. “They have recognised they should get their house in order first before they can go about the business of driving the bank into new markets,” says Meriton.

Apart from Aozora, GoldenSource has also signed several top ranked global banks, including a recently signed license agreement with the global corporate investment bank, markets and securities services divisions of one of the largest banking and financial services organisations. “These divisions are standardising their data management infrastructure on the GoldenSource EDM suite,” says Meriton. “No matter what size of bank, these firms all have the same data issues.

**Regulation**

Central to the idea of reference data management is regulation. And, in the last few months, the most significant piece of regulation to impact data management is MiFID. MiFID has brought two significant EDM issues to the fore. Firstly, firms should be able to document best execution and publish proof of their trading and instrument pricing. “This requires an EDM platform to standardise a firm’s transactional and reference data so that you can report to your trading partners the fact that you’ve executed according to best practices. MiFID presents banks with an opportunity to conduct interbank trading for a large block trade in order to fulfill customer demand. It requires that a high bar of proving the documentation of best execution be established. “The connection with EDM is that EDM is not just reference data,” says Meriton.

“EDM refers to reference and transaction data management. Reference data relates to security master, pricing and corporate actions. Counterparty master and customer master data also represent core reference data pieces. The
use of core reference data enables you to construct a transaction. A trade consists of a customer, a product and a counterparty. EDM also allows firms to aggregate their positions and transactions data in real time across all lines of business. The siloed view of exposure by product lines such as equities, fixed income, money markets, derivatives, etc. gets consolidated into a real-time positions master that can transform silo risk systems into enterprise risk systems accessing real-time EDM positions data.

MiFID requires that firms document their intrabank and inter-bank trading. The directive also says that if banks are trading outside or inside of their own organisation, they should report this and demonstrate best execution. Pricing data should also be reported and individual transactions be documented.

“With EDM you can construct reference data by indicating the venue in which the trade occurred and the counterparty you transacted with,” says Meriton.

By employing EDM, banks are becoming their own internal exchanges and have to report on their transactions. MiFID provides banks with an opportunity to trade without the use of an exchange, provided they abide by the standards for capturing information.

Banks within the European Union are directly impacted by MiFID. “Inside the rush of EDM, MiFID has created an incentive for banks that must now have an EDM platform in place, whether it’s GoldenSource, or whether it is built in-house. It adds to the growing list of regulatory issues, including Basel, know-your customer and Sarbanes Oxley. They require financial statements to be backed up all the way to the source transaction so that when the CIO and CEO statements are tied to real information, data is at the heart of every regulatory or compliance issue.”

According to Meriton, events such as Sibos will show financial institutions that their data management development does not end with reference data. “Data management transcends through the full awareness of all forms of data that are underlying all institutions, including transactions and position data,” he says. “Having the security master only is not good enough. You should also carry the promise of managing customer data, counterparty data, transaction data and position data because all five forms of that data together enables you to manage your company as an integrated institution.

“The EDM council proves that the data management issue is more than reference data. The number one theme is that it has grown beyond reference data and if you want to respond to MiFID you should have your transaction & positions data under control. Similarly, if you want to respond to Basel 2 you should have your position and exposure data for maintaining the appropriate capital in your firm under control. These issues are much more expansive than reference data management.”

“[If you acquire businesses that can’t control their data, you run the risk of incurring costs, poor customer service and losing visibility and control of your overall parent company business]”

Michael Meriton
President & CEO - GoldenSource

With more than 20 years of experience in business management, software development, strategic partnerships, and corporate start-ups Meriton is responsible for the strategic vision, overall management and business leadership of GoldenSource Corporation.

Meriton is charged with executing the company’s aggressive vision - “To be the leader in Enterprise Data management (EDM) by providing software solutions that enable financial services companies to consolidate company data at an enterprise level to gain a substantial competitive advantage.” Executing this vision includes continual innovation of the company’s products and services, accelerating new product time-to-market and reducing implementation time.

Prior to joining GoldenSource, Meriton served as President of CheckFree’s Financial and Compliance Solutions (CFACS) where he led the launch of MissingMoney.com.

During his tenure, CFACS’ revenues grew by 30 per cent. In 1997, Meriton founded JGI/BAAN a successful Mid-market systems integration company generating $12 million in revenue within one year. Meriton has served in multiple successful executive roles at Dun & Bradstreet Corporation, Oracle and Automatic Data Processing (ADP). Meriton is also a member of the GoldenSource Board of Directors.
Apart from satisfying regulatory demands, proper data management could yield a return on investment for financial institutions, says Ger Rosenkamp.

Managing Data

The New Wave

Firms in the asset management industry have largely recognised the need for a strategic approach to data management. A recent A-Team Consulting study, sponsored by Reuters, found that an overwhelming majority of firms are committed to strategic data management, though many are still evaluating how to execute it. Another A-Team study, sponsored by SunGard, found that more than 90 per cent of respondents would consider outsourcing as a solution for managing the many sources and volume of data necessary for investment research, portfolio management and customer service.

Considering the Options

The responses to these studies indicate a huge shift in attitudes regarding the handling of reference data. A decade ago, the criticality of data management was recognised by analysts and other direct users, but was hardly on the radar screen of senior management.

When Asset Control first entered this realm as a vendor of centralised data management software, its selling process usually involved days of explaining to IT and business executives why a centralised approach could reduce costs, improve efficiency and cut risk in their firms. Today, subsequent to the increasing awareness of STP issues and the burgeoning list of data-hungry regulatory reporting standards such as know-your-counterparty, Basel 2 and new accounting and tax standards, the importance of data and its supporting architecture are well understood.

The open-mindedness to outsourcing is similarly a relatively new concept. In financial services of all stripes, data analysis is typically viewed as a proprietary advantage and something to be held closely. However, with increasing requirements for data access, data integrity and the ability to link multiple data categories for reporting efforts – i.e. linking counterparties, credit ratings, legal hierarchies, prices and investment data for counterparty credit risk – the related investments in data cleansing and integration can seem daunting, but virtually mandatory. Outsourcing part or all of this work becomes more attractive.

The question, of course, is whether or not to allow this crucial operational element to be managed outside an organisation’s four walls? And if it is, what will be done about the proprietary elements that carry exceptional ROI in terms of competitive advantage or strategic initiatives, compared to the standard cleansing and integration of commodity data obtained from vendors or other third-party sources?

To find an answer, it may be useful to compare common features and benefits of in-house versus standard outsourced data management. The list (PG 31) assumes that both solutions offer similar quality of processing and output: The list clarifies the obvious answer. The optimal architecture is a combination of in-house and outsourced data management. Outsourced data management makes economic sense, offers the opportunity to centralise acquisition and integration, and is also likely to be completely up-to-date in scope of services and support of industry standards. This is an attractive value proposition, especially when the data and its management are not related to highly proprietary issues. The great majority of costs and effort related to handling investment-related data falls into this category.

Best of Both

A hybrid data architecture merges the benefits of in-house and outsourced data management. For firms that are pursuing a strategic approach to data management – that is, centralising control and standardising data across the firm for users and applications – a hybrid solution can be implemented in stages. This enables existing data silos to be phased into the centralised environment without the risk of a “big bang” conversion.

This article began with a discussion of...
The gathering, cleansing, consolidation and maintenance of this data is basic housekeeping work that is conducted by every financial institution that uses it. To share these costs and efforts with other firms through an outsourcing service makes economic sense, and it also relieves the firm of a significant operational burden that ultimately provides only baseline capacity to conduct business. Likewise, shifting vendor management to an outside firm can relieve administrative burdens, and convert a tangle of incoming feeds to a single “golden copy” set delivered to applications, an internal network or internal data hub.

The ultimate foundation of a fully centralised data architecture, however, depends on in-house capability. There is no question that the more that is outsourced, the more money that is saved. However, the inclusion of a sophisticated in-house data hub supports a broad range of benefits in immediate efficiencies, in long-term capacity to grow, and in time-critical agility to meet emerging business challenges.

In viewing the need for an internal system for proprietary activity, the definition of “proprietary” data and its management equates to financial, competitive or strategic significance. In other words, this may be data that originates in internal systems, such as definitions of structured investments or internally generated credit ratings. It may be internally developed processes such as custom or ad hoc analytics for risk, advanced trading or ratings. It may be internally developed processes such as custom or ad hoc analytics for risk, advanced trading or ratings. It may be internally developed processes such as custom or ad hoc analytics for risk, advanced trading or ratings. It may be internally developed processes such as custom or ad hoc analytics for risk, advanced trading or ratings.

Beyond these existing elements, it also includes development capacity that will quickly accommodate new sources or reporting requirements, on-the-fly research in response to market changes, specialised output for downstream systems, and the creation of new applications, products or services and even user applications based on the managed data. With this flexibility available in-house, linked to outsourced management of standard data operations, the firm can be supported by truly strategic data architecture.

Criteria for Success

It is easy to envision this ideal strategic architecture for data management. Finding the right components and navigating the internal issues is more challenging. From our experience with clients, including those that are now moving toward hybrid solutions, we offer the following suggestions:

Seek simplicity – All efficiency and cost benefits of improved data management result from simplifying the data architecture. In-house and outsourced systems should operate on the same standards and, to the extent possible, mirror each other in methodologies and processes. More consistency equates to less integration effort, as well as more freedom to shift components of the data universe from in-house to outsourcing or vice versa with minimal effort.

Begin where the ROI is the greatest – When establishing a hybrid data environment, it makes no difference whether the first step is to establish the outsourcing relationship or to implement a centralised internal environment. The money saved from outsourcing can fund the upgraded in-house system. Alternately the efficiency and strategic benefits of an advanced in-house platform can facilitate the shift of standard data handling to the outsourced service. As long as the two solutions are fully integrated, the extension is natural and relatively simple.

Create a single and consistent view – The benefits of standardisation, “golden copy,” enterprise consistency and all the other buzz words attached to data management all come down to the concept of creating a single view of the data that can be accessed and shared by everyone. A single view is easier to create and maintain earlier in the data process chain, cleansing and integrating data as it arrives from sources, rather than attempting to reconcile the disparate views of independent data silos. It may be initially challenging to enforce a single view across the various constituencies and fiefdoms of even a mid-sized firm. But to the extent it can be done, a major advance in operational coherency is the reward – in STP, in front-to-back-office integration, in every kind of risk analysis.

Select providers that share your vision – This is an obvious bit of advice, but one that is sometimes forgotten in rigors of the procurement process. Data, while a constant in business operations, is also a fluid element. What is needed, how it is handled, industry standards and departmental requirements will change, and in fact need to change as fast as the markets and your organisational business imperatives do. Make sure that you and your vendors have a similar vision of the future, or at least how to adapt to it.

The ideal architecture is possible, practical and available today. The availability of integrated in-house and outsourced solutions can simplify your decision processes and your implementations. The important thing to remember is that in-house or outsourced is not an all-or-nothing decision. The best solution with the greatest ROI may incorporate both options.

Ger Rosenkamp is CEO of Asset Control.
Emerging trends such as offshoring have significantly impacted securities services providers as they report increasing interest from their clients for component-based services. ISJ speaks to the securities services experts about the direction in which they see the market moving.

Sid Khanna, Partner, Accenture:

In addition to developing markets, companies are also taking advantage of the developed markets (such as UK and US) to outsource their technology-related functions...

At the advent of technology outsourcing in the late 1980s, only local service providers were used for service delivery, either onsite at client premises or offsite at the service provider’s own premises in the same location as the client. The main drivers of technology outsourcing at this point in time were productivity improvements, better levels of service provision and a re-focus on core competencies. In recent years, with the aggressive improvements in IT infrastructure communications and branding of India as an offshore location for technology outsourcing, India (as well as other remote sites) has become a key consideration for any technology outsourcing arrangement due to the additional benefits achieved through access to a flexible resource pool of large numbers of highly skilled resources at low costs. The key question therefore for financial organisations is not one of onshore versus offshore but of determining the optimum mix of both onshore and offshore resources to deliver high performance. From a strategic perspective, organisations cannot deliver optimal results to support the business by exclusively following one path. Obtaining the appropriate balance of work distribution between onshore and offshore locations requires in-depth analysis of factors such as risks, costs, proximity to the business and users as well as do-ability. Accenture’s approach for determining the optimum mix is obtained by developing a series of ‘Readiness Indicators’ based on the application portfolio and assessment criteria. The distribution of work will inevitably vary depending on client, deal shape and particularly over the execution lifecycle of the various work activities and packages. For example, in Accenture’s experience, typically in the area of Application Maintenance, 70 per cent to 80 per cent of work can be offshored. Using Accenture’s approach to determine the right onshore/offshore mix, our clients have been able to improve productivity, mitigate risk and substantially lower the cost of delivery. With more than 40 delivery centres in strategic locations worldwide (including India, the UK and the US) we are able to offer our clients 24/7 coverage and access to the right skills at the right time. This allows for seamless integration between the client’s organisation and Accenture’s skilled staff, IT development and maintenance tools, capabilities and delivery centres.

Robin Kneale, Product Manager, ADP Wilco:

Technology outsourcing has varied in recent years, from white-labelled technology, to internally implementations or full outsourcing to an external vendor. Which of these will emerge as overall winner?

There is nothing new or innovative about outsourcing. Goods and services have to be manufactured and delivered to customers and go through many steps in the process. Is it more cost effective to achieve this through a vertically integrated business or by sub-contracting (outsourcing) steps in the process chain to specialist suppliers who can bring economies of scale and specialist expertise? Financial Services is a highly fragmented market with thousands of institutions supplying millions of end customers. It is self evident that in many instances there will be a place for “outsourcing”.

The “outsourcers” may in turn outsource!

It is in the laps of the “outsourcers”, which include many financial firms, to put together service packages that mix together hardware, application and operational outsourcing to create value for their customers whilst ensuring service and managing risk. Neither the outsourcers nor their potential clients should under-estimate the scale of the investments required to deliver truly scaleable solutions, and it is through scale that most of the outsourcers hope to improve their own margins. It is perhaps worth mentioning that the “outsourcers” may in turn outsource!

There is unlikely to be a unique or dominant solution to the outsourcing story so long as the financial services industry itself remains so diverse with so many players operating in different ways in different geographies in varied regulatory, legal and tax regimes.

To give a simple example sales tax, VAT in the European context, has a major impact on the economics of outsourcing to financial institutions who may in turn only be able to offset a part of this cost of supply against their sales to end clients. Consolidation and harmonisation in financial services generally will certainly be accompanied by consolidation in outsourcing providers, but this will be a slow process.
Cross-data integration and transparency of process are two trends emerging from new regulatory mandates. These challenges are driving new investments in data management technology. Emerging regulations demand finer granularity of detail in reporting. Data for these reports are drawn from various sources including internal and external sources and cover all asset classes and data types. If these data parts are not linked together in a common format, then generating these reports is operationally expensive and time-consuming, if not impossible. Many firms see operational efficiencies in doing cross-data integration earlier in the process chain to create efficiencies for the entire firm. With a centralised approach to data consolidation, they can standardise formats and establish consistency across many front, middle and back office applications. In addition, a centralised data environment offers a host of other benefits, including streamlined STP processes, increased application design timeliness and productivity, lower ownership costs, overall resilience to business threats and even profit opportunities. Transparency is a similar issue.

The validity of the reporting data must be defensible. The regulators are increasingly interested in the sources of data and the various types of manipulation it has been subjected to, including cleansing and consolidation protocols. This scrutiny, in particular, is related to counterparty and credit data, where failures to track a firm’s ownership structure have been linked to massive investment losses. The auditability of all investment-related data content is rapidly evolving from nice-to-have to a standard operational requirement, offering another compelling argument for a centralised data management approach.

By implementing verification, consolidation and cleansing protocols as early as possible in the data-processing lifecycle, the audit trails are simplified. A state-of-the-art data management platform will supply GUI-based functionality for not only drill-down audits, but also configuration of protocols and cross-data research into specific histories of suspect or altered data. Financial firms are facing increased stringency in the demands by regulators for auditable data and linked data. These demands present challenges to existing data management structures and are driving investment in more sophisticated and centralised data management environments.

The most successful outsourcing relationships are those where provider and client work closely together. A larger company with more relationships to maintain can lose this capability. However, there is a limit on how small providers can be. Any third party alternative has to deliver at least the same level of quality. Bigger does not mean more beautiful.

A number of financial institutions have reversed outsourcing decisions because providers have fallen foul of not meeting expectations in quality of service. It’s easy to be seduced by the statistics of an outsourced IT helpdesk function, for example, the number of calls handled per helpdesk operator. But if the business is bypassing the helpdesk due to lack of confidence in the service provided, you have a problem and one that you’ve paid for – remember, cost saving can be only one dimension of the decision-making process. Can a small company provide a higher-quality service, or is scalability paramount - small versus large? If you look at the investment management industry, companies tend to be smaller than their larger cousins in investment banking and custody and demand a personal, specialised service from outsourcers. As this service was provided by an in-house function, any third party alternative has to deliver at least the same level of quality. Bigger does not mean more beautiful.
What are the benefits of outsourcing financial technology functions to low cost locations and what types of post-trade / pre-settlement functions are normally outsourced to where?

Henry Raschen, Head of Market Strategy, Europe, HSBC Securities Services:

The term “low cost locations” for financial technology outsourcing has in recent years mainly come to mean East Asia, but within the UK in past decades there has been plenty of movement by banks of such financial technology to lower cost centres outside London.

Examples dating back over the years are Lloyds in Bristol, Midland (now HSBC) in Sheffield and JP Morgan in Bournemouth. Similarly, aggregation of specialist skills led to outsourcing to third party providers where in-house IT development resources could be used for greater added value. A particular example here is the outsourcing of proxy voting service provision by custodians, who appreciated that a specialised company with vast low-unit-cost processing resources in a US-based but way out-of-town facility could provide a lower cost and lower risk proxy-voting solution than the custodians could themselves in expensive City of London premises.

The main benefits of offshoring occur now through lower costs, timezone flexibility, and scaleability. Many core custody operations within settlements, income collection and corporate actions can be offshored. Thanks to technology, a high-volume process that can be “STP-ed” in the UK can be STP-ed anywhere. However, it is important to distinguish between service outsourcing in this instance, and captive offshoring.

With captive offshoring, savings are made, with the extra benefit that the offshored unit is retained within the business and managed as part of the “home” business.

Local management is crucial in ensuring service and resourcing levels are to standard, but offshore employees are part of the business and feel they belong, as they should in any overseas branch or subsidiary.

Specific destinations for captive offshoring have been driven to a large extent by the potential of large numbers of highly educated English- and Chinese-speaking personnel in East Asia, notably in Malaysia, India, the Philippines and China.

Further drivers for HSBC Group in the region have been strong local presence and brand recognition.

Would you describe technology outsourcing as “location-specific”? Are financial institutions in certain areas keener to outsource their IT functions than those in other areas?

Martin Cotteril, Associate, Latham & Watkins:

There are certainly differences in the maturity of the outsourcing market in different countries which heavily influences an organisation’s readiness to outsource their IT functions. Ultimately it is all a question of balance between operational risk versus benefit.

It is the outcome of this analysis that ultimately drives a decision to outsource or not. Geography is merely one in a list of risks that exist and, these days, it is not as high up that list as it once was. Consider the explosion in offshore IT outsourcing deals to locations such as India. Financial institutions have lead the charge with multi-sourcing strategies that encompass significant offshore elements.

However, it is not sufficient to consider “IT” in a single lump, there are nuances that exist that drive their own trends. For example, the most prolific area for offshore outsourcing is application development work. After all you can negotiate a deal today with suppliers in India who operate at CMM Level 5, farm work out to two (keeping healthy competition to drive competitive cost benefits) and slash your development costs.

If you compare the time and cost involved in trying to raise your own internal development shop’s capability, the offshore alternative becomes compelling. This type of multi-sourcing strategy is being repeated across financial institutions worldwide.

It is these nuances that also drive contrary trends in other areas of IT. For example, many organisations outsource their data centres because of the cost benefits achieved when retained costs are converted to a consumption based cost, but very few of these deals are placed offshore due to a combination of increased geopolitical risk, limited expertise and limited productivity gains over near-shore alternatives that drive the resulting analysis in favour of risks outweighing benefits.

As you look at each area of IT, similar trends emerge but all of these trends ultimately are driven from the basic risk analysis. As we have seen with many areas of IT already, IT outsourcing is becoming much less location specific as maturity and capability in different markets increases. Outsourcing is a true global economy and very few parts of an organisation’s IT is sacred any more.
Letting go. In an IT outsourcing relationship, how can a client be assured the functions they have outsourced are carried out in an appropriate fashion without having to get too involved once they have outsourced? How is that balance achieved?

Frank Foy, Vice President and UK Head of Outsourcing, Capgemini:

Outsourcing is the fastest growing sector of the IT services market, and has evolved to the extent that companies now outsource activities that were once the preserve of in-house operations. Specialist third party providers free their clients to focus on strategy. Clients jointly agree key performance indicators for the service and for ongoing improvements with their outsourcing partner, and ensure that the service meets the needs of the business. They don’t have to get involved in the day-to-day operations.

To achieve this outcome, it is essential that clients and their partners have the right relationship, contract and commercial partnership from the outset - at the very beginning of the decision to outsource. Customers should begin building relationships with partners during the procurement exercise. This is the first opportunity to match cultural and delivery requirements with those of a service provider.

By jointly identifying and resolving issues during negotiations, before the start of a new contract, the relationship is genuinely focused on working towards shared objectives. In order to move from contract to a successful long-term relationship, the goals, working relationship and principles for operating need to be clearly defined in a governance model. This defines the governance structure to steer ongoing delivery of services, and it is a guide for all concerned with the service, from the joint partnership board, to management, users and service delivery operations teams. A clear framework for effective communication helps build trust, and ensures early notification of issues and suggested resolutions.

With a clear business case for creating value from business processes and IT, and a relationship based on shared objectives and effective governance, clients are able to focus on their business strategy, and benefit from improved service and better value for money.

Getting it right is not so much letting go, as gaining control.
Hedge funds have traditionally been available to only the most sophisticated of investors. But five years of half decent returns mean that pressure to extend their availability down the retail scale is increasing. As various countries try to legislate to create retail hedge fund markets, somewhat inevitably the talk has turned to whether hedge funds should be domiciled, as well as managed, onshore.

Indeed the traditional home for hedge funds is the Caribbean. The first hedge funds created in the 1960s by US lawyers needed to be placed offshore in view of their inherently risky investment process. When London lawyers began to look at hedge funds in the 1980s then they too turned to the Caribbean centres as there already existed a pool of expertise. In so far as hedge funds have been available only to the most sophisticated investors then this structure has worked. The regulatory demands of the Cayman Islands or Bermuda were seen as adequate for investors who could more or less take care of themselves.

The administration and fund servicing would be carried out closer to home in centres that were still offshore and therefore tax exempt, but that were sufficiently well regulated for investor comfort. Management of the funds would take place in a major financial centre like London where the manager and the prime broker would be situated.

For the most part this situation has suited everyone. But now that demand from pension funds and other retail type investors mean that national regulators must at least consider how they could make hedge funds more widely available and the way that the whole industry operated is being called into question. But it is not a case of whether a parallel universe of hedge funds sold and domiciled onshore should be created, but rather whether the Caribbean is just a bit too far and a bit too risky for the new breed of ‘retail’ hedge funds to be domiciled.

New hedge fund investors have significantly different product demands and return expectations. They want hedge funds to have robust business models with higher standards for overall management, operation and client service. For these clients then the middle way increasingly being considered is for the offshore centres that have built up a specialistism in the servicing aspect of hedge funds, now also to be an appropriate domicile too.

Frederic Perard, head of global fund services products at BNP Paribas explains: “The previous model would be that the domicile would be in Cayman and then the outsourced administrative work done in Luxembourg and Dublin. But now that the funds themselves are more complex and the potential audience is much wider then there becomes a compelling case of having a domicile that is closer to the end investor.”

He thinks that the structures in place in the Caribbean are not as developed or as sophisticated as they could be and that hedge funds available to retail or institutional investors would have greater demands placed on them from local regulators when it comes to accounting and reporting.

There is also the comfort factor to consider. Pension funds investing in hedge funds need to be certain that their money is being invested according to defined investment criteria and that reporting standards are sufficient, timely and transparent.

And places like Dublin, the Channel Islands and Luxembourg seem ideally placed to benefit. All have developed over the years a deep pool of expertise in all aspects of financial services and crucially...

Central Perk

“it is not a case of whether a parallel universe of hedge funds sold and domiciled onshore should be created, but rather whether the Caribbean is just a bit too far and a bit too risky for the new breed of ‘retail’ hedge funds to be domiciled”
Contenders

One such case in point is the qualified investor regime in Guernsey. Like similar regimes in other jurisdictions the aim has been to ensure that new investment vehicles are not over regulated. By placing the burden of compliance and due diligence onto the administrator, funds can be swiftly and easily set up there. In this way the Island’s fund services providers have assumed greater responsibility as far as regulation is concerned and in doing so are building up a compelling case for the scope of functions that they deal with to be increased.

But Dublin is perhaps the main contender. It has built up a formidable reputation in the hedge funds services arena and could well become more than just a bridgehead for Cayman domiciled funds even if it is currently capturing only a small percentage of business.

David Aldrich, head of Securities Industry Banking at the Bank of New York in Europe comments: “The Irish regulator puts additional onus on the service providers. A trustee is needed for Irish domiciled funds and the trustee has an obligation to oversee the other custodians. The prime broker must be appointed as one of the sub-custodians of the trustee, which entails regulatory oversight of the prime broker’s activities. This obviously takes more work than simply having a Cayman domicile and in turn that means a cost overhead implication for the fund itself should an European Economic Area domicile be chosen.”

And Sean Parceir, managing director at BBH, Dublin adds: “Broadly, moves to regulate hedge funds involve transparent record keeping and the ability to demonstrate to the eyes of a third party that all is well as far as administration, reconciliation and prime brokerage are concerned. The Dublin regulator requires a greater degree of interaction between all the various functions and so on that level a product based in Dublin is more likely to satisfy the requirements of a hedge fund geared towards a wider audience.”

In the UK as well the authorities are now looking at where investment decisions are actually made and this may be one of the leading factors in future funds being domiciled closer to home. The issue here is that funds domiciled offshore do not attract tax. But to retain an offshore domicile then certain decisions regarding investment strategy have to be made outside of the UK.

“New hedge fund investors have significantly different product demands and return expectations”

Location

Gavin Farrell, partner at Ozannes law firm in Guernsey, says: “Sometimes where the domicile is in Cayman but in reality the fund and decisions about it are not actually taken there with board meetings happening in various locations globally rather than everyone flying out to Cayman. If that is happening then it’s hard to prove that for tax exemption purposes, decisions are not being taken in the UK.”

Farrell thinks that jurisdictions like Guernsey have much to offer in that they are only a short hop away, have an existing qualified investor regime set up specifically to deal with more complex investment vehicles and have an existing pool of high quality industry professionals able to act as trustees to funds domiciled there.

Perard too thinks that logistics alone present a good case for bringing some hedge funds closer to home. “On the liability side of things the transfer agent is generally in Luxembourg and so it is easier if the domicile is there as well, that way the same contacts and so forth can be used. And from a Know-Your-Customer point of view it is also easier to monitor who is investing in the fund if all that
Hedge Fund Domiciles

A recent report undertaken by the Bank of New York found that although to date the majority of hedge fund investors are endowments and foundations, that future inflows from defined benefit plans and other institutional investors will increase from $60bn to $300bn within five years. The Bank says that this new category of investor will soon account for more than 50 per cent of annual net flows into hedge funds and that funds of hedge funds will attract over half of this capital. As a consequence the report found that inflows into long-only investments from this group could shrink.

Choice
But will any of this actually add up to a significant swing to a domicile closer to a fund’s actual investors? Industry commentators for the most part cannot see any significant flow of domicile out of the traditional Caribbean centres to European ones.

Simon Bleeson, partner in the regulatory group at Allen & Overy law firm thinks that the SEC is in the process of starting a trend towards indirect regulation by trying to look at the actual fund structure and building a way of regulating it. It is not just on the closer to home angle that Cayman and Bermuda may face flack. Another threat is the trend towards indirect regulation of the hedge fund by increasing rules surrounding the way that investment decisions are taken and who by. The current SEC initiative SPV governance, for example, enforces supervision at the prime broker level.

“From a Know-Your-Customer point of view it is also easier to monitor who is investing in the fund if all that sort of compliance activity is taking place in the same country” Simon Bleeson, partner in the regulatory group at Allen & Overy law firm

Another issue currently being dealt with is UCITS III that legislated for complex structures such as derivatives and OTC instruments. This happened in tandem with the increase in demand for such instruments to be used in hedge funds and has left many countries scrambling to support their use.

The automation of data flows between prime brokers and funds services providers is yet another concern.

“If invested in OTC instruments it is imperative to get independent pricing – the prime broker may be a price source or there may be a requirement to utilise a specialist price vendor, such as Reech Capital or Lombard Risk,” says Aldrich.

“Therefore there are three problems: the process flow, the instruments traded and the pricing/valuation requirements of the manager which combine to add complexity to the administrator’s role.”

The solution is provided through technology investment and investing in human capital, both of which are in short supply on the street,” says Aldrich.

Who will the new hedge fund investors be?

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AE
The British Virgin Islands is one of the world’s premier centres for international business. Besides its economic and political stability, it boasts a wealth of knowledgeable and innovative professionals, a modern, robust yet business-friendly regulatory regime, and an attractive commercial environment that is a one-stop-shop for both corporate and personal wealth management.

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• The introduction of a new Insolvency Act, which affords far greater protection and clarity to investors and creditors than is available elsewhere; and
• The enactment of a new corporate statute, the BVI Business Companies Act, an innovative, leading-edge piece of legislation that was crafted with the requirements of the international business community in mind.

To find out more about how the BVI will help you to protect, preserve and manage your (clients’) assets, contact:

Humphry Leue, Chief Operations Officer of the BVI International Finance Centre, at hleue@gov.vg or call us on +1 284 494 1509
Evolution or Revolution?

How has the shape of the cross-border fund administration market changed in recent years? Using annual research on market shares for all fund administrators in Luxembourg and Dublin, Ed Moisson offers unique insights into this area.

Luxembourg

Looking first at Luxembourg, as the world's largest centre for marketing funds across national borders, this is a key fund market for identifying broader trends in Europe and beyond.

Here the number of companies administering funds has seen a gradual consolidation since the end of 1997, falling from 101 to 76 companies by the end of 2003. However, the maintenance of the same number of administrators in 2003 and 2004 (76 companies) might indicate that such consolidation – in the administration arena – has reached a plateau for the time being.

For a closer look at activity in Luxembourg over 2004, Claude Hoffmann, Commercial Director at EFA, offers the following insights: "Luxembourg has not only reaffirmed its leadership role in the pan European distribution of UCITS products but also managed to successfully diversify to become an administration centre for alternative funds. For 2005 we anticipate that the trend towards consolidation at all levels of the industry will continue to be fostered by increasing regulatory and compliance requirements and a growing demand for sophisticated products."

Picking up on the growth in alternative investment funds, it is interesting to note that total assets for these funds (excluding funds of hedge funds) more than doubled to reach US$ 18.7 bn over the twelve months to 31 December 2004. Looking at which companies are administering these alternative investment funds, one finds that the five largest fund administrators of all funds in Luxembourg also dominate this more specialised area, together with State Street. It is worth noting that alternative investment funds only make up 1 per cent or 2 per cent of assets for all Luxembourg funds.

Dublin

In Dublin it is important also to consider non-domiciled funds serviced in the jurisdiction, which add more than 50 per cent of assets to this centre's fund servicing business. All funds domiciled in Dublin totalled US$ 503.3 bn as at 30 June 2004, but reached US$ 768.7 bn when non-domiciled funds under administration or custody were included.

A younger fund centre than Luxembourg, Dublin saw a steady growth in the number of companies administering funds from mid-1997 to mid-2002 (rising from 39 to 47). However, the slight consolidation reported over the two years to 30 June 2004 (with the number of administrators falling from 47 to 44), might indicate a growing maturity of the market. It will be interesting to see if this trend continues in Fitzrovia’s forthcoming annual analysis.

Product innovation has been identified in Dublin as an important aspect of the industry’s evolution, as in Luxembourg, with Michael Deasy of the IFSRA (Irish Financial Services Regulatory Authority) suggesting that “2004 has been a very interesting year from the perspective of new fund applications with the expansion of assets classes available to UCITS schemes under the new Directives and an increase in new innovative and more complex fund structures for professional and qualifying investor funds.”

Among administrators of alternative investment funds serviced in Dublin, the companies with largest total net assets include BISYS, CITCO, Fortis, Investors Bank & Trust, PFPC International and SEI Investments. Already it is being suggested that Dublin administers 20 per cent of the world’s hedge funds (quoted in Legal Week, 28 April 2005).

Fund Promoters

Approaching the same underlying data from a different angle, we can establish trends in the number of promoters of Luxembourg-domiciled funds. This is very useful for fund administrators in showing the number of potential clients in this market.

This analysis highlights the growing trend of consolidation in the industry over the past three years (through 2002 to the end of 2004), with a decline in the number of promoters.

We have also subdivided the total number of promoters into groups by assets under management. There is a declining dominance (by number) of smaller promoters in the industry: 424 (77 per cent) of promoters have less than US$ 1 bn in assets under management, while 124 (23 per cent) have over US$ 1 bn. However, the percentage share of smaller promoters is slowly declining (it was 85 per cent at the end of 1997).

Overall we can see that product innovation and regulatory changes continue to create opportunities in administration of cross-border European funds.

Ed Moisson is Head of Communications at Fitzrovia
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Are fund of hedge funds an effective panacea for institutional investors who look to the alternative funds space for improved returns? Correctnet’s Robert Miller investigates

**Fund of Funds: Tailor-made?**

Not so long ago, the guiding principle for institutional investors might have been: “do no harm.” But with so many traditional investment vehicles yielding minimal performance, and the reality of troubled - if not moribund - economic conditions, many institutional professionals are being forced to look elsewhere for better returns.

Increasingly, the performance and risk attributes of alternative investments have become more and more appealing to institutional investors willing to adopt a more liberal and flexible attitude toward risk. The fund of hedge funds (or FoF) represents a highly leveraged business model for alternative investments. It affords institutional investors access to the broadest range of asset exposures and strategies via a single trusted party who is charged with responsibility for hedge fund manager selection and due diligence research. As testament to this model’s appeal, it has directly and indirectly accounted for almost 50 per cent of the over USD $1 trillion currently invested in hedge funds.

**Options**

Several choices exist for the newly adventurous institutional investor. One might be the Real Estate Investment Trust, or REIT. Although several tax features of this investment - which establishes positions in income-producing properties and mortgage instruments - can be quite attractive, particularly with regard to US federal tax statutes, significant downsides can mitigate its usefulness. One is the standard practice of distributing 90 per cent or more of taxable income in the form of dividends to shareholders. This can dampen a REIT’s ability to exhibit growth with internal funding. Combine this with share price sensitivity to prevailing interest rates, and growth-oriented investors will often look elsewhere.

Though economic necessity has forced them to embrace a greater tolerance for risk, not many institutional investors will enter the private equity sphere. Though returns - with proper due diligence - can prove quite enticing, inherent illiquidity in this class of investment is often too great a barrier. Being locked into an investment for several years without the ability to unwind a position to limit losses is anathema to most institutions.

Of course, direct investing in hedge funds offers exposure to more volatility and greater freedom in terms of leverage, short selling, diversification, and other hedging strategies - and the associated potential for superior returns - than other, more conservative investment channels. However, putting to work the large amounts of capital at an institutional investor’s disposal has its own set of challenges. Direct investing would require the management of potentially dozens, if not hundreds, of hedge funds. Few institutions believe they have the internal talent and highly specialised resources to perform proper due diligence on individual hedge fund managers, which now number more than 8,000 worldwide.

**The Fund of Funds Value Proposition**

The core value proposition of fund of funds (FoF) managers to their investor pool consists of:

- The ability to provide accurate and detailed appraisal and insight regarding the historical and projected performance, investment philosophy, management talent, and business execution capabilities of individual hedge fund managers
- Allocating capital from investors to hedge fund managers in a manner consistent with each client’s overall investment goals and objectives
- Collecting raw data from each hedge fund manager,
enriching that data with commentary, performance metrics, and other meaningful and useful information, then aggregating and presenting it to investors so that each gains a clear understanding of their overall investment performance and risk profile.

In practice, FoF managers typically allocate investments among 40 to 80 hedge funds that range across a wide variety of asset classes and strategies, with another 50 to 100 funds monitored on their investment radar for possible future utilisation. Largely because of the enabling role FoF managers have played in providing critical investment insight and a means of channelling huge volumes of capital across thousands of individual hedge fund managers, approximately 50 per cent of hedge fund investments are placed by institutional investors, as opposed to roughly 20 per cent only five years ago (see graphic on previous page).

“The performance and risk attributes of alternative investments have become more and more appealing to institutional investors willing to adopt a more liberal and flexible attitude toward risk”

Operational Challenges
For FoF managers, anything that takes time away from their core competency of scouting and selecting hedge fund manager talent is at best an annoyance and at worst something that hurts their ability to attract investors. Certain paper-bound processes like subscription and redemption paperwork will not be replaced by electronic analogues anytime soon, at least for the next few years. But automation opportunities abound in areas like regulatory reporting and in client-friendly business processes such as advanced data aggregation and synthesis of raw hedge fund data, portfolio performance reporting, and statement generation. These processes, which represent significant value-added services to clients and prospects when run effectively, lie well outside the areas of expertise most FoF managers and their support staff can claim. They are therefore natural candidates for outsourcing.

Many FoF managers are investing in technologies and services that will allow them to parallel key operational aspects of the straight-through-processing solutions being implemented by many large financial institutions.

As it relates to transparency and reporting, institutional requirements are not arbitrary. Because they have their own internal and regulatory constituencies to appease, institutional investors demand and receive accommodations not afforded to smaller players. General transparency with respect to investment and hedge fund manager performance — with a considerable amount of on-demand reporting — is now considered de rigueur.

Winning the Business
The ability to attract significant institutional investment is based on the ability of the FoF to deliver the terms and transparency these investors have come to demand (retaining them, of course, will hinge on delivering the returns they seek). In return for huge amounts of investment capital, FoF managers grant shorter fund lockup periods, exit protections, and other accommodations. These trends will continue. FoF managers must make system infrastructure investments to satisfy the needs of institutional investors and differentiate themselves from competing asset management professionals. Their systems must deliver the following capabilities:

- Gather and store in a standardised and easily accessible manner an enormous amount of quantitative and qualitative data related to the hedge fund managers they actively invest in, as well as managers they may choose to work with in the future.
- Process data seamlessly in conjunction with a variety of performance, analytic, and allocation systems.
- Provide high-performance reporting and presentation tools (including decision support tools like management dashboard displays and drilldown report views) that enable FoF managers to sift through large amounts of data quickly, identify important trends, and support all phases of the investment decision-making process.
- Supply institutional-grade portfolio and performance reporting to their clientele.
- Offer comprehensive internal control, compliance, and exception processing functionality.
- Seamlessly integrate with core service providers like fund administrators and middle office systems.

With proper FoF system infrastructure in place and highly enriched portfolio data stored in a high-performance data management system, the final bells and whistles that close a contract can be added. Configurable investor reporting views via high-performance Web view interfaces, automated statement and PDF document generation, data extract "pulls" that can be loaded into Excel spreadsheets for ad hoc analysis and "what-if" scenario explorations…the list of potential value-added client services that the FoF manager can offer is long indeed. (See above graphic)

Allure
The allure of fund of funds to the institutional investor is undeniable:

- Relatively easy access to the wide diversity of asset classes and investment strategies available in the hedge fund universe, without the costs and human resource demands mandated by due diligence research.
- FoF managers offer specialised, dedicated, often peerless knowledge and management expertise in the hedge fund investment space.
- Risk/return profiles can be precisely tailored to match each investor’s goals and objectives, and managed dynamically by the FoF manager.
- The hedge fund universe has the capacity to absorb large amounts of investment capital.

When armed with support systems that enable cutting-edge data synthesis, investment decision-making, and client-side reporting and other services, FoF managers are poised to wrest an ever-increasing share of institutional investment funds away from other asset management professionals.

Robert Miller is the founding principal and CEO of Correctnet, Inc.
The IN & OUT Club

The outsourcing of back office operations of buy-side institutions to third-party administrators has led to a reduced demand for back office solutions from investment managers. Rekha Menon reports...

There is no doubt, outsourcing ranks among the most significant developments in the investment management space. Over the last few years, several leading buy-side firms have decided to outsource their back office operations to third-party administrators, mainly custodian banks such as State Street, Bank of New York and BNP Paribas. This has led to a reduced demand for back office solutions from the investment management community, notes Robert Harris, Business Development Manager at reconciliation and matching solutions vendor, City Networks. "A number of asset managers have already outsourced their back office solutions or are in the process of deciding about it. It is a very long decision making cycle and can take several years. A key focus is on third-party fund administrators," says Harris.

Kim Holloway, Global Sales Director at DST International, agrees. DSTi provides front to back investment management solutions, and over the last two years has seen the demand for its fund and investment accounting solution, HiPortfolio, coming more from custodians than asset managers. HiPortfolio is currently deployed by several leading custodians like JP Morgan, Mellon and BNP Paribas. Holloway says that DSTi has aligned its product strategies to the market dynamics. "Seeing that the trend of middle and back-office outsourcing is here to stay, DSTi is now focusing very strongly on front office products in the areas of decision support and compliance where the demand is very high from investment managers. Another area that is receiving a lot of attention of late from both investment managers and custodians is data management and we are seeing a very high demand for our investment data solution."

Demand

Indeed, with the back-office increasingly getting outsourced, regulatory pressures and performance pressures, the buy-side is directing technology investment towards the front-office. "Pension funds are demanding higher returns from the asset management industry as pension liabilities grow. In order to achieve this, fund managers must focus on two key areas - improving investment performance and reducing costs," explains Thomas Aubrey, investment management director at Thomson Financial. He says that for any solution to improve a fund manager’s performance, a critical element is to provide integrated content and applications to allow investors to make better decisions faster. Focusing on end user work flow is key to improving productivity and freeing up time to generate investment ideas, he adds.

Clare Vincent-Silk, consultant at investment management consulting firm, Investis agrees that the front-office is the hub of most action at investment management firms. "With the upcoming directives on pre-and post-trade transparency and problems of fragmented markets, we see order management systems becoming vital. They are incorporating pre-trade transaction cost analysis tools and automated trade execution capabilities". Although algorithmic trading and direct market access are areas that are receiving a lot of attention, Vincent-Silk is skeptical about the speed of adoption by traditional institutional buy-side firms. "Almost half of buy-side firms have not adopted FIX yet."

"I strongly believe that investment managers should focus on the production of alpha rather than on the technology side."

Kim Holloway

“A number of asset managers have already outsourced their back office”

Trends

Algorithmic trading is an area that is currently more sought out by hedge funds rather than by traditional investment managers, echoes Hugh Byrne, senior vice president at SunGard. He says that one of the main trends in the industry currently is the movement of traditional long-only investment managers into the hedge fund space. A survey commissioned last year by State Street to study the role of hedge funds in institutional investors' portfolios revealed that while nearly one-third of the global institutional investors responding to the survey already had a portion of their portfolios invested in hedge funds, a majority of the respondents intended to increase their holdings to 10 per cent or more over the next three years. Commenting on this trend, Byrne says, "We have to ensure our systems can support a wider variety of complex instruments, which were previously only utilised by hedge funds."

A survey conducted recently by Investit corroborates Byrne's point. Nearly 50 per cent of companies view fixed income as a key functional area for development in the year ahead. The Investit survey also revealed that while 14% of the respondent firms had in-house built front-office systems, the remaining 86 per cent of the respondents had bought front office systems from vendors. The KPMG report too points at a definite shift from 'build' of internal systems to 'buy' of packaged solutions and systems integration. With vendor solutions becoming more mature, asset managers are preferring to buy off-the-shelf solutions rather than develop solutions from scratch, says Vincent-Silk.

“I strongly believe that investment managers should focus on the production of alpha rather than on the technology side. Not only does it require a different kind of expertise, building solutions is very expensive and time consuming as well,” says Alberto Fontana, managing director of Financial Tradeware. Fontana should know. Financial Tradeware was set up in 1997 to provide software solutions to investment management firms owned by its parent company, Dharma Holdings. And only over the last two years has the firm moved to the Microsoft architecture .NET and started targeting small to medium sized investment managers, which are now responding very positively. But that was no longer the case. Mature solutions were available to meet the needs of all sizes of investment managers.

Thomas Aubrey of Thomson Financial says that software solution vendors need to develop strategic partnerships with clients to ensure that when an asset manager decides to buy rather than build a component for its business they can trust the supplier to provide a service which is built using open technology and can be easily integrated into their own systems. "Pension funds are demanding higher returns from the asset management industry as pension liabilities grow. In order to achieve this, fund managers must focus on two key areas - improving investment performance and reducing costs. Suppliers to the asset management industry must focus on these two aspects if they are to be successful," states Aubrey.
For a high performer, preparation is the antidote to pressure. To see how we can help your business become a high-performance business, visit accenture.com

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When writing about mermaids and seafarers, Danish storyteller Hans Christian Andersen will have probably overlooked the potential of his hometown as host to the biggest securities event of the year.

But the assembly of over 5000 people in Copenhagen in September will reinforce another of the City’s capabilities: host of Sibos 2005.

Following the cancellation of the Singapore chapter after 9/11, the organisers were committed to hosting the event in the Nordics as soon as possible and turned to SWIFT’s Scandinavian constituency to find the best location within an acceptable time frame.

The organisation opted for Copenhagen, where its premier event was held several years ago. “Scandinavia has always had a pretty good track record for Sibos attendance,” explains Patrick Neutjens, Director of Sibos. “We expect this year’s event to be in line with other European Sibos events, with between 5500 to 6000 people in attendance. It is still early days to predict the areas of highest attendance, but the best indication we have is in the exhibition.”

The actual exhibition at this year’s Sibos event is expected to be about 10 per cent larger than it was at Atlanta, Georgia last year. This appears to be a good indication that overall attendance will be high.

Demographics

In terms of attendee demographics, the breakdown will be similar to Sibos 2004. “Every year we see an increase in attendance from the securities industry,” says Neutjens. “The event has become more relevant for the securities industry and we are seeing attendance growth in this area, in terms of speakers, exhibitors and delegates. We expect this trend will continue.”

A third of the people in attendance at Sibos 2005 will be from the payments industry, close to a third will be from the securities industry and the rest will represent areas such as cash management, trade and e-commerce.

Last year’s Sibos marked the beginning of corporate attendance at the annual event, which spurred significant discussion in this area.

Neutjens elaborates: “Sibos 2004 attracted a number of corporates who today are participating in some of the SWIFT member administrative fund user groups, while others are currently using the SWIFT Network for some of their processing. We expect further discussion of this nature to be triggered this year.”

“We will run the programme again this year as it gives us the opportunity to communicate the SWIFT value proposition to the investment management community.”

The interest from corporates in Sibos has reached a peak and this sector is now a solid part of the conference. Although SWIFT is not yet in a position to formally invite the corporate sector to attend Sibos, it has a number of big members who selectively invite some of their corporates and treasurers to attend specific parts of Sibos, in order to be informed existing existing technology solutions. “Sibos is definitely an area of great interest, primarily to financial institutions, but increasingly to the specific corporates who are part of the current solutions and who are pushing for more and better solutions,” says Neutjens. “The latter group’s participation will be an interesting development going forward.”

The corporate sector has effected an attitudinal change as a result of attending Sibos. “There has been a change in awareness and expectations,” says Neutjens.

“The corporates know what is needed to reach the level of automation and efficiency they are looking to achieve in conjunction with their member banks.

“They are much more aware, in a SWIFT-related context, how automation and efficiency can evolve and develop in terms of standards and specific business solutions.”

Transformation

Sibos’ latest theme transformation picks up from where the securities and payments industries left off in Atlanta 2004. During a memorable keynote speech, JPMorgan’s Worldwide Securities Services CEO Heidi Miller spoke on behalf of the financial services industry and SWIFT members, highlighting a number of key challenges for both groups. Neutjens recalls some of the highlights: “Miller said that if we really put our heads together and our minds to it, there is a lot we can change and transform.

“She highlighted a number of challenges, which a few people put into practice in order to make transformation...
happen, to save the industry a lot of costs and to increase efficiency in a number of specific areas."

One of these areas relate to corporate banking, where a lot of opportunities exist. “These opportunities relate equally to the securities industry, which has rallied behind and committed to a number of initiatives,” says Neutjens.

Securities
Strategically, SWIFT is committed to providing comprehensive messaging solutions for its customers in the securities industry. At Sibos, the utility will focus on the areas of asset servicing, investment funds distribution and front office trading – all areas where SWIFT has solutions to provide customers with end-to-end automation in transaction processing.

Corporate actions
“There has been an increasing interest in and take up of corporate actions messages over SWIFTNet in the last year,” says Susan Burrage, marketing communications specialist – securities, SWIFT.

“Corporate action messages were the fastest growing securities traffic on SWIFTNet FIN, with the London Stock Exchange adopting ISO 15022 messages to distribute corporate action notifications. Singapore and Tokyo stock exchanges are expected to follow in 2005.

Investment funds distribution
In recognition of the significant role investment managers play in the securities markets, SWIFT launched a two-day Investment Manager Forum at Sibos last year, with an agenda tailored to this target group.

“We will run the programme again this year as it gives us the opportunity to communicate the SWIFT value proposition to the investment community,” says Burrage. It has been well documented that manual processing costs funds institutions in excess of EURO 5bn annually and the fact that there is a strong case for automation, is not disputed.

At Sibos the funds players come together to debate how progress can be achieved and how SWIFT can facilitate the process of automation.

Front office trading
There will be a focus at Sibos on the development of electronic trading in the context of end to end operational efficiency. “Trading is an increasingly complex area and a lot of possibilities and solutions are entering this market space” says Burrage. “SWIFT customers want to be able to leverage their investment in SWIFTNet by taking advantage of additional services on top of the standard financial messaging. SWIFT can offer messaging services for the whole trade lifecycle and there are conference sessions and demonstrations at Sibos designed to give customers a view of what SWIFT can offer them.”

Networking
Apart from being a conduit for increasing automation across the securities industry, Sibos has prided itself on being a premier networking event for financial services institutions.

Neutjens explains: “The reason why so many people attend Sibos is it the one event where various industries can get together and network. They debate and openly discuss issues, opportunities and possibilities at the event.

“To highlight the importance of the securities industry at Sibos, the key representatives of this industry are present at the event and are part of the critical dialogue that takes place. This is how Sibos contributes to the evolution of the industry.

“Not all of the decisions are made here but a lot of the initiatives, possibilities and opportunities take shape and are carried forward.”

With increasing numbers expected at this year’s Sibos event, the networking opportunities and advancement of critical dialogue are certain to take place. Similarly, these criteria bode well for making transformation a reality.
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Copenhagen welcomes the 2005 Sibos event.
Transformation is this year’s theme.

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The world of securities lending is increasingly reliant on cash. **Brian Bollen** analyses the popularity of cash reinvesting in the industry.

Cash is king, the familiar mantra says. But is it? Yes and no is the answer, especially in the world of securities lending. “Cash is king because of its flexibility,” says John Arnesen, head of securities lending at The Bank of New York in London. “But with cash you have to reinvest.”

Indications from within the securities services industry are that the reinvestment of cash pledged as collateral is growing in importance as a method of increasing revenues from a portfolio of investments. That reinvestment, though, also presents new risks as well as new rewards, and the principal players in what has become an unusually conservative industry agree that it is important that the beneficial owners of assets being lent understand the credit, interest rate and liquidity risk they take on. They also agree on the importance of customising cash reinvestment portfolios to the specific risk appetite of individual clients.

**Flexibility**

Paul Wilson, Senior Vice President and head of Securities Lending and Investment Products for JPMorgan Worldwide Securities Services in Europe, the Middle East and Africa, highlights a number of issues, some new and some recurring. “As markets grow and spreads compress, collateral flexibility is becoming increasingly important in order to maintain historical returns. However, increased flexibility could mean increased risk and this needs to be considered in context of the client risk appetite and tolerance threshold. Given some of the spread compression, some lenders are pushing the risk and flexibility envelope a lot more aggressively than others.” Against this background, client education around the product and risk remain at the forefront for lenders, he insists.

“Risk versus reward continues to be the key discussion,” says Jacqui Waller, vice president, Securities Lending, Northern Trust (Europe). “How does the risk associated with accepting cash collateral lead to improved returns? Both parties, the lender and the borrower, benefit; depending on the underlying assets, a lender taking cash collateral can expect to get more on loan, plus make incremental investment income via cash reinvestment. The borrower has greater flexibility in the collateral that can be provided. Investing the necessary time to explain risk management processes and the cash reinvestment methodology is critical to successfully attuning the client to the benefits of cash collateral. Returns vary depending on the reinvestment vehicle, some will generate more returns but for more risk. Understanding the client’s attitude to risk is key.”

“Ask most US lenders what the largest part of their collateral pool is and they will tell you that it is cash,” says Mark Faulkner, chief executive of Spitalfields Advisors, increasingly cited as a source of solid data on securities lending activity and trends. “Ask lenders why this is the case and a typical reply may take one of three forms.”
Either; “it’s the safest form of collateral there is”; or “our regulators insist upon it and give us little practical leeway”; or perhaps “it’s what our agent advised us to.” To state generically that cash is the safest from of collateral is an over simplification to say the least, and naive at best, he argues. “While cash can be highly appropriate collateral, particularly when there is no foreign exchange risk, what you or your agent does with the cash can have a major impact on the relative performance and safety of this option.” Investors with unexciting portfolios who are not prepared to embrace cash reinvestment to a significant degree, thereby taking on additional duration and credit risk, will find that their agent lender might struggle to generate any significant return, adds his colleague Andy Dyson. “The role of cash can be crucial in overall returns, whether the collateral is special or general,” he says. “The key thing from a beneficial owner’s perspective is that risk isn’t necessarily a bad thing. But you have to know the risk, understand the risk, and get paid for the risk.”

**Indemnification**

For the most part, many lenders participate in an agency programme which offers a variety of indemnities against borrower default and collateral shortfall, continues Mark Faulkner. What might well surprise some less sophisticated investors is that these indemnities do not necessarily extend to cash reinvestment activities. For this reason it is vital that clients understand the risk that they are taking, but also because the availability of flexible collateral options will have a positive effect on the level of outstanding loan balances and earnings.

Agreements governing the reinvestment of cash collateral typically impose a contractual obligation to reinvest 100 per cent of clients’ cash on the day the cash is received and each day thereafter, he notes. “With respect to the returns on cash reinvestment this varies by lender and is dependent upon individual client investment guidelines and can range from a few basis points over Fed funds upwards.”

**Risk**

Paul Wilson identifies several main areas of risk. The first is credit risk or issuer default risk, the risk that the cash invested will be lost. The second is interest rate risk, the risk that a change in interest rates will result in a negative return relative to the rebates rate negotiated at the time of the securities lending transaction. The third is the gap risk, where the risk is that cash is invested for a longer duration than loans (which are typically recallable on demand) and that investments will need to be broken to satisfy the return of the cash collateral to the borrower.

“While both the lender and borrower benefit from cash reinvestment, all risks are borne by the securities-lending client, so how can they be managed?” he asks. “Creating investment criteria that are understood by the client and then utilising a vast array of resources that evaluate and assess credit and market risk on an ongoing basis is very important.”

“Is cash collateral the best? Cash collateral does offer greater flexibility and affords the lender potentially more loan opportunities and increased earnings. Typically the position in the US, which is far larger and more mature, affords far more collateral options and reinvestment opportunities. The more reinvestment options there are, the more lending opportunities there are. In Europe, cash collateral is typically limited to euros only, which has far less reinvestment options relative to the US. Australian dollars are also commonly taken as cash collateral. The industry is growing in importance as a method of increasing revenues from a portfolio of investments”

**Industry**

Meanwhile, a new breed of specialist cash reinvestment managers is growing up to service the industry’s demands, and certain institutions are building up a reputation around their style, philosophy and track record both in terms of risk management and returns. “Clients who have multiple lending relationships have asked us to manage the cash reinvestment across their entire book of business,” says Paul Wilson. “The best in the field tend to be the best because they have the depth and breadth in resources (credit and risk analysts) and the systems and people that understand the business and take a very consultative approach to the cash reinvestment business. Smaller boutiques, by contrast, often lack the breadth of cash collateral analysts, because it is very expensive to maintain the necessary level of investment in resources and proper fiduciary controls.”

**Debate**

There has always been a grand debate about cash versus securities in terms of taking collateral, says Tim Douglas, managing director, Global Head Securities Finance, Citigroup Global Transaction Services. “One general observation I would make is that cash has historically been more prevalent in the US than in Europe, where other forms of security were the preferred form of collateral. Cash is becoming a more common form of collateral as we see an increase in the willingness and desire of Europeans to take cash.”

One of the key issues that needs to be taken into account is the margining process, marking to market on both sides of the transaction, he continues. “The loaned asset and the pledged asset will broadly speaking move in the same direction, whereas short-term cash doesn’t move very far, if at all. If the loaned asset moves up, and cash doesn’t, more cash will be required to be posted. If you lend UK equities against sterling cash at 100 per cent, and the securities go up, more cash is needed. But if you lend UK equities...
against similar UK equities, and the market goes up, the two equities will broadly move in line with one another."

When cash is collateral, the question then arises: what are you going to invest it in? Cash gives greater flexibility and does not always lead to greater risk. If the lender has agreed the cash will be reinvested in an instrument with a longer term or different credit value than overnight deposits, returns could be significantly higher, explains Tim Douglas. "Cash very quickly becomes very appealing to some who have an appetite for additional risk. Securities lending offers them the opportunity to take modest amounts of additional risk and gain extra reward. The world opens up when you’re reinvesting cash collateral."

"As markets grow and spreads compress, collateral flexibility is becoming increasingly important in order to maintain historical returns"
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Analysis of the latest securities lending industry results from the Risk Management Association. A comparison of securities on loan in the first quarter of 2005 against the first quarter of 2004 & balances of securities on loan against cash as collateral.

US treasuries were the most active securities in the first quarter of this year. About USD$ 330.59 bn worth of US treasury securities were on loan during the first quarter of 2005, compared to USD$ 218.431 in the first quarter of 2004.

US equities were far more active than their Canadian counterparts. About USD$ 215.416 bn of US equities were on loan at the first quarter of 2005, compared to USD$ 163.624 bn during the first quarter of 2004. The value of Canadian equities on loan increased considerably over the year, from USD$ 2.49 bn during the first quarter of 2004 to USD$ 6.9 bn during the first quarter of 2005.

Within Europe, French equities were the most active asset class, increasing their assets on loan from USD$ 19.85 bn in the first quarter of 2004 to USD$ 27.36 bn in the first quarter of 2005. The least active European equities were Italian, with about USD$ 7.156 bn on loan in securities lending programmes. Scandinavian equities on loan increased substantially, from USD$ 7.804 bn in the first quarter of 2004, to USD$ 10.4bn in the first quarter of 2005.


The most active EURO denominated sovereign bonds for the first quarter of 2005 were German sovereign bonds, with a total of USD$ 3.845 bn of securities on loan. Eurobonds on the other hand, increased their involvement in securities lending from USD $9. 268bn in the first quarter of 2004 to USD $36.014 in the first quarter of 2005, impacted by the addition of foreign corporate bonds.
A summary of the securities lending industry, including top performing securities, at 25 May 2005.

Performance data is provided by Data Explorers;

The analysis begins with a snapshot of the top performing equities and bonds at 25 May 2005.

NetFlix Inc. (in Table 1) was the top performing equity at 25 May 2005 for equities that are greater than USD $10 million but smaller than USD 100 million.

Novostar Financial Inc (in Table 2) was the top performing equity at 25 May 2005 for equities that are greater than USD $100 million.

Calpine Corporation (in Table 3) was the top performing corporate stock at 25 May 2005 for corporate stocks that are greater than USD $10 million but smaller than USD 100 million.

General Motors (Table 4) was the top performing corporate stock at 25 May 2005 for corporate stocks that are greater than USD $100 million.

In summary the total balance of securities on loan at 25 May 2005 was USD$1.3 trillion, which is considerably higher than the figure of USD$1.2 trillion in the last analysis at 30 March 2005. The figure also compares favourably to the total number of lendable assets of USD $4.266 trillion. About 19.38 per cent of lendable assets were on loan at 25 May 2005. The securities lending fee for all securities at 25 May 2005 was 49.87 basis points.

In May 2005 the securities lending return to lendable assets ended at 6.84 basis points, after a lending tenure of 103 days.

In terms of utilisation, bonds have outstripped equities since February 2005. The utilisation rate for Lenders’ bonds at 25 May 2005 was 25.74 per cent of assets available for lending. The utilisation rate for Lenders’ equities at 25 May 2005 was 13.57 per cent of assets available for lending.
Hedge fund essay wins ISJ writing prize

Hedge funds - have attitudes towards risk changed or is the party over? This was one of a set of questions posed to students from over 200 business schools worldwide. The best answer, offered by Sara Grillo in just over 2,000 words, argued that regulatory developments and their effect on risk will be the catalyst that leads to the emergence of hedge funds as a prominent investment option amongst the investing public at large.

In March this year, Investor Services Journal launched the first integrated securities services essay competition to seek out tomorrow’s stars. The magazine invited any student of securities services to write 2000 words with the prize for the winning entry of US$2,000.

The Competition, sponsored by HSBC and Accenture, received entries from around the world, from Toronto to Lahore. Entrants included people who are currently studying full time and those who are enrolled in the securities industry and studying on a part-time basis.

The judging panel analysed the quality of the essays according to relevance, originality, content and organisation.

Winner Sara Grillo earned her Bachelor of Arts degree from Harvard University with honours. She is currently enrolled in a part-time M.B.A program at the New York University Stern School of Business.

Other high-scoring entrants include:

Jeremy Ghez (First Runner Up) - Topic: What role do you see “value-at-risk” playing in the investment industry? Jeremy is an economics major at the HEC School of Management (Paris, France). Miroslav Vassilev - Topic: Basel II is a Basel too far? Discuss the relative advantages and disadvantages of the New Capital Framework. Miroslav is a full-time student at Harvard University’s John F. Kennedy School of Government.

Investor Services Journal would like to thank everyone involved in the essay competition and looks forward to strengthening the event in the years to come.

Thanks are due to...

The Industry Judging Panel

Accenture - Kevin Hanley, Partner, Capital Markets Practice

HSBC Securities Services - Paul Stillabower, Head, Business Development

BNP Paribas Securities Services - Tony Solway, Head, UK

Citigroup Global Transaction Services - Giulio Di Cerbo, Managing Director, Head of Banks and Broker Dealers

JPMorgan - Mark Austin, Head of Strategy, Investor Services EMEA

State Street - Jeff Conway, Managing Director, Investor Services

Judges Comments on the Essays...

Kevin Hanley, Accenture:
"the winning essay really stood out from the pack on a number of counts; namely content, originality, relevance and organisation. It was a well structured, well researched, fact based essay that, perhaps most importantly, answered the question posed in the title. It was an informative, well paced read that expertly took a difficult topic and made it more accessible and understandable. All of the judging panel were unanimous in their praise of both the winning essay and the general quality of all of the essays submitted."

Paul Stillabower, HSBC Securities Services:
The whole concept was very refreshing from start to finish. We thought it was extremely worthwhile to engage young people - potential future professionals - in a thought process around the investor services business, since we are not the most visible, sexy part of financial services. The overall quality of the responses was very high, with strong analytical skills displayed, superb presentation and organisation and an interesting regional bias in the responses. For me, five essays stood out from the pack. In particular, the winning essay displayed some interesting insights to the question(s) posed, was especially well researched and flowed logically from start to finish. HSBC was delighted to support this process.

...and thanks especially to...

The Academic Advisory Panel

Professor Eva Liljeblom
HANKEN Swedish School of Economics and Business Administration

Professor Frank Kirwan
The University of Edinburgh Management School

Associate Professor Narayan Naik
London Business School

Christian C.P. Wolff, Ph.D
Amsterdam Institute of Finance

Dr. Sami Tamer
School of Management and Economics
The Queen’s University of Belfast

Margaret Woods
Nottingham University Business School

Christopher Cook
University College Northampton

Trainers - Center for Interactive Financial Training (CIFT)

Robin Brown
Capital Consultancy Ltd

Paul Meadows
Director - Chadley House Training

Andrew Street
Managing Director - Value Consultants Ltd

and ISJ also thanks all the Global Securities Services students who took valuable time at the end of an academic year to enter the competition.
Judges Luncheon  Thursday 26 May 2005...

Following the first round of essay judging, Judges and ISJ representatives met at the Chartered Accountants Hall in the City of London to discuss the quality of essays assessed during the first round and to receive their criteria for judging the second round. Judges also took the opportunity to reflect and comment on the latest developments within the securities industry.

Judges Luncheon Top Row (L-R) Justin Lawson (ISJ), Kenny Thomas (ISJ), Giulio Di Cerbo (Citigroup), Janet Du Chenne (ISJ); Mark Austin (JPMorgan), Tony Solway (BNP Paribas), Stuart McKinlay (State Street), Paul Stillabower (HSBC); Mark Austin and Tony Solway; Middle Row (L-R) Paul Stillabower; Stuart McKinlay, Paul Stillabower, Justin Lawson, Kenny Thomas, Giulio Di Cerbo, Kevin Hanley (Accenture); Stuart McKinlay and Paul Stillabower. Bottom Row (L-R) Justin Lawson, Kenny Thomas; Tony Solway and Stuart McKinlay.
Groucho Club London: ISJ Awards 2005: (from top left): Sara Grillo (overall winner), Maria Claassen (HSBC), Paul Stillabower (HSBC); Justin Lawson (ISJ), Kevin Hanley (Accenture), Stephen O’Sullivan (ISJ); Sally Moore (Broadgate), Ed Moisson (Fitzrovia), Janet Du Chenne (ISJ) Row 2 Sharon Prasad (Broadgate), Kevin Pakenham (Putnam Lovell NBF Securities), Sara Grillo, Paul Stillabower; Maria McCoy (HSBC), Maria Claassen; Mike Martin (HSBC), Sara Grillo Row 3 Maria Claassen, Paul Stillabower; Justin Lawson, Kevin Hanley (Accenture); Mike Martin, Kate Cramer (HSBC); Sara Grillo, Tony Solway (BNP Paribas) Bottom Row Kenny Thomas (ISJ), Evangelos Macharias (finalist); Paul Stillabower, Sara Grillo, Kevin Hanley; Mark Latham (ISJ); Kate Cramer, Paul Stillabower, Tasha Fryer (ISJ), Justin Lawson
Evolution of risk in the hedge fund industry.

by Sara Grillo

Since the first funds appeared in 1949 to the advent of hedge fund giant George Soros in 1969, the boom of the late 1990s and the bust of the early 2000s, few sectors have seen more change than the hedge fund industry. With tenfold growth over the last decade, hedge funds are becoming more than just an investment vehicle for high net worth spending money. Attitudes towards hedge fund risk are poised to change, and the evolution will have positive results for the industry. This paper will examine proposed improvements in risk measurement, as well as the consequences of risk on portfolio performance. We predict that regulatory scrutiny will be the catalyst that forces risk levels down and ultimately drives the industry toward a period of maturity. Within this more stable environment, inflows from retail and institutional investors will surge, leading to the emergence of hedge funds as a more popular investment choice amongst the investing public.

Strong Demand

The retailisation of the hedge fund industry has created a preponderance of SEC-registered 1940 Act vehicles. Many advisors are hoping to market their funds with lower investment minimums by couching the offering within a 1940 Act open-end or closed-end mutual fund vehicle. This would allow investment minimums to hover as low as $25,000, which increases distribution potential. This structural innovation is a sign of increased demand from the investing public. The most important driver of growth in the hedge fund industry will be the throttling demand from institutional investors such as pension funds and endowments. Of the $52 trillion of financial assets that exist worldwide, $25 trillion of that is institutional money. The burst tech bubble has left many defined benefit plans facing lacklustre equity returns and bulging pension benefit obligations. They look to hedge funds to come to the rescue with potentially stable returns hedged from market downturns. Experts project that institutional cash flow to the industry will increase from $60 bn to $300 bn within five years.

While hedge funds may seem fortuitously poised to capture surging institutional demand, the challenge is risk. Most pension funds do not trust or understand the hedge fund industry. In a 2003 survey of US plan sponsors conducted by Fidelity Investments, 56 per cent of plan sponsors that invest in alternative investments say they “do not understand the risks they are taking.” Hedge fund and pensions are at odds in other ways; hedge funds often fail to meet a fiduciary’s need for complete transparency, low management fees, seamless client service, and strong operational and risk controls. The need for transparent and understandable risk monitoring is a call that hedge funds must hear and respond to.

The Risk Obstacle

Events such as the collapse of Long Term Capital Management and the Asian currency crisis in the late 1990’s have cast doubt on the integrity of the industry as a whole. The true performance of hedge funds is often obscured by the flaws in the statistical parameters that define it. As a result, due diligence in the hedge fund industry is highly qualitative and even the most trustworthy of parameters can be gamed. The articulation of risk in this dynamic industry is a virtual Christmas tree of confounding factors: lack of legal constraint, suboptimal performance reporting standards, and inadequate risk measures.

Hedge fund managers are free from many of the legal constraints that regulate other vehicles such as 1940 Act registered mutual funds. Prospectus requirements that would protect a mutual fund investor are not present, creating a virtual “black box” of investment policy. The investor must rely completely on the discretion of the manager to decide how the underlying investments are weighted, or the degree of leverage. Moreover, the lack of a prospectus-defined investment allocation erodes the predictive value of any historical risk measure.

Manager opinion can present a large risk as diversification may be compromised and allocations can change freely. The individual nature of these investments obscures trends and leads to low fund correlations across and even within categories.

Lack of performance standards detracts from reporting credibility. Indices are replete with survivorship and selection bias. Many times only the performance of surviving hedge funds is recorded. The indices that do exist, CSFB Tremont for example, can only offer data from managers who have opted to report. The Darwinian result is a possible upward bias in data measurement that could potentially skew investment performance. Industry experts hypothesise that this bias could be as much as 3 per cent annually, which is significantly misleading to a retail investor. Additionally, the surge of fund launches in the early 2000s has created a plethora of young funds, many with track records of less than four years. The performance of these funds may be skewed by lack of persistent market conditions over the period. There is a need for industry standards to eliminate these biases.

Risk metrics themselves fail to capture the true nuances of these funds and bias can plague even correctly calculated measurements. Multicollinearity may undermine diversification, particularly in a Fund of Funds where the underlying managers may be subject to common risk factors. Traditional linear measures such as VaR misstate or fail to capture this risk at all. Leverage causes non-linear exposure to risk factors, which distorts risk statistics. Moreover, intentional manipulation can occur. For example, hedge funds have figured out how to use derivatives to optimise the Sharpe Ratio. Effectively truncating the right tail of their return distribution and shifting this return to worse performing periods, they can smooth volatility while keeping total return constant. Quantitative measures such as stress testing, Monte Carlo simulation, and attribution analysis are tools that can be used to mitigate risk factors.

We predict that regulatory scrutiny will be the catalyst that forces risk levels down and ultimately drives the industry toward a period of maturity.
The true performance of hedge funds is often obscured by the flaws in the statistical parameters that define it.

Striving for Normalcy

Industry experts have recommended several risk parameters that may capture risk more accurately. One such metric, the Bernardo-Ledoit Gain-Loss Ratio, is “the ratio of the expectation of the positive portion of the returns divided by the expectation of the negative portion.” This measure would be more predictive than the Sharpe Ratio because of its forward-looking nature. Others suggest weighting funds by beta, which forms a “BVAR,” or Beta and Volatility Adjusted Returns ratio. This enables “a fund that has a lower return but is uncorrelated to the market [to] be appropriately compared with a fund that achieves a higher return but is highly correlated with the market.” Academics have also proposed a Conditional VaR measurement, which would express the likelihood that an expected loss would occur in an amount greater than the VaR. We should perhaps consider estimating a fund’s risk by analysing its style. By evaluating the historical performance of certain style factors, perhaps we can reach a more accurate measure of the true risks associated with each style. We may adjust the positive bias present in flawed index data by perhaps restating index values with a 2 to 3 percent haircut. These models would elucidate the true uncertainties of particular hedge fund investments, which would improve confidence in the asset class.

To this end, the preponderance of confounding information in this industry has prompted increased oversight from industry watchdogs. As of October 26, 2004, the SEC has required any hedge fund with more than 14 clients to register with the SEC on a look-through basis. Funds must be in accordance with applicable requirements by February 1, 2006. Perhaps implementing a universal set of reporting metrics is a next step that regulators should take. The SEC could possibly carve out a recognised alternative investment regulation authority or implement a standard multi-factor system for evaluating hedge funds. Thus, we may capture risk more accurately. One such metric, the Bernardo-Ledoit Gain-Loss Ratio, is “the ratio of the expectation of the positive portion of the returns divided by the expectation of the negative portion.” This measure would be more predictive than the Sharpe Ratio because of its forward-looking nature. Others suggest weighting funds by beta, which forms a “BVAR,” or Beta and Volatility Adjusted Returns ratio. This enables “a fund that has a lower return but is uncorrelated to the market [to] be appropriately compared with a fund that achieves a higher return but is highly correlated with the market.” Academics have also proposed a Conditional VaR measurement, which would express the likelihood that an expected loss would occur in an amount greater than the VaR. We should perhaps consider estimating a fund’s risk by analysing its style. By evaluating the historical performance of certain style factors, perhaps we can reach a more accurate measure of the true risks associated with each style. We may adjust the positive bias present in flawed index data by perhaps restating index values with a 2 to 3 percent haircut. These models would elucidate the true uncertainties of particular hedge fund investments, which would improve confidence in the asset class.

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To this end, the preponderance of confounding information in this industry has prompted increased oversight from industry watchdogs. As of October 26, 2004, the SEC has required any hedge fund with more than 14 clients to register with the SEC on a look-through basis. Funds must be in accordance with applicable requirements by February 1, 2006. Perhaps implementing a universal set of reporting metrics is a next step that regulators should take. The SEC could possibly carve out a recognised alternative investment regulation authority or implement a standard multi-factor system for evaluating hedge funds. Thus, we may capture risk more accurately. One such metric, the Bernardo-Ledoit Gain-Loss Ratio, is “the ratio of the expectation of the positive portion of the returns divided by the expectation of the negative portion.” This measure would be more predictive than the Sharpe Ratio because of its forward-looking nature. Others suggest weighting funds by beta, which forms a “BVAR,” or Beta and Volatility Adjusted Returns ratio. This enables “a fund that has a lower return but is uncorrelated to the market [to] be appropriately compared with a fund that achieves a higher return but is highly correlated with the market.” Academics have also proposed a Conditional VaR measurement, which would express the likelihood that an expected loss would occur in an amount greater than the VaR. We should perhaps consider estimating a fund’s risk by analysing its style. By evaluating the historical performance of certain style factors, perhaps we can reach a more accurate measure of the true risks associated with each style. We may adjust the positive bias present in flawed index data by perhaps restating index values with a 2 to 3 percent haircut. These models would elucidate the true uncertainties of particular hedge fund investments, which would improve confidence in the asset class.

Inevitable Collapse in the Long Term

Herzberg and Mozes’ research would imply that risk and return levels in the hedge fund industry are headed for mean reversion as regulators catch on to hedge fund shenanigans. As the SEC requires hedge fund registration by February 2006, data vendors will be exposed to more information which they will sell to the investing public. As reporting becomes more standardised, the value of being a younger or smaller fund will erode. Informational inefficiencies will be harder to identify and exploit. We may predict that the value of size and age factors will erode, and the level of risk will emerge as the dominant factor in determining performance. Consequently, skill-focused managers will persist over bet takers, driving down volatility levels. Volatility will decrease, and the industry will segregate into broad style categories, much as the mutual fund industry has done.

This reversion to mean standards will only occur after an equilibrium point is reached. Growth in international demand will occur from privatisation of pension schemes in Europe and Asia. Exposure to more trustworthy data will lead retail investors to feel more confident investing in hedge funds. As institutional and retail investment surges, new funds will launch. New players will enter the foray until the industry arrives at a saturation level where the capital supply is exhausted.

Market efficiency will result, with profits levelling off, eventually causing firms to merge and the weaker players to exit. The industry will bifurcate into smaller niche funds and large investment houses. This will be the ultimate maturity level at which the asset class will persist in the long term.

Conclusion

The show is not over yet. In fact, it is just beginning. As attitudes towards risk evolve, there is still plenty more room for the industry to grow. Although industry scandals have left investors reeling, scepticism will fade as industry regulation will increase transparency. Increased scrutiny by industry watchdogs will lead to the normalisation of risk and return, which will ultimately decrease the level of hedge fund volatility. As volatility levels normalise, hedge funds will become more popular with retail investors and pension funds. This surge in demand will propel the industry through its lifecycle until it reaches its ultimate maturation level. Regulatory developments and their effect on risk will be the catalyst that leads to the emergence of hedge funds as a prominent investment option amongst the investing public at large.

Sara Grillo - Ms. Grillo earned her B.A. from Harvard University with honors. She is currently enrolled in a part-time M.B.A program at the New York University Stern School of Business. She passed the CFA Level One examination in June 2003, and is an affiliate member of the New York Society of Securities Analysts and the CFA Institute. Ms. Grillo is Series 7 and 66 registered.

References
Taking Stocks

NAME OF SCHEME: SAINSBURY PENSION AND DEATH BENEFIT SCHEME. SIZE OF FUND: £3BN. CUSTODIAN: NORTHERN TRUST.

Geof Pearson, pensions manager at the Sainsbury Pension and Death Benefit Scheme talks to James Wallace about the challenges and opportunities facing one of the UK’s biggest corporate pension schemes...

Does the fund participate in a securities lending program?
Yes we do but it operates differently now as the custodian does it all for us.
The program itself is 10 years old and generates in the region of £100,000 per annum, which is a relatively modest amount given our fund size. But that is because we don’t have many active managers and therefore little assets with which to lend.
As effective as the programme is for the fund we are not going to switch from passive to active simply to grow a security lending programme – that would be to let the tail wag the dog.

How much of the fund’s assets are allocated towards alternative investment instruments?
We would define alternatives as hedge funds, private equity and property unit trusts (PUT). Our total allocation to those asset classes is currently 5 per cent with a commitment to increase to 10 per cent by December 31, 2005. That will see individual allocations of 3 per cent for hedge funds, 3 per cent for private equity and 4 per cent for PUTs.
The decision was taken to double the allocation to match the trustees’ rising confidence levels in the asset classes.
There was always the intention to get it up to 10-15 per cent but not straight away. Fundamentally, it is not a performance issue – it is about trustee confidence which has risen despite poor hedge fund investment returns over the last 18 months. It was difficult to get the returns out of single figures for a lot of asset classes, but hedge funds in particular were poor last year. That, though, was not the case for private equity and property.

How is the fund structured?
The fund started with a structure of 60 per cent equities and 40 per cent bonds. And then we delved into alternative asset classes which prompted a 5 per cent reduction in both equities and bonds leaving the fund with 55 per cent equities, 35 per cent bonds and 10 per cent in alternative asset classes as outlined earlier.

What is the investment strategy?
Our main objective is to get a long term return of RPI plus 4 per cent which our actuary tells us we require in order to meet our liabilities at the present level of employee/employer ordinary contributions.

How do you make decisions about where to invest?
We have a well-diversified portfolio geographically – probably more than most UK pension schemes – but we do hedge most of the currency risk back to sterling.
Our investment view is governed principally by the investment advice we get from Frank Russell.
We are very sensitive to the danger in oversubscribing to domestic equities – if the markets are weak the returns will suffer and with the majority of our assets still in equities that could be critical.
Our strategy to diversify geographically mitigates that risk to some extent. Importantly, diversification is for risk reduction rather than expectations of additional returns.

How important is corporate governance and socially responsible investment?
We were one of the leaders that promoted SRI when it was first mooted by the UK pensions minister at the back end of the last century.
We believe all pension schemes have a responsibility to take corporate governance seriously but it is a very difficult job to do on a day-to-day basis so we have to delegate it, and our requirements, to our fund managers.
Two of our fund managers in particular, Legal & General and Hermes, have excellent records in this field so we feel we are in safe hands.
We believe adopting corporate governance and socially responsible investment can boost investment returns and reduce portfolio risk.
Fundamentally I think it should be done because we are the owners of the businesses and we ought to take our responsibilities seriously.
If through our governance processes we can cut short some of the abuses and highlight some of the risks and get better performance out of the assets that must be good for all concerned.

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If through our governance processes we can cut short some of the abuses and highlight some of the risks and get better performance out of the assets that must be good for all concerned.
Alternative investment vehicles have blossomed in recent years. Traditionally, the asset classes bracketed under this umbrella are property, private equity, venture capital and increasingly hedge funds. It is the latter asset class that has attracted the interest among trustees and is gaining in prominence in more and more pension scheme portfolios.

Five years ago European pension fund investment in alternatives was primarily in the real estate and private equity sectors. According to State Street, at that time approximately 80 per cent of the alternative allocation was in private equity and real estate holdings, with a 15 per cent allocation to hedge fund the remaining five per cent was in other minority asset classes. That figure for hedge funds has risen to almost 25 per cent as confidence levels have soared.

Trends
Principally, interest in hedge funds has predominantly been the domain of larger pension funds. It is only with more recent pressure to capture additional alpha and diversification benefits that we have seen a broader move towards alternative asset classes.

Traditionally among pension funds, access to and familiarity with alternative strategies would not have been commonplace. Nowadays, greater knowledge at a trustee and investment committee level, as well as more opportunities, makes the move into alternative asset classes more feasible.

Flat equity markets and a low interest rate environment have forced trustees to think outside the box. Typically, schemes have sliced their allocation to equity markets and moved into the potentially greater rewarding hedge funds. Pension funds are now looking for diversification of risk and more sustainable performances. These factors drive the movement to alternative asset classes and away from traditional assets.

But while hedge fund allocations have boomed private equity and property allocations have remained stable. The overwhelming majority of investment in alternatives is still private equity and property – the industry has come a long way over five years but there still is someway to go before it catches up with property and to a lesser extent private equity.

ABN AMRO Mellon head of relationship management Europe René Wiegel says at first, pension funds were investing in more traditional vehicles, such as government bonds. However, because of their low yield curve, funds began to move into equities, looking for diversification and performance benefits. She says: “Over time, with the continuing need for diversification, property, venture capital, private equity and hedge funds have been added as asset classes to the pension fund portfolio mix.”

Expertise
Northern Trust head of European sales Anne-Lise Winge says: “Over the last 12 to 18 months we have seen pension funds broaden their portfolios to include alternative assets.
As a result, our group has acquired additional expertise in hedge funds, private equity and property to broaden our product range. "As a dedicated custodian to European pension funds we believe we must respond to the growing demand for services associated with the delivery of these asset classes. We must be able to develop our functionality as demand for alternatives grows among our client base."

Again it is hedge funds which have stolen all the headlines. According to Watson Wyatt in the UK over 2004, pension funds had a 40 per cent increase in allocation to alternatives and of that increase over half of it was hedge fund investment.

State Street head of alternative investment services Gary Enos explains why there has been such a fanfare surrounding hedge funds in recent years. He says: "The media have latched on to hedge funds and thrown the asset class under the spotlight. This, coupled with some landmark failures and unique investment strategies, has generated significant interest. Also, in many cases the hedge fund managers themselves don’t exactly shy away from publicity."

**Strategies**

But returns have hardly been sensational and there still is someway to go on the education phase. People on the pension boards and chief investment officers are sitting back trying to figure out how much of an allocation can really effect the overall return of a plan.

Wiegel says: "As you would expect, it is the larger pension funds that are leading the charge with respect to alternative asset classes. However, in recent years, and with the advent of more accessible solutions, we see more pension funds adopting such asset classes as part of their overall investment strategy. As custodians, it is incumbent upon us to support this move and facilitate the changing reporting requirements of pension funds."

**Custodians**

Custodians’ entrance into the hedge fund market is relatively recent. Regulation in many European nations now calls for greater transparency, opening the door for custodians. This move first originated in Ireland. The Central Bank of Ireland put forward the regulations requiring a custodian to act between the pension fund and the prime broker. While it was first put forward for fund of hedge funds, there are now drafted regulations in several European countries for direct hedge funds strategies.

Today a custodian is usually hired by a pension fund to act as a safekeeper and in some situations a trustee for the overall oversight of the fund. This has been prompted by hedge fund failures in the past. To achieve this transparency the custodian is responsible for safekeeping the assets, valuing the assets, executing the assets and financing the assets. The role of the custodian in respect of hedge funds is not Europe-wide in terms of law but it is Europe wide in terms of best practice and interest. Pension funds are increasingly demanding the custodians’ service in this field. Therefore, as pension funds continue to increase allocations to alternative assets, the role of the custodian will continue to rise to the centre and to the fore. Indeed demand for custodians is coming both from the regulators and the pension schemes themselves. Enos says: “Most world class custodians know that they never do things fast enough for their clients and never do it cheap enough so sometimes we do feel under appreciated. But in this case, with the growing interest of the regulators and this demand for transparency, I do think there will be more value placed in the custodians’ role here.”

**Private Equity & Property**

Meanwhile, pension boards are so comfortable with their asset allocation to private equity and property that we are unlikely to see any significant movement in the coming years. In terms of property, the interest is primarily due to stability and consistency of returns. Real estate portfolios have rarely fallen in value over the last decade or even longer. Indeed these portfolios have been a strong investment probably for as long as many of these plans have been in place. Private equity, though, is a little different. Enos explains: “There has been a lot of access to capital as interest rates have been so low but in a rising interest rate environment I don’t know if all that capital will be as readily available as it used to be. This could lead to a situation where there is a move from private equity to the fixed income environment.”

**Hedge Funds**

Hedge funds, though, are the asset class on the rise. To put it into context, hedge funds have only become prominent outside the high net worth community in only the last three or four years. However, a recent study carried out by State Street last year revealed that 30 per cent of respondents would be increasing their hedge fund allocation by 1-2 per cent while over 40 per cent would increase it by 10 per cent or more. Over the next three years over 90 per cent of the same group of European pension funds said they would increase hedge fund allocations. The UK and the Netherlands have been the fastest growing in terms of getting into the hedge funds space. There has been a lot of media coverage in Germany but we have not seen as many assets move despite the changes in the regulatory environment. Winge says the custodian can play a pivotal role in the flourishing alternatives market. She says: “We are seeing more and more of our clients adding hedge funds in particular to their portfolios. Our duty is to ensure that we can provide a safe environment for these investments. So we need to build a robust process for these alternative assets so that we can report on them accurately in a timely manner. We can definitely play a role in this market evolution.”

Custodians are very much moving with the times to ensure that they continue to be their clients preferred choice for custody. It looks like hedge funds will be an asset class that is here to stay. Indeed as allocations continue to increase the role and the need for the custodian will continue to rise.

*ISJ*
While it is true that asset manager outsourcing is today an established part of the fund management landscape in the UK and Europe, the business model having largely proved itself to be sustainable, replicable and profitable, one cannot help but question the longer-term viability of some of the deals struck in recent years.

With five years having elapsed since the announcement of the first, headline-grabbing 'lift-out' deals, one senses that the economic and operational implications of some high profile mandates have not been scrutinised as closely as they might.

With commentators quick to single out the 'laggards' that were slow to take the plunge, the pressure on custodians to secure their first outsourcing clients has certainly been intense. As a result, there has been a flurry in the marketplace, with providers rushing to jump aboard the outsourcing bandwagon before it was too late.

Factors
The factors driving the upsurge in asset manager outsourcing deals witnessed over the past couple of years are by now familiar to one and all. Risk, regulation, costs, competition, efficiency: these are all areas where managers are under unrelenting pressure.

Boutique and hedge fund managers in particular are prime candidates for outsourcing. Their lack of infrastructure typically increases their dependency on a service provider for a complete front to back office solution. However, buy-side firms are themselves looking more seriously at this 'virtual manager' model as they seek to become nimbler and cut costs through a more specialised, focused approach.

They have sought to reprioritise and reengineer in order to move toward a more streamlined business model – and outsourcing is a key strategic tool to help facilitate that goal. Indeed, escalating cost and efficiency pressures mean that ultimately all activities designated as 'non-core' by a fund manager will be outsourced.

Timing
The question on everyone's lips these days is not whether a firm should outsource, but rather when and to whom. However, no two fund managers' requirements are identical, particularly in areas such as life funds and structured products, and consequently those providers that have built flexibility into the heart of their business model will be better able to offer the sort of bespoke solutions required.

RBC Global Services has always adopted a consultative, 'high touch, high feel' approach across all business lines, and so it follows that we have concentrated on developing outsourcing solutions around the client.

To this end, we have resolved to pursue a more modest and measured alternative to the classic 'lift-out' model – instead of taking one large cornerstone client and building our outsourcing offering off the back of their platform, we have put in place a strategic framework around a limited number of more moderate sized clients.

Rather than adopting a 'big bang' approach that would require us to digest outsourced employees while grappling

Asset manager outsourcing has captured a fair amount of media attention in recent years, but what are the long term impacts of these deals? Rob Wright analyses the longevity of this outsourcing.

Aiming for outside alpha?

Future Perfect?

Rob Wright

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Rather than adopting a 'big bang' approach that would require us to digest outsourced employees while grappling
with all the technology issues that inevitably arise from such a fundamental transition, this more controlled approach may involve a longer implementation timeline, but it will also ensure that our model is robust and that we can provide a better client experience from the outset.

**Key to Success**

The key to a successful outsourcing arrangement is for the outsourcer to become an extension of the asset manager’s operation in every sense of the word. Ultimately our success is their success. While as a provider you need to be able to build and leverage the scale economies that are central to the outsourcing proposition, you need to look beyond size or technology if these relationships are truly going to be successful.

Outsourcing is fundamentally about collaboration and partnership. It follows that we devote a lot of time and energy prior to any transition to re-engineering the client’s business.

**Re-engineering**

The importance of a deeply-ingrained service culture is all too often overlooked by custodians entering the market. As a provider, we have to be both proactive and reactive as appropriate if we are to support a fund manager’s evolving needs. We must be innovative, creative and responsive in areas that have not traditionally fallen within the custodian’s remit, such as helping fund managers develop and launch new products.

Our personnel, many of whom have asset management backgrounds, can help the client to build out the right business model and operating processes, while also supporting their client relationship and marketing efforts.

Outsourcing should never be a matter of reincarnating what a client has already done, but rather about creating a more potent business model to allow both them and us to be more effective.

A holistic view of business architecture, data and systems architecture, in conjunction with a robust service architecture whereby the fund manager interacts seamlessly with the service provider, is also vital, as this approach will ensure a business model that is at once flexible and scaleable.

Some of the other deals we have seen in the market seem to promise a pain free transition. Unfortunately, in reality many fund managers have ended up having to build a huge middle office and keep people back, and ultimately the new model is not much different from what they had before.

We are looking at something far more transformational. Accordingly, the clients we are working with may need to put in a little more effort up front, but in the end that will pay off. By being a contributing participant in the process, at the end of the day the client will have a much a better and more robust business model.

**Cornerstones**

Capability, cultural fit, communication, and, last but by no means least, commitment on both sides: these are the four cornerstones of a successful outsourcing relationship. With consolidation within both the fund servicing and fund management communities inevitable, depth and breadth of product proposition will be vital if service providers are going to be able to support multi-disciplinary fund managers across multiple jurisdictions and client segments, be they institutional or high net worth clients.

However, it is also vital that providers can establish a truly collaborative and flexible outsourcing model if they are to succeed in implementing the sort of fundamental business reengineering and transformation required to deliver real value to their clients in the long-term.

Rob Wright is Managing Director of Global Fund Services at RBC Global Services.

**Rob Wright**

As Managing Director, Global Fund Services, RBC Global Services, Institutional & Investor Services (IIS), Rob Wright is responsible for the development of the global business strategy for the global fund management business segment for investment administration, custody and related services.

In addition, Wright is a member of the IIS Operating Committee, the RBC Global Investment Management (GIM) Board, the Royal Bank of Canada Europe Limited Board, the Royal Bank of Canada Australia Limited Board, the Royal Bank of Canada Fund Managers (Jersey) Limited and the Royal Bank of Canada Offshore Fund Managers Limited.

Wright has worked for RBC Global Services since 1992. Prior to his role as managing director, he was Vice President, Sales and Relationship Management, RBC Global Services, responsible for business development and strategic account management. In this role, he developed a strong international sales and relationship management team in a network of offices across Canada as well as in London, Tokyo, Singapore, Sydney, New York and Dubai. In July 2001, Mr. Wright relocated to London, U.K.

Wright’s experience outside of RBC Global Services includes various senior management positions with information technology companies providing services to leading financial institutions.
Institutional investors face a lengthy soul-searching exercise prior to their leap into hedge funds. Derek Duggan and Joanna Roemer-Babelek of Thomas Murray explain how this exercise can best be dealt with...

**Coping Strategies**

The question which every investor and investment manager asks before putting money into a hedge fund or a fund of hedge fund is: how should we structure the investment decision process? If you extend this question you are actually asking: what is the most efficient approach to cope with the amount of information provided by the managers and/or advisors, and how do we achieve an efficient and scalable evaluation, selection and due diligence process? Most investors choose the route of an Request for Information or Request for Proposal process which in its essence means constructing a dedicated questionnaire, a questionnaire which can be individually structured and sent to as many candidates as required (e.g. a fund of hedge fund manager selecting underlying hedge fund managers would create a questionnaire to assess the investment strategy of the manager, their organisation, operational controls and financial strength, for example).

**Questionnaires**

Historically, questionnaires were structured as a word document and stored by the recipients as a soft and hard copy. However, this approach proved to be neither efficient nor scalable for both sides: the candidates/respondents as well as the recipients of the information. There were often different versions of the same questionnaire within the organisation, not to speak of the challenges of tracking updates to responses and attaching supporting documentation. The comparison and evaluation process of different candidates was very tiresome, involving manual copying of information into dedicated reports or working with several hard copies.

Electronic Requests for Proposals (RFPs) were created to address the issues listed above as they allowed the processing of information, its storage as well as reporting in a structured and efficient manner. These RFPs have subsequently become internet based, which enables international organisations location independent access to the information.

Investment and business risks, increasing requirements for compliance management, complex operational procedures and the need to monitor and benchmark are all driving the use of electronic RFPs in the evaluation, selection and monitoring of all parties involved in the investment process: the hedge fund managers, the fund of fund managers as well as the service providers. The advantages of an e-RFP platform are that it streamlines and standardises processes, allows flexible use of specialised questionnaires, shortens response times, reduces costs and improves the analysis associated with the investment decision and service provider selection process.

“The benefits offered by web based RFP management systems extend also to the respondents, who can import responses to previous questionnaires and collaborate more effectively on the document “
**Choice of a service provider**

The process of selecting or re-selecting service providers remains something of a 'Cinderella' industry compared with the selection of fund managers or global custodians by institutions (refer previous Thomas Murray article in ISJ article). However, an in-depth evaluation of service providers before assigning mandates and continued monitoring during the course of the relationship is crucial to the success of the investment strategy overall.

When an organisation is looking to make an investment decision or to appoint a service provider they need to choose the best option to suit them from the range of potential investment opportunities, fund of hedge fund managers or suppliers available. In the case of service providers the traditional method is to ask all potential suppliers to submit a proposal which describes their product. The problem with this approach is that it is difficult to make a detailed side by side comparison between the proposals, because they are likely to be structured very differently. A more accurate comparison can be made if, rather than asking each supplier to draft their own proposal, the customer creates a questionnaire requesting the specific details they wish to find out. Such a questionnaire is, in effect, an RFP. However, not everybody has the necessary skills and experience to create an RFP from scratch and therefore should look to utilise market standard questionnaires (we should all be requesting 80 to 90 per cent of the same information) and supplement these with questions around any client specific requirements. The AIMR guidelines, which encourage sound practices within the alternative investment community are a starting point, but are not sufficiently detailed to support a full evaluation and selection exercise.

Once an RFP is in place many groups manage the process offline, which has multiple disadvantages:
- Service providers generally need to get input from different staff to answer different sections of the RFP. Sending a single document makes it more difficult to involve multiple response authors simultaneously.
- Questionnaire authors need to copy and paste questions to reuse them between questionnaires. The same problem applies to respondents managing responses.
- Scorers and analysts cannot easily compare responses between questionnaires.
- Respondents tend to break document structures, making it difficult to automate the collation of responses for comparison and analysis.
- Analysis is time consuming, error prone and can be inconsistent.

**Online**

An on-line RFP tool can be an efficient and cost effective method of managing the process. Most e-RFP tools maintain market standard questionnaires which may be augmented with specific questions users may wish to ask. Responses are automatically captured and consolidated and expert analysts are usually available to evaluate the responses against a transparent methodology to create an in depth presentation of the analytical results.

The benefits offered by web based RFP management systems extend also to the respondents, who can import responses to previous questionnaires and collaborate more effectively on the document, but the e-RFP tool ensures that they cannot break the questionnaire document structure.

**Hosted e-RFP Tool**

Thomas Murray Alternative Investments Services (TMAIS) has designed a hosted e-RFP Tool which is available to the industry, rather than a traditionally licensed software product. TMAIS has rolled out its e-RFP platform to assist all industry participants in the analysis associated with the service provider selection process. In this regard, TMAIS has made its e-RFP platform and alternative investment evaluation and selection questionnaires available to the alternative investment community.

Comprehensive questionnaires are available to support the evaluation of custodians, fund accountants and transfer agents, with a service provider matrix available to assist groups in considering who to include in an RFP mandate. Upon receipt of responses analytical tools to allow structured evaluation of the candidates can be made available to the investors and investment managers.

TMAIS has been working in close cooperation with major institutional investors and investment managers, to develop alternative investments specific evaluation and selection questionnaires, due diligence processes and rating methodologies. Using comprehensive electronic databases and e-platform tools to manage various types of RFP responses and structured due diligence processes, the aim has been to create a standardised and efficient process for all industry participants for the selection and monitoring of service providers as well as assessment of the operational risks in the industry. Thomas Murray has been operationally using the e-RFP platform for over four years and currently issues over 500 RFPs per annum.

**e-RFP Tool**

Seven simple steps to evaluating and monitoring service providers

1. **Step 1** Register at [http://ais.thomasmurray.com](http://ais.thomasmurray.com)
2. **Step 2** Access and review on-line questionnaire(s) – add your own specific questions
3. **Step 3** Choose service provider(s) from the matrix and/or add your own providers to the list
4. **Step 4** Define your profile based on the on-line template
5. **Step 5** Issue RFP(s) to selected service provider(s)
6. **Step 6** View on-line consolidated results immediately upon submission
7. **Step 7** Undertake your own analysis or engage Thomas Murray

At the end of the RFP completion period, the e-RFP Tool will consolidate the responses to allow for easier analysis, which users can do so themselves or engage Thomas Murray, who can provide both a directional rating analysis based on the responses to the RFPs or a private ratings which includes on the ground operational review with a comprehensive rating report output.
Fund of hedge funds - better than the real thing?

Once touted as the favoured alternative to the traditional hedge fund, fund of hedge funds appear to have been upstaged over the last year to May 2005, according to Chicago-based Hedge Fund Research Inc (HFR).

In the company’s latest data for Investor Services Journal, HFR sets the Rate of Return scene for hedge funds and fund of funds. The research delivers surprising results, considering the recent hype about fund of hedge funds.

Composite Index
The HFRI Fund Weighted Composite Index delivered rate of return of 0.22 per cent for the year to May 2005. On the other hand, the HFRI Fund of Funds Composite Index delivered a negative rate of return of -0.24 per cent for the year to May 2005.

The month of May 2005 alone delivered a positive rate of return of 1.04 per cent for the HFRI Fund Weighted Composite Index, compared with only 0.36 per cent for the company’s Fund of Funds Composite Index.

Benchmarks
The HFRI Fund Weighted Composite Index also performed favourably against popular indices such as the MSCI Indices US$ World Index, the NASDAQ Composite and the S&P 500 w/dividends for the year to May 2005. These indices reported a negative rate of return of -2.45 per cent, -4.93 per cent and -0.95 per cent respectively.

The HFRI Fund Weighted Composite Index was outperformed by the Lehman Brothers Aggregate - US Government Bond Index and the Lehman Brothers Aggregate Corporate Bond Index, which recorded a positive rate of return of 2.54 per cent and 1.80 per cent for the year to May 2005 respectively.

Meanwhile, the HFRI Fund of Funds showed a positive rate of return only for its Strategic Index, which reported 0.16 per cent for the year to May 2005.

Top performers
Among the top performers in the HFRI Hedge Fund Index were the HFRI Short Selling Index, which delivered a positive rate of return of 6.66 per cent for the year to May 2005, and the HFRI Short Selling Index, which delivered a positive rate of return of 3.39 per cent for the year to May 2005.

In the HFRI Fund of Hedge Fund category, the top performer was the HFRI Fund of Funds: Strategic Index, which delivered a positive rate of return of 0.16 per cent for the year to May 2005.

In the HFRI Hedge Fund Index, the weakest performers were the HFRI Convertible Arbitrage Index, which delivered a negative return of -6.73 per cent for the year to May 2005, and the HFRI Equity Non-Hedge Index, which delivered a negative rate of return of -1.16 per cent for the year to May 2005.

In the Fund of Hedge Funds Indices, the weakest performers were the HFRI Fund of Funds: Market Defensive Index, which delivered a negative return of -1.38 per cent for the year to May 2005 and the HFRI Fund of Funds: Conservative Index, which delivered a negative return of -0.17 per cent for the year to May 2005.

Despite reporting a negative rate of return of -4.93 for the year to May 2005, the NASDAQ Composite bounced back in the month of May, reporting a positive rate of return of 7.63 per cent.

HFRI Hedge Fund Index - Rate of Return for the year to May 2005

Fund of Hedge Fund Indices Rate of Return - Year to May 2005

Source: HFR
Northern Light

By virtue of the Nordic region’s many attractions, one might presuppose a link between the host city of the world’s biggest securities industry event and one of the strongest financial regions in Northern Europe. ISJ investigates the financial might of the Nordic countries and their close bond with the Baltic states.

As contenders in Continental competitions such as championship football and the Eurovision Song Contest, the Nordic and Baltic countries have certainly strengthened their resolve in a European context. In fact, the spirit of togetherness is evident among these States, particularly in the context of financial services. Most of the stock exchanges in these countries have formed alliances, thereby creating one point of entry for remote trading members. The common trading system of this alliance, known as SAXESS, has recorded an increase in the number of remote members since the alliance. Apart from a common trading platform, plans for a common settlement depository are well underway, with the creation of the Nordic Central Securities Depository (NCSD) by the Finnish CSD APK and the Swedish CSD VPC. “This will be an important development for Sweden,” says Neal Meacham, head of custody at Swedbank. “The NCSD would most probably like further participation from other Nordic countries in this development, but nothing has been confirmed yet. It could be a wait and see situation.”

Custody Alliances

 Securities services providers in the Nordic region have followed in the steps of their infrastructures and entered into significant alliances. The pan-Nordic custody alliance, for example, consists of OKO Bank in Finland, Swedbank in Sweden, Amagerbanken in Denmark and DnBNor in Norway. The alliance was created to offer a pan-Nordic custody solution to remote as well as domestic investors in each member country. “We are looking to improve our existing services and look for new avenues in the alliance that weren’t open to us before,” says Meacham. The alliances between Nordic and Baltic states will present further opportunities for securities services providers going forward. “Although the volumes are not yet there, as those markets develop and as the volumes in those markets increase we’ll see more evidence of the opportunities,” says Meacham. “We effectively have one exchange and one point of entry to several exchanges. We have not yet seen the effects on clients yet, but I think we will in the future.” The creation of a trading bridge between the Nordic and Baltic stock exchanges is worth its weight in gold. “Having access to several markets through one exchange provides investors with a great deal of leverage,” says Meacham. “Even if the Baltic markets are not very big, the exchange alliance provides us with a bit more leverage when it comes to accessing those markets.”

Efficiencies

Despite the greater leverage afforded to securities services providers by stock exchange alliances, certain providers have yet to report on efficiencies in the areas of settlement and clearing. “This will happen when the CSDs begin to further consolidate or create effective links between each other,” says Meacham.

As the land of opportunity in the Nordic region, Sweden has fully embraced the notion of alternative investments, particularly hedge funds. Fund managers who participate in this market provide securities services companies with an opportunity to service their assets. “Hedge funds need the support of the banks,” says Meacham. “These funds are an important development in Sweden and is something everyone is watching.”

As the development of the onshore hedge fund industry in Sweden continues, institutional investors are becoming more comfortable with these types of products, including fund of funds and structured products. This level of acceptance extends to securities lending, where products and programmes have been widely used for a number of years. “Securities lending in Sweden is mature market,” says Meacham. “We are fortunate to have the legislation that enables us to work more actively with securities lending programmes.”

Infrastructure

 Securities services providers in the Nordic region are poised for further enhancements to the Nordic and Baltic infrastructure. Meacham explains: “Firms who operate in the custody and settlement world are very dependent on the post-trade environment. As a result, our opportunities will depend on the infrastructure. As investors become more confident and more ingenious with new products,
There is a surplus of stock available in Sweden, a fair amount in Finland and a current shortage of lendable stock in Denmark and Norway.

Management, whereby Handelsbanken was mandated to provide local custody and Northern Trust was mandated to provide global custody services to the insurance company. Commenting on Northern Trust’s Nordic inroads, Anne Lise Winge, head of relationship management, says: “We are concentrating on the traditional pension fund market, which is very active at present. Pension funds are demanding more value-added products. With the acquisition of Barings Financial Services Group, we now have a growing fund manager client base called Global Funds Services.”

Northern Trust has recorded significant opportunities within the Nordic fund management sector and currently has about $100bn in assets under custody and about 25 clients in this region. The Group has decided to concentrate its efforts on this region and recently appointed Allan Nedergaard from Danske Bank as head of Nordic business development. Commenting on his appointment, Winge says: “Allan is both a global and a local expert, who will ensure we continue to provide innovative solutions. We are seeing the development of full and component-based outsourcing in the Nordic region, as well as an increase in demand for our trade services.”

In the delivery of its trade services, Northern Trust takes responsibility for the entire trade matching process, including exceptions management and the processing of trades through the virtual matching utilities. “Clients are not only asking about how we can help in the back office but also in the front office,” says Winge. “They are asking if there is anything in their front office they can outsource in order to become more efficient with their core functions. These functions include trade execution, order management, pre-matching and pre-trade management. Firms are beginning to explore these functions with us.”

Northern Trust has also recorded an increase in the use of alternative assets in the Nordic region. “About three years ago, we decided not to be a derivatives clearing provider because of the risks associated with that service,” says Winge. “Then we noticed the Nordic region was increasingly trading in derivatives. So we decided to provide derivatives clearing through a partner, Goldman Sachs. Nordic institutions are looking at a more diverse range of alternative assets and want to invest more of their portfolio in a range of hedge funds. This is why we purchased hedge fund administrator BFS, which we will use to meet the needs of the Nordic institutions who are going into hedge funds.”

Northern Trust has also noticed a need among institutional investors for asset liability matching services. The company has launched an asset liability tool and will conduct road shows throughout the Nordic region to inform institutions about this tool. The Swedes are currently analysing the impacts of an asset liability management directive,” says Winge. “We are trying to preempt this regulation so that we can assist these institutions with the demands that are likely to be placed upon them.”
Opportunities
As a Nordic provider of custody services, Handelsbanken has recorded a significant interest in mutual funds. Johan Wennerberg, head of Relationship Management, Svenska Handelsbanken, Nordic Custody Services sets the scene: “From the beginning of 2000 investors went into fixed income funds as a result of falling markets. Nowadays, there is more optimism and more people are moving into equity. This creates opportunities for all of us. There has also been an increase in the number of assets on loan. Lending assets to cover short positions is a big part of what we do.”

Looking abroad, Wennerberg is cautiously confident about opportunities in the Baltic region. “At the moment two major Estonian companies are being de-listed, equating to 70-80 per cent of market turnover. These markets are small and quite sensitive to any extraordinary developments. The inclusion of the Baltic states into the Nordic stock exchange alliance will increase their liquidity and opportunities for investors in these markets. Their main area of opportunity stems from the consolidation of the CSDs in Sweden and Finland and the new business arrangements, which can be established on the back of this set up.”

International investors looking into the Nordic region will look for one solution to cover all Nordic countries. “RFPs and other requests are almost 100 per cent issued on a pan Nordic basis,” says Wennerberg. “Those who succeed in offering a pan-Nordic model will win the most clients.”

SAXESS
All stock exchanges that are part of the OMX exchange group are operating on the SAXESS trading platform. The most recent adopter of the platform is the Vilnius Stock Exchange in Lithuania. SAXESS was launched to realise the vision of an integrated Nordic and Baltic securities market. “Any securities firm, whether inside or outside of the Nordic region need only make one technology investment in order to transact with this region,” says SEB’s Ulf Noren. “OMX now has control over several stock exchanges with full integration between Sweden, Finland and Denmark and the three Baltic countries.”

OMX currently owns all stock exchanges in the Nordic and Baltic region, except for those in Iceland and Norway. Securities services providers such as SEB have noticed efficiencies from the consolidation of stock exchanges in the Nordic and Baltic region. “Members will have one source for participating in these joint exchanges, not only in terms of IT, but also in terms of membership application and education,” says Noren.

Members of the Oslo exchange are now able to view the trading books of other Nordic and Baltic stock exchanges but can only trade if they are members of all participating NOREX exchanges. “We would like to see a common Nordic stock exchange to enable one point of entry,” says Noren. “This is within reach. The merging CSDs are hoping to introduce a common model for clearing and settlement in November 2007. A fully integrated CSD for the Nordic region will take longer as the different tax regimes in the countries have to be considered along with other legislative actions.”

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There will be a marginal possibility for providers to operate as niche providers, but this is hardly possible in the sub-custody arena.

Nearly all of the liquidity in the Estonian market, for example, exists in the shares of Hansa Bank. By purchasing all of the shares in this bank, Swedbank has taken most of the liquidity out of the Estonian market.

Hedge funds

Noren agrees that the development of the onshore hedge fund industry in Sweden has created significant clearing and custody opportunities for local banks. “We are awaiting a few pieces of legislation in Norway to move the hedge funds industry forward,” says Noren. The growth of hedge funds has a direct impact on the securities lending industry. “Sweden has an extremely well developed securities lending market, which commenced in 1989,” says Noren. The prime brokerage lending market is also an important and increasing business line. Some providers have well developed auto-borrowing systems in order to support their custody activities. There is a surplus of stock available in Sweden, a fair amount in Finland and a current shortage of lendable stock in Denmark and Norway. Cultural and tax-related factors in these countries used to hold back the development of securities lending. Now that the tax barriers have disappeared, it is merely a case of getting comfortable with the market.

Nordic Presence

SEB is currently present in all Nordic and Baltic countries. As institutions continue to look for one securities service provider who can offer a pan-Nordic solution, providers are creating alliances or are consolidating to meet this demand. “This consolidation is good for our business,” says Noren. “The downside is the ongoing price and fee pressure, paired with an enormous investment requirement to ensure that we stay ahead in terms of service provision. We are also required to make mandatory investments into the infrastructure. The equation will be very challenging.”

Traditional banking regulations such as Basel 2 are also expected to affect custody provision in the Nordic countries. “The law says there is a low, mid and high level for organising your internal control and exposure control,” explains Noren. “The implication is that you have to allocate less collateral in order to run your activities. The problem is that the highest level is not yet defined by the regulator. Regulators are currently addressing banks at a mid-level because they do not allow a custody provider to have the lowest level of control. 20 per cent of a bank’s custody revenues have to be collateralised i.e. some collateral has to be put aside. The result is that if the supplier made EUR1 bn per year from custody activities, EUR200m has to be put aside as collateral for this revenue.”

The collateralisation rule is expected to increase the competition for capital. “This competition will be further accentuated by the ESCB-CESR standards, which seek to regulate a significant number of custody providers in the same way as CSDs,” says Noren. “These banks will supply credits on the basis of collateral. The problem is that traditionally, banks have survived by taking risks. If they are suddenly forced to collateralise every single trade in connection with securities activities, it would seem unnatural in many cases. The need for collateral and capital will no doubt increase. But this regulation will drain the collateral resources and will take liquidity out of the European market. Good collateral will be thrown after secure processes while risky processes still might well be uncollateralised.”

As a result of the ESCB-CESR standards, a number of investment banks, who have credit arrangements with other firms, will have to collateralise every single intraday exposure. “Our clients would not be prepared to pay much for this collateral,” says Noren. “The result is that clients would be naturally driven towards providers, which have a lot of collateral available.”

Competition

Apart from the impact of regulation, Noren expects further competition from non-Nordic custody providers in the Nordic region. “We will see more suppliers entering the Nordic market,” he adds. “These include organisations who have typically appeared in Europe. In order to stay alive in the Nordic-Baltic custody scene you need to expand your book of business with further regional assets and transaction volumes and expand outside of your traditional core markets in order to get the benefit of scale. There will be a marginal possibility for providers to operate as niche providers but this is hardly possible in the sub-custody arena. You need to be able to invest to provide a pan-Nordic solution. On this basis, providers who do not invest in a regional solution will not remain in the business.”

As one of SEB’s biggest competitors Nordea cites the creation of the Nordic CSD as the foremost important development in the Nordic market. “The aim is to have the other Nordic CSDs in Denmark and Norway on board too,” says Oda M. Myklebust, head of client relations at Nordea. “We hope to have a consolidated Swedish and Finnish market for clearing and settlement by 2008.”
During the first phase of the Nordic CSD development, members of the Finnish and Swedish CSDs have to agree on a new Nordic market model. The second phase involves the harmonisation of legal, regulatory and market practices. The third phase would involve the development of a common system platform, which involves a choice between Exigo, NewClear or HexClear as the most apparent alternatives for a new platform. “We have invested in the existing platforms in Finland and Sweden,” says Myklebust. “The evaluation of each platform aims to establish the most efficient one, in order to accommodate the needs of the Nordic market.

Nordea is both a user and an owner of the Nordic infrastructure. “Our intention is to make the Nordic capital markets as efficient and attractive as possible,” says Myklebust. “We have established an internal body for the development of this infrastructure. We are using this committee to further develop a horizontal and consolidated market. As a custody provider, our strategy is to heavily invest in developing markets. Until trading, clearing and settlement infrastructures merge, we will develop our services in each of the four markets.”

The only country to remain outside of the OMX Exchange consolidation process is Norway, even though it uses the SAXESS trading platform. According to Richard Quinn of Norwegian securities services provider DnBNOR, a lot of work is required in order to enable a true merger between the stock exchanges in the Nordic region. “The existing alliance has not brought any new systems to the table,” he says. “The negative impact of this consolidation is that the bigger stock exchanges could take up the most priority in a merged stock exchange situation. All the focus would then fall on Sweden, which is the largest market.”

Quinn is equally weary of moves to merge the CSDs in the Nordic region. “Merging systems is not easy,” he says. “There are tax regulations, different currencies, languages and time zones to take into account. Consolidation may be coming together, but at a very slow pace.”

While the merger of the APK and VPC took place over six months ago, these Nordic CSDs are deciding which settlement system to use “The choice of system should become a top priority but this has not yet been solved,” says Quinn.

“The negative impact of this consolidation is that the bigger stock exchanges could take up most priority in a merged stock exchange situation”

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Regulation
The fragmentation of the Nordic market is not limited to clearing and settlement. Different regulations make it difficult for some of these markets to set up hedge funds, for example. While Sweden is regarded as one of the largest onshore hedge fund markets in Europe, Norway is somewhat behind in allowing these types of funds to be set up. “You can’t have a hedge fund, but you can hedge your fund,” says Quinn.

Bente Hoem adds: “The regulations on securities lending has changed. However, certain Norwegian institutions are reluctant to lend their portfolio as they are awaiting changes in their own articles of associations and they do not have the system to manage securities lending. We believe that when this is solved the institutions will become more interested in lending their portfolio.”

The Norwegian regulator has changed the securities lending rules for mutual funds, allowing them to lend 50 per cent of their portfolio. The downside, says Quinn, is that these mutual funds can only lend in blocks of five per cent, to Norwegian counterparties only. “The fund has to administer the securities lending programme, for a restricted return, due to the fact that they have to divide their lending between 10 counterparties,” he adds.

However, if these restrictions were lifted, it would be more worthwhile for these mutual fund companies to lend. As a custody bank, DnBNOR is considering whether to offer this type of administrative service for potential lenders.

Opportunities
DnBNOR perceives its alliance with OKO Bank, Amagerbanken and Swedbank as a gateway to the Nordic region. “We expect further growth among investors in the Norwegian market and we are considering the possibility of offering outsourcing services,” says Hoem. “There are further possibilities among broker dealers and asset managers to outsource settlement and middle office activities. We also see increased activity in the securities financing and lending area.”

Quinn adds: “The margins in the world of clearing and settlement are becoming very small and middle office services and securities financing and lending are the future for us. These services are creating a new product life cycle for us in the Nordic region. We are just waiting for the market to move. There is an increased interest in outsourcing. Institutions are realising that having the best settlement team and the best corporate actions team in town is not going to make them any money. Stock picking makes money. People are starting to wake up to the fact that administrative based functions don’t make money and don’t have to be done inhouse. The custodians are really the experts at this.”

DnBNOR is currently targeting small investment managers, who do not want to invest a lot in maintaining systems. “The small and medium-sized investment managers are an interesting market for us,” says Quinn. “It wouldn’t be that interesting for the likes of JPMorgan or Citigroup because a lot of these asset managers are just too small.”

Baltic Inroads
As the northernmost country in the Nordic region, Iceland is also trading on the SAXESS trading platform. Its securities services providers maintain a positive outlook on the development of the OMX stock exchange grouping. “We expect that further inroads into the Baltic region will be possible when OMX enables direct access into this region through a single access point,” says Salome Birgisdottir, head of custody at Arion Custody Services.

According to Birgisdottir, Helsinki is an important piece in the OMX grouping, owing to its long standing relationship with the Baltic regions. “The Baltic region is an emerging market and we have a lot of investor interest in this region,” she says. “In some ways they are quite underdeveloped and their tax regime can be very complicated. We are hoping these alliances will enable further development in this region.”

Countries as far North as Iceland have a limited experience in hedge funds owing to the history of some of these funds. “Icelandic investors are quite shy, but their confidence is increasing,” she says. “Traditionally, investors used to buy funds issued by various Islandic companies.

There has been a change in the last few years and investors are now drawn towards the investment funds arena. The array of investment funds has multiplied. The number of investment funds has substantially increased and investors have more of a choice in how they invest.”

Unfortunately, the securities lending infrastructure in Iceland is virtually non-existent, despite the level of interest in this activity. “The legal infrastructure is currently being developed and we are sure this activity will take off,” says Birgisdottir. “An association of bankers and investors is working on making securities lending in Iceland a reality.”

Apart from securities lending, Arion Custody is reporting interest from investment banks, who wish to outsource their back office.

“This goes beyond custody and these companies now wish to outsource a lot more. We have clients for whom we provide post trade and accounting services. We have a lot more interest from investment banks who wish to do what they do best and would like somebody else provide the back office functions. This has been a major development in the last year and is something that will grow.”

As the Nordic region continues to mirror the world’s most developed markets for financial services, securities service providers are preparing for opportunities emanating from a consolidating clearing and settlement infrastructure.

“There are further possibilities among broker dealers and asset managers to outsource settlement and middle office activities”
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A number of notable mergers and alliances have occurred in the Nordic/Baltic region. What does this pattern of convergence signify and has it helped to make the custody and settlement markets more efficient?

Salome Birgisdóttir is Head of the Security Services Division at Arion Custody Services hf. Arion is a subsidiary of Kaupthing Banki hf and part of the Kaupthing Group. Arion was established in 2003 to provide custody and related services to the Kaupthing Group and other financial institutions. Birgisdóttir has been with Arion since its establishment. Prior to Arion, she was with Kaupthing Banki in Iceland from 1995.

Bente Iren Hoem is Head of Global Relations and Business Development Norwegian provider DnB NOR, a position she has held since December 2003. Prior to that she worked as a project leader in DnB within the securities services area. She has 15 years of experience within the custody business, from Christiania Bank og Kreditkasse, where she headed up International Securities Services and from SEB where she established and headed up its Norwegian securities operations.

Neal Meacham is the head of custody at Swedbank. He has worked in the Swedish securities industry for well over 20 years of which the last seven years have been with Swedbank in Stockholm. Prior to his current managerial position Meacham has primarily worked with client relations management and client services. He was born and educated in the US, but has been a resident of Sweden since the mid-1970’s.

Oda M. Myklebust is Senior Vice President and Head of Client Relations in Custody Services in Nordea. Myklebust heads up the Nordic groups and is responsible for the Nordea’s global client base of 1100 investment banks, broker dealers, global custodians, financial institutions, pension funds and fund companies with assets under management of EUR 460 bln. She holds a Masters of Science degree from Purdue University and is a Certified European Financial Analyst. Myklebust’s career with Nordea has spanned 13 years.

Ulf Noren has headed up the sub-custody Client Relations Department of SEB’s Nordic venture for the past one and a half years. He previously held custody positions with State Street Bank and various other Nordic financial institutions for the past 22 years. Noren lives in Oslo with his wife Anita and Rottweiler Sasha.

Johan Wennerberg is a Vice President at Svenska Handelsbanken. He has been with the bank for 27 years in various positions. Wennerberg is currently Heading the Relationship Management Team for Nordic Custody Services at Svenska Handelsbanken.
Birgisdottir: These are important steps towards harmonisation and standardisation. For example, OMX, which owns the Exchanges in Stockholm, Copenhagen, Helsinki, Tallinn, Riga and Vilnius, is migrating all trading activity onto the SAXESS platform. All NOREX (Nordic stock exchange alliance) members will have access to these markets. For the Nordic and Baltic market, this migration will overcome one of the barriers set out by the Giovannianni report regarding national differences in information technology and interfaces. (A common trading platform) should lead to lower costs for market participants, who will not need to invest in understanding the relevant technologies and multiple back-office interfaces, required to participate in each market. The mergers and alliances have led to a simpler environment, but there is a long way to go as unique market practices, taxation, legal and national differences still prevail in each market.

Hoem: The merger of three of the Nordic exchanges will not have much impact on the custody and settlement markets in the Nordic/Baltic region, as these exchanges have already been on the same system platform for many years. It is therefore difficult to see any significant changes at that level. The merging of the Swedish and Finnish central securities depositories (CSD) will, on the other hand, eventually bring many benefits to its users. But we believe it will take many years before the Nordic Central Securities Depository (NCSD) can live up to its name and deliver any tangible benefits when they have yet to agree on a common system platform.

Meacham: These mergers simply signify the need for the Nordic/Baltic region to function as a region as opposed to a number of individual entities. This is true for the unification of the exchanges, the formation of the Nordic CSD (NCSD) and even with regard to the consolidation, which is evident among financial institutions. The convergence of the exchanges has had little impact on the post-trade and custody market. The NCSD should most definitely bring efficiencies to the market and will give participants in the Swedish and Finnish markets a number of options. Unfortunately, this will not happen overnight as we are looking at a minimum of a couple of years before reaping the benefits from this effort.

Myklebust: On a Nordic level there has been significant movement towards a common Nordic securities market. The Finnish CSD APK and the Swedish CSD VPC took the first step towards a consolidated Nordic CSD by creating a Finnish-Swedish CSD in 2004. This merger is likely to accelerate further consolidation of the CSDs in the Nordic region. However, there are still significant challenges on the way to achieving a truly Nordic CSD, due to the differences in infrastructure and legislation in the Nordic countries. The mergers have not yet resulted in a Nordic securities market and no real benefits have been introduced for the market players so far. Nordea is actively involved in the consolidation of the Nordic markets as a shareholder and a user of the Nordic CSDs and stock exchanges. Nordea strongly supports horizontal consolidation and the development of a joint Nordic securities market. We believe the consolidation and harmonisation of the Nordic infrastructures and processes will ultimately benefit both market players, issuers and investors as a result of increased efficiency in the capital market.

Noren: If we look at mergers within the agent bank arena, the merger between DnB and UBN in Norway created a new savings bank in that market, while taking another supplier out of the market. In 2004, SEB assumed the responsibility for the custody clients at HEX in Helsinki. This strategic move contributed to the changing vertical silo in Finland. OMX has, through various transactions such as the Copenhagen Stock Exchange, secured a strong position in the Exchanges business, with ownership control in six of the eight markets. All exchanges in the region are now on the same trading platform. The ownership of a joint Nordic Exchange is important for consistent allocations but the system used and the willingness to assimilate in the NOREX alliance is even more important. There is a deliberate Nordic/Baltic effort to improve the environment to provide the best possible conditions for market liquidity. The consolidation of the CSDs is much more important for efficiency’s sake. The most important transaction on this front was the merger between the Swedish VPC and the Finnish APK. Consolidation is now in full force and the most important stakeholders are participating in the Strategic Advisory Board. It is a fairly established truth that the cost of operating any of the individual Nordic CSDs currently equates to the cost of running any of the others in Europe. The cost of running one Nordic/Baltic CSD would equal the cost of running one of the current CSDs. Although this reasoning does not take into account the cost of making such a regional CSD multi-currency enabled, it stands without doubt that it would be considerably cheaper.

Wennemborg: The building of the Nordic/Baltic exchange alliance has led to increased interest in the region from international investors, and has most surely influenced the creation of the NCSD. When it comes to the merger between the Swedish and Finnish CSDs, and their ambition to become a Nordic CSD, we are positive about this ambition and believe a common CSD will lead to increased liquidity, efficiency and interest in our home markets. There have not been any significant changes so far. With our pan-Nordic presence we are very well positioned to service clients in all of the Nordic markets.

“How important is the issue of scale among securities services providers in the Nordic and Baltic region? Does scale ensure staying power in the custody and settlement markets or are their still opportunities for niche providers in these markets?”
Panel Discussion - Nordic/Baltic Region

**Birgisdottir:** Scale is a very important issue, particularly as the pressure is on securities services providers to lower their prices. Systems automation is a key element towards achieving scale without incurring burdening costs at the same time. There are opportunities for niche providers in these markets as well. A single Nordic Baltic market is on the horizon but it is still many years away. Specialised market knowledge is necessary and there is also always room for providers who specialise in quality services. This has been proven by the single market in the United States. Several niche providers have thrived there by providing exemplary services to their customers.

**Hoem:** Obviously scale is important. Large volumes ensure that efficiencies can be achieved, resulting in cheaper unit production. However, because of different infrastructures, different currencies, laws and regulations, I would question whether scale, at a regional level, is achievable.

**Meacham:** Scale has always been important and will be even more so as margins continue to dwindle. I’m sure everyone will agree that a certain amount of critical mass is necessary to operate in this business. What makes this interesting is that the scale, which is necessary to remain profitable is different for each and every one of us. A combination of product mix, better margins on special solutions, good cost management, varied service offering, etc is what leads us to the bottom line. Scale doesn’t necessarily always mean profitability.

**Myklebust:** Size, scale and critical mass in terms of clients, volumes and holdings are all very important in the Nordic/Baltic region. Considering the current competitive situation and price pressure in the region and taking into account the recent consolidation, we feel that only two custodians will survive in this region in the future and Nordea will be one of them. We believe Nordea is the one custodian with the critical mass and commitment required to stay in business and survive in the new consolidated Nordic market. We think that smaller local custodians without the Nordic coverage and critical mass will be challenged and will find it hard to survive the competition during the consolidation process.

**Noren:** Only quality of service and efficiency will ensure survival. Being regional and being good will not be enough. The survivors will be those providers, which are regional and which benefit from the scale of a combined service offering. This benefit, in addition to the ability to supply a superior service, is supported by constant dialogue with clients and having the backbone and support to increase investment in the provider’s business.

**Wennerberg:** Size matters to some extent as development becomes less costly when divided over a larger number of accounts. It also costs less for providers which can settle securities in-house, without involving the CSDs. However, the smaller providers have great opportunities if they focus on major issues such as quality, pro-activity, flexibility and the ability to tailor-make services. These players are being innovative in developing new solutions in line with client demands. Niche providers need to be very good and focus on a very specific client segment in order to maintain a market share.

Comment on the development of STP in the Nordic and Baltic region. Have buy-side institutions begun to automate some of their process or is there still a long way to go before automation is realised?

**Birgisdottir:** The larger players have focused on achieving STP in as many areas as possible for a long time now. All developments that enable STP in the markets are warmly greeted and STP solutions are sought after as a result. Looking for opportunities to enable STP has become deeply ingrained in the corporate culture of most market players. Automation is an ongoing process. For now the markets differ in their capabilities to offer automation to the market players. The bottom line is that it always comes down to dollars and cents as automation must incur enough savings to justify the cost that has to be spent to achieve it.

**Hoem:** The easiest way to achieve STP, through SWIFT, remains a very expensive solution for domestic small and medium-sized Nordic institutions. However, other means of STP are now beginning to take hold, like system-to-system interfaces. Domestic institutions are now beginning to wake up to the fact that they need to be more efficient than they have been in the past. Cross-border institutional clients have enjoyed high degrees of STP for many years, however corporate actions processing still remains to be a critical issue, due in particular to the ever-increasing complexity of this area.

**Meacham:** Cost savings exercises have more or less forced the majority of institutional investors in the region to streamline their processes. Some have been very successful in following industry standards whereas others have not always done their homework before heading down the STP development road. It is extremely important that the
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Panel Discussion - Nordic/Baltic region

“Cross-border institutional clients have enjoyed high degrees of STP for many years, however corporate actions processing still remains a critical issue, due in particular to the ever-increasing complexity of this area”

Myklebust: The Nordic financial institutions are still largely non-SWIFT members. However, Nordea offers more automation to Nordic clients via different solutions, including the eCustody and file transfer solution. The different solutions bring more efficiency, STP and cost benefits for our non-SWIFT clients.

Noren: STP levels in the trade and post trade cycle are very high and settlement efficiency is increasing. The STP-element in corporate action treatment is also steadily increasing. The drive for better efficiency and lower fees will in itself provide the answer. Very few institutions can afford to be operating with poor STP rates. If STP can’t be addressed by operational re-engineering, it will be artificially fixed by way of auto-resolution.

Wennerberg: In the Nordic region, the level of automation is very high. The STP rate is close to 100 per cent in all markets and it is continuing to increase, as system updates, such as Newclear and HEXclear, take place.

Comment on the market for securities services outsourcing in the Nordic Baltic region. Are financial institutions willing to fully outsource their middle and back office to a focussed provider or is component-based outsourcing the order of the day?

Birgisdottir: There is an increasing interest in outsourcing, both in terms of component-based outsourcing and full outsourcing of middle and back office functions. Outsourcing depends on the needs of each client. Back office and middle office costs were historically bundled in other fees and it was most often the case that financial institutions did not realise the true expense these functions were costing them. This has changed as financial institutions have begun to focus on the true costs and the risks involved. These institutions have come to appreciate the benefits of outsourcing. Traditionally, the back and middle office are not departments that bring in revenue and if (and when) things go wrong they can quickly eat into a company’s/bank’s profits. By outsourcing the back and middle office to a focused provider financial institutions do not need to invest in professional knowl-
edge or the development of expensive IT and can instead divest themselves of some of the risks involved, especially in settlement and corporate actions handling. The focussed provider is in the business of middle and back office management. Their corporate strategy evolves around providing cost efficient professional services. It is in their best interests to have quality employees and invest in IT solutions. This is generally not the main focus of other financial institutions.

Hoem: Outsourcing is definitely an area that is picking up a lot of interest. As we all know, no two outsourcing deals are the same. I believe we will see deals that are characterised by the outsourcing of limited functions as opposed to the complete outsourcing solution. In other words, we are at the beginning of an evolution here in the Nordic region and many types of hybrid will emerge.

Meacham: It is still too early for full-scale outsourcing deals in this region but I’m sure we will see more and more of the smaller deals coming through. Having said that, it could be a case of opening Pandora’s Box and one major outsourcing deal could trigger a series of others. I’m sure there are many Nordic institutions maintaining close tabs on some of the major deals which have been done outside the region and trying to apply the logic to their own business cases.

Myklebust: Outsourcing is not practised to a great extent yet. But we are seeing movements in this direction in our markets.

Noren: The outsourcing market in the region has been evidenced on a very limited number of occasions. However, we are sure that the region will follow global trends in the future. Outsourcing will comprise component based outsourcing and full back office lift outs.

Wennerberg: To our knowledge, outsourcing is not a very common practice in the Nordic region. Most securities services institutions are full service providers.

How is financial regulation likely to impact the business of securities services providers (for better or for worse?) and why?

Birgisdottir: In the last five years, financial regulation has swung to extremes we have not seen before. This regulation has become too burdensome for securities services providers and in some cases is seen to conflict with good practice. In the late 1990s, the market pushed for deregulation, in order to simplify cross border trading and open up access to markets. Some regulation is necessary and we believe financial institutions should be supervised by the regulatory body in each country. But there must also be a way to protect investors’ rights and interests. Financial institutions need to earn more trust from the regulators than they have at present.
Hoem: We predict increased regulation at almost every level. Worldwide regulatory developments include Basel and anti-money laundering and Europe-wide developments include Giovannitti and G30. At the local level we have seen a tightening of trustee regulations, which affect tax reporting. The danger is that some of these pieces of legislation could conflict with each other, leading to the dangers of over-legislation. This could exert even more requirements on securities service providers, leading to legislation where it is not needed. An example includes the treatment of custodian banks in a similar fashion as International Central Securities Depositories (ICSD’s).

Meacham: Regulation is extremely important for this industry when considering the significance of keeping a high level of investor confidence. There is however concern that the recent rash of regulation and legislation in some cases is over-lapping and possibly conflicting. At any rate, the sheer amount of new regulation is an area of concern since any changes have to 1) be completely understood and implemented by the entire marketplace and 2) be monitored and enforced. Suggested legislative changes concerning trustee functions for mutual funds in Sweden may cause some challenges for custodians should they be adapted.

Noren: The impact of regulation will mainly be negative. Many local moves will increase the bureaucracy in the tax arena where deduction at source will be replaced by a tax reclaim procedure for many investors. On the positive side, Sweden will introduce a new Corporate Act in 2006 to ease constraints in the Voting field. The main worries are to be found in European regulations. Examples include:
- According to Basel 2, Banks will have to apply a number of costly control and reporting measures. As the regulators have not yet defined the highest (and thereby less costly) standard, custodians will have to be consumers of collateral at levels around 15-20 per cent of gross revenues for the custody product.
- The ESCB/CESR Standards will lead to a number of unwanted consequences:
  1) Credits will need to be collateralised. Good collateral will be assured following very safe risks (settlements) while riskier elements, within structured products for example, to a large extent will remain uncollateralised. This will naturally drain the European collateral markets and we fear it might make post trade activity in Europe more expensive.
  2) We have yet to see any European regulation being implemented in all EU and European Economic Area (EEA) countries at the same time and in an identical fashion. As a result, negative consequences will hit some players harder and earlier than others.
3) The Standards are “soft-law” at level two and three, but we still do not know the foundation for the shape of Clearing and Settlement Directive (level 1 legislation).

Wennerberg: In theory, a harmonisation of the financial regulations across the Nordic region could lead to a more efficient and transparent market. However, we have noticed that the local regulators are moving in slightly different directions, thereby disabling a harmonised market.

Comment on the savings culture among institutional investors in the Nordic / Baltic region. Are there any real opportunities for securities services providers?

Birgisdottir: There is a strong savings culture in the Nordic region, resulting in good opportunities for securities services providers. Investment structures may change but investors will continue to need securities services. The latest trend we have noticed in requests from clients is for us to take on greater responsibilities in their middle and back office functions. By outsourcing these functions to us, these institutions are able to concentrate on what they do best and leave those worries behind.

Meacham: As long as the institutional investor community continues to be creative in the development of new investment vehicles there will be opportunities for the securities services providers.

Hoem: Institutional investors have always been more imaginative at investing than the retail funds business. The ability to support these instruments will require investment from the providers, but the returns will be evident. In addition to clearing and settlement, providers will be able to insource the administration of these complex products.

Noren: The impact of regulation will mainly be negative. Many local moves will increase the bureaucracy in the tax arena where deduction at source will be replaced by a tax reclaim procedure for many investors. On the positive side, Sweden will introduce a new Corporate Act in 2006 to ease constraints in the Voting field. The main worries are to be found in European regulations. Examples include:
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By outsourcing the back and middle office to a focussed provider, financial institutions do not need to invest in the development of expensive IT"
Panel Discussion - Nordic/Baltic Region

Derivatives are another area where we will see continued growth. Risk management services will become more and more prevalent as the products and services we offer become more and more complex.

“There is a strong savings culture in the Nordic region, resulting in good opportunities for securities services providers”

Myklebust: The general growth in the investment community is providing opportunities for service providers. The growth of hedge funds in the Nordics is also a significant development, providing further opportunities for securities services providers.

Noren: Nordic savings in securities products has a proven track record. This trend is adopted by public schemes, creating opportunities for securities providers in this region.

Wennerberg: Due to changes in the pension systems of the Nordic countries, local pension funds and insurance companies have become clients of magnitude for the securities services providers.

What can securities services providers in the Nordic / Baltic region look forward to in the coming years?

Birgisdottir: We can look forward to increased access to the Nordic and Baltic markets. We trust the governments of this region will realise the benefits that can be derived from a similar market environment and implement the necessary changes needed to achieve this goal.

Hoem: The competition is getting more difficult and the standard products are providing even smaller margins. We are seeing an increased demand from clients and regulators, and larger IT bills in order to cope with their requirements. It is therefore important to be in the forefront and offer solutions and new products to clients. However, the arrival of the larger custodians in the Nordic region will no doubt have an impact, the extent of this impact remains to be seen.

Meacham: A variety of currencies and a number of CSDs are just two of the hurdles we work around when attempting to be more efficient and cost effective on a regional basis. We will continue to see the large global custodians trying to gain market share and we will also see the commercial and investment banks, which formerly concentrated primarily on one market, now expanding to cover the entire region. Even more areas of the settlement, clearing and custody world will be seen as commodity services with high efficiency and low margins of profit.

Myklebust: The consolidation process in the Nordic region has begun. The goal of a consolidated Finnish and Swedish market is set to be completed by 2008 to 2010. The integration and consolidation of the CSDs in Denmark and Norway may follow.

Nordea’s aim is to support and continue to participate in the future shaping of a common Nordic securities market. We trust this will result in increased efficiency, cost benefits, simplified transaction processing and the harmonisation of market practice and legal infrastructure, which provided a competitive and sustainable capital market in our region. Nordea will continue to participate in this development process on all levels and in all of the Nordic markets.

Noren: The coming years will involve lots of work in the consolidation of infrastructure, tougher competition from the infrastructure, third party service providers, global custodians and European regional sub-custodians. We will be impacted by increased fee pressure, increasing investment needs and the need to increase volume by geographical expansion.

“IT is not unlikely that an international player will try to enter the region within a few years’ time”

Wennerberg: Within the next 12 months we believe the NCSD will decide on and implement a common system platform for use in Sweden and Finland. This decision will be very important for us, and will hopefully lead to a more transparent and efficient market. It is also likely that other CSDs in the Nordic region may enter discussions about joining the NCSD, thereby taking another step towards a pan-Nordic/Baltic CSD. The local securities services providers will be facing fierce competition once a regional CSD solution is in place. This solution will benefit providers who are already working on a regional basis and who have a lot of experience and knowledge on all markets. It is not unlikely that an international player will try to enter the region within a few years’ time.

ISJ: Thank you.
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Making it possible
The development of the international debt market has implications for the clearing and settlement structures in Europe. ISJ seeks Jeffrey Tessler’s views on the role of competition in the development of these markets.

Forty-two years ago an industry began. In July 1963, the very first Eurobond was issued for USD 15 million by the Italian company Autostrade. Whilst Autostrade may not be a household name across Europe, to those involved in the international debt markets it was the beginning of an industry. Over four decades later, the international debt market now operates in a global environment with 24-hour over-the-counter (OTC) trading in securities now worth over USD 12.8 trillion and with future growth rates estimated by Mercer Oliver Wyman to be around 11 per cent per annum for the next five years. The history of the industry should provide a guiding light as we look to its future argues Jeffrey Tessler, CEO of Clearstream International.

The emergence of the Euromarket in the 1960’s was a response to the growing demand for an international wealth creation process. Since then, the international debt market, through continuous new issuance, has flourished while cross-border investment flows have increased dramatically. The International Market and international clearing and settlement have evolved hand in hand to create a distinctive solution to a historic problem that has a familiar tone – fragmenation. Such fragmentation is due to long standing and persistent differences in market practices, differences in securities holding, transfer and processing methods, differences in corporate, banking, securities and secured transactions rules and regulations, and differences between tax legislations in each domestic environment.

However, the international debt market has overcome many of these obstacles by operating under the market practices and rules of the Swiss-based International Securities Market Association. This ability has been extended by the operations of the two main ICSDs (Clearstream Banking Luxembourg and Euroclear Bank in Brussels) which has resulted in the creation of a market where pragmatism rules. As a result, a market has developed where debt issuers can raise finance by overcoming the myriad of complexities in the national environments and where deep pools of collateral now exist.

Competitive Forces

Across the decades, the industry has developed into a competitive duopoly where clients benefit from the competition between Clearstream and Euroclear to be the preferred service provider in the Eurobond market. Competition thrives today and this is despite some voices in the industry, calling for some form of utility to be created.

But Tessler argues that any form of utility structure would never produce the levels of innovation and development that have been the driving force behind the industry thus far. “Such calls for some form of DTCC (Depository Trust & Clearing Corporation)-model for Europe are entirely missing this critical point. As an American, with the fortunate position of having worked in this field on both sides of the pond, the nearest comparison in the US is in fact evident in the Fedwire-eligible securities arena,” he says. The US market space is dominated by the trading of US treasuries and the Fedwire Securities Service has become a real-time, delivery-versus-payment (DVP), gross settlement system that allows for the immediate, simultaneous transfer of securities against payment, operating for over 21 hours a day. In volume terms, the market handles over 500,000 transactions daily, with a value approaching USD 2 Trillion. The service is used by all main primary dealers, in fact over 2,000 securities brokers and dealers use the service. Tessler points out that the dominant settlement agents in the US market include two well-respected and entirely commercial organisations – the Bank of New York and JPMorgan Chase. “The professionalism of these two providers and the competition between them creates a level of efficiency that would be severely undermined if changed,” he says.

In Europe, there are also two highly professional and competitive organisations managing the settlement activities for the fixed income sector – a hugely important and continually growing market. It is unthinkable that in the US there would ever be realistic market support for a drive to merge the operations of Bank of New York and JPMorgan Chase. “It is the sheer power of competition that is widely accepted and regarded as fundamentally valuable,” says Tessler. “In fact, the debate was held some time ago and closed. In Europe, this reality is dawning and I am happy to say that the market has finally accepted Clearstream’s long-held view that competition must be the primary force in defining market structure.”

In recent times, a different debate has emerged which was arguably sparked mainly by consolidation moves at the stock exchange level, primarily by Euronext. This acquisitive strategy has led to consolidation of CSD platforms in some European countries. This has

Market Infrastructure
become a major project under the title of the 'Single Settlement Engine'. Tessler says that whilst this project should be regarded as commendable in its spirit of harmonisation, the effort and expense has in fact stirred emotions in different areas of the industry. He adds: "Firstly, the project is originally based on Euronext's needs to resolve cross-border equities settlement issues following their acquisition drive, and is really not focused on the fixed income sector.

Choice

Clearstream has chosen not to focus on the harmonisation debate and whilst actively participating in the various industry initiatives, Tessler says the debate has clouded people's understanding of what role an International Central Securities Depository actually has. It may well have been an unintended consequence, but there has been a period where the original founding aims of international clearing organisations such as Euroclear and Clearstream have become partially misunderstood, perhaps forgotten or at best muddled with other projects of a distinctly European nature. "This debate has largely overshadowed the real reason that ICSDs exist and now it is the right time to remember their purpose," says Tessler.

Founding Fathers

When Clearstream was formed in early 1970, it carried the tag line 'for the market, by the market' for a clear purpose. Over the years the ownership structure has changed, but the mantra still remains valid and is the guiding light on subjects such as customer service and strategic direction. Clearstream's role is to serve the growing needs of the international securities market across the globe through a network of efficient relationships. But Tessler says this role seems to have been forgotten by the industry. "At Clearstream, we understand our role is to deliver the highest quality post-trade processing products and services to the international debt market and this is a role we are good at and fully intend to expand," he says.

The distinctive competence of international settlement and custody providers stands at risk of being ignored as the debate on European fragmentation rages on. "It seems to be easy to forget that international settlement organisations have become adept at overcoming the complex task of finding legal, contractual and technical solutions to allow domestic markets to 'link' with each other"
Mandates

Control is Key

Discussions about outsourcing have focused on individual investor services, which are being sold on a component basis. New mandates highlight the popularity of component based outsourcing.

Several years ago, when large scale lift outs deals between fund managers and custodians enjoyed the limelight, institutions were eager to outsource as many middle and back office functions to a service provider as possible. This activity was hailed by investment institutions as the best way to avail themselves of operational and back office functions, thereby enabling revenue generation.

Nowadays, the global securities services industry has grown to appreciate that the tables have turned. Institutional investors and asset managers, who have questioned the success of lift out deals, are less willing to pass full control of their middle and back office functions to a service provider just because everybody else is doing it.

And judging by the success of recent lift out deals and the time taken to fully complete these deals, the jury on complete back office outsourcing is still out. Institutional investors are taking a step by step towards outsourcing, handing over certain components of their middle and back office to a specialist provider. Based on the success of these deals and depending on how comfortable they are with the service provider, the institution will then outsource more functions to that provider.

Trust

The level of comfort afforded by service providers is evident in the recent mandate awarded to State Street Corporation by the UK’s West Sussex County Council Pension Fund. Based on an existing relationship in which the custodian served a portion of the Fund’s £740m of assets, State Street has now become the exclusive provider of custody and performance measurement services to the Fund. Under the terms of the agreement, State Street will provide custody for the Fund’s assets, while performance measurement will continue to be provided through WM Performance Services, the European performance measurement division of State Street. The Fund was advised by Thomas Murray in its custody review.

“We look forward to building upon our partnership with West Sussex,” said Alasdair Reid, head of State Street’s Asset Owner Group in Northern Europe.

“State Street serves as a custodian to one-quarter of the UK’s 100 local authority pension plans, and this mandate reinforces our prominent position in this sector.” State Street has also been retained by the Oregon State Treasury to provide a variety of investment services for $60 bn in assets. State Street will provide custody, accounting, securities lending, performance and analytics, and transition management services. The Oregon State Treasury has been a State Street customer for more than eight years. Global custodian RBC Global Services, Institutional & Investor Services (IIS) has also expanded its custodial agreement with Mavrix Fund Management Inc. to include outsourcing of the fund valuations for its 25 funds.

Rob Wright, managing director Global Fund Services, RBC Global Services added: “Outsourcing continues to play a crucial role as many companies look to develop and expand their business and need to find a partner who can leverage existing technologies and services to help them grow.”

Transfer Agency

Within the asset management and fund distribution sector, the investment services component that is most likely to be outsourced nowadays is transfer agency. In order to focus on their distribution strategies, asset managers and insurance companies are outsourcing this component of their middle office to specialist providers such as IFDS, the international transfer agency joint venture between State Street and DST. UK fund manager Foreign & Colonial Asset Management has consolidated its UK open-ended fund range transfer agency servicing with IFDS. The new consolidated business will operate on an outsourced basis with IFDS providing a wide range of investor and distributor services on behalf of F&C to retail and institutional investors, financial advisors and distributors.

Commenting on the mandate, Dominic Sheridan, Director Retail Operations, F&C Asset Management said: “F&C welcomes the opportunity to continue its long-standing relationship with IFDS. IFDS has established itself as the UK’s premier open ended transfer agency service provider and has consistently demonstrated the values F&C expects from a service provider. Its systems and services continue to meet the high standards that F&C wants to provide its Customers and set the benchmark for investment administration processing”. Brown Shipley Solus fund range has also gone live with IFDS’ transfer agency services. Administration of the Brown Shipley Solus range of funds will operate on an outsourced basis with IFDS providing a wide range of investor, advisor and distributor services on behalf of Solus to retail and institutional investors, financial advisors and distributors.
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<td>EUR1.5bn</td>
</tr>
<tr>
<td>March</td>
<td>Mellon</td>
<td>Golden Leaf</td>
<td>US</td>
<td>Custody &amp; Inv. Services</td>
<td>$400m</td>
</tr>
<tr>
<td>March</td>
<td>State Street</td>
<td>BofAmerica</td>
<td>US</td>
<td>Investor Services</td>
<td>$224bn</td>
</tr>
<tr>
<td>February</td>
<td>Bisys</td>
<td>JO Hambro</td>
<td>London</td>
<td>Administration Services</td>
<td>$4bn</td>
</tr>
<tr>
<td>January</td>
<td>BNP Paribas</td>
<td>B. Sabadell</td>
<td>Spain</td>
<td>Global Custody</td>
<td>EUR5.8bn</td>
</tr>
<tr>
<td>January</td>
<td>N. Trust</td>
<td>Insight IM</td>
<td>UK</td>
<td>Outsourcing</td>
<td>-</td>
</tr>
<tr>
<td>January</td>
<td>N. Trust</td>
<td>KBL</td>
<td>UK</td>
<td>Fund Accounting</td>
<td>£325m</td>
</tr>
<tr>
<td>January</td>
<td>State Street</td>
<td>ChevronTex.</td>
<td>UK</td>
<td>Investor Services</td>
<td>$2 bn</td>
</tr>
<tr>
<td>January</td>
<td>BNY</td>
<td>ING IM</td>
<td>UK</td>
<td>Outsourcing</td>
<td>EUR 67bn</td>
</tr>
<tr>
<td>January</td>
<td>BNY</td>
<td>NBP</td>
<td>France</td>
<td>Global Custody</td>
<td>EUR 80bn</td>
</tr>
<tr>
<td>January</td>
<td>BNY</td>
<td>Abbey</td>
<td>UK</td>
<td>Global Custody</td>
<td>£30bn</td>
</tr>
<tr>
<td>December</td>
<td>Fidelity</td>
<td>TextronInc.</td>
<td>US</td>
<td>Investor Services</td>
<td>-</td>
</tr>
<tr>
<td>December</td>
<td>CIBC Mellon</td>
<td>Manulife</td>
<td>Toronto</td>
<td>Custody</td>
<td>$60 bn</td>
</tr>
<tr>
<td>December</td>
<td>BNY</td>
<td>New Smith</td>
<td>London</td>
<td>Custody</td>
<td>New Fund</td>
</tr>
<tr>
<td>November</td>
<td>BNY</td>
<td>Sun Micro.</td>
<td>US</td>
<td>Record Keeper</td>
<td>$2,300</td>
</tr>
<tr>
<td>November</td>
<td>State Street</td>
<td>BA</td>
<td>London</td>
<td>Investor Services</td>
<td>£10bn</td>
</tr>
<tr>
<td>November</td>
<td>Butterfield</td>
<td>Liortrust</td>
<td>Guernsey</td>
<td>Fund administration</td>
<td>£32m</td>
</tr>
<tr>
<td>November</td>
<td>IFDS</td>
<td>Investec</td>
<td>London</td>
<td>Transfer Agency</td>
<td>New Facility</td>
</tr>
<tr>
<td>November</td>
<td>State Street</td>
<td>OAC</td>
<td>Singapore</td>
<td>Fund acc./Reporting</td>
<td>$2bn</td>
</tr>
<tr>
<td>November</td>
<td>RBC</td>
<td>Hermes</td>
<td>Channel Is.</td>
<td>Custody/Fund admin</td>
<td>£500m</td>
</tr>
<tr>
<td>November</td>
<td>BFSG</td>
<td>ARC</td>
<td>Canada</td>
<td>Custody</td>
<td>$1bn</td>
</tr>
<tr>
<td>November</td>
<td>Dresdner</td>
<td>OPERS</td>
<td>Ohio</td>
<td>Securities Lending</td>
<td>$4bn</td>
</tr>
<tr>
<td>November</td>
<td>Key Bank</td>
<td>OPERS</td>
<td>Ohio</td>
<td>Securities Lending</td>
<td>$4bn</td>
</tr>
<tr>
<td>November</td>
<td>BNY</td>
<td>JO Hambro</td>
<td>London</td>
<td>Investor Services</td>
<td>New Fund</td>
</tr>
<tr>
<td>October</td>
<td>ING-BHF</td>
<td>BNY</td>
<td>Germany</td>
<td>Custody Services</td>
<td>-</td>
</tr>
<tr>
<td>October</td>
<td>N. Trust</td>
<td>Michigan CC</td>
<td>US</td>
<td>Global Custody</td>
<td>$400m</td>
</tr>
<tr>
<td>October</td>
<td>BNP Paribas</td>
<td>Master Sup,</td>
<td>Australia</td>
<td>Global Custody</td>
<td>$11.9bn</td>
</tr>
<tr>
<td>October</td>
<td>N. Trust</td>
<td>LAPP</td>
<td>US</td>
<td>Global Custodian</td>
<td>$1bn</td>
</tr>
<tr>
<td>October</td>
<td>N. Trust</td>
<td>Teeside</td>
<td>UK</td>
<td>Global Custody</td>
<td>£63m</td>
</tr>
<tr>
<td>October</td>
<td>State Street</td>
<td>Clore Duffield</td>
<td>UK</td>
<td>Global Custody</td>
<td>$10.4bn</td>
</tr>
<tr>
<td>September</td>
<td>State Street</td>
<td>Illinois State</td>
<td>US</td>
<td>Global Custody</td>
<td>-</td>
</tr>
<tr>
<td>September</td>
<td>Vanguard</td>
<td>Teleflex, Inc.</td>
<td>US</td>
<td>RecordKeeper</td>
<td>-</td>
</tr>
<tr>
<td>August</td>
<td>Nationwide</td>
<td>City of LA</td>
<td>US</td>
<td>RecordKeeper</td>
<td>$30m</td>
</tr>
<tr>
<td>August</td>
<td>Front Capital</td>
<td>City of JHB</td>
<td>SA</td>
<td>Software</td>
<td>Technology</td>
</tr>
</tbody>
</table>
Letters continued from page 4

Double-checking (continued)
Their objective is to analyse the current sources of risk rather than the past behaviour of the portfolio which may reflect significantly different market conditions. However other tools can provide a valuable contribution to an efficient oversight of investment mandates. Performance measurement tools compare the performances of various portfolios and managers. Their drawback is that the measures are only significant over long periods and offer little insight into the source of performance or associated risk. Performance attribution is used to detect the sources of under and over performance in the portfolio. For actively managed portfolios, attribution highlights significant, strategic and style biases and separates the market impact from the manager’s contribution.

Choosing the right strategy
The long-term success of a hedge fund, and its ability to outperform competitors, is frequently dependent upon the firm owners, ability to develop and refine a proprietary research capability that enables them to uncover market inefficiencies and the windows of opportunity in which to exploit them, and to identify investment risks and establish the means to track and manage them. Additionally, hedge funds of any size must carefully weigh the minimal use of standard technique as to avoid parity with the marketplace, eroding competitive edge. Unfortunately, while many money managers are expert at what they do, few are also expert at constructing a proprietary probabilistic inference based multi-factor analytics software model to support their business. So its all too easy for them to make a less than perfect decision as to how to best spend limited resources – time and money. One of the biggest problems for the money manager, I believe, results from selecting a less than optimal analytic methodology on which to construct their portfolio’s model.

Bayesian networks are the implementation of a statistical method of prediction deduced by Thomas Bayes. Bayesian theory predicts uncertainty by the combination of known factors to produce unknown values and even detect undiscovered factors. The properties of the factors are known to the analyst and therefore the model is easily understood.

“the careful choice of a quantitative analytics strategy must meet the specific goals of the money management firm”

While other approaches such as Monte Carlo and Neural Networking illustrate good prediction capabilities, they can fall short in promoting understanding of the inner workings of model structure as well as the analysis of disparate problem types. Regardless of the mathematics chosen, the careful choice of a quantitative analytics strategy must meet the specific goals of the money management firm, whether this is analyst based or forms the basis of an automated “black box” platform.

Chris Poulin, Principal, Poulin-Hugin

Down the Yellow Brick road
I wanted to outline some thoughts about the impact that technology is having right now on trading strategies and the effect it will have on financial institutions ability to differentiate in the future.

Today, algorithmic trading has become something of a self-fulfilling prophecy. The more Wall Street adopts algorithmic trading tools, the more it depends on them to cope with their consequences.

The major focus over the past 10 years has been driving the inefficiencies out of the execution process and we have squeezed commissions to pennies. Where will the next savings be realized? Quantitative trading strategies, including algorithmic trading and arbitrage or strategy trading, have emerged as the next generation of solutions to facilitate the electronic trading markets. As the markets continue to evolve and deeply embrace more automation it has become apparent that technology has gone beyond automating the traditional business processes and is now dramatically reshaping how the financial markets operate.

To quote a recent report from Towergroup: “Trading remains a zero-sum game, and it is not surprising that quantitative trading strategies will facilitate the continued cannibalisation of the cash desks of institutional brokers. Perhaps less apparent is the impact algorithmic trading will have on program trading and direct market access.

“Today, algorithmic trading has become something of a self-fulfilling prophecy”

Chris Poulin, Principal, Poulin-Hugin

“Quantitative trading strategies have emerged as the next generation of solutions to facilitate the electronic trading markets.”
In these electronic trading markets, algorithmic trading will take market share away from program trading as buy-side firms step back from bundling programs and as the price point for algorithmic trades falls below the price point for program trades.

The adoption of automated trading techniques is such that any institution without an algo or DMA strategy is already behind the 8 ball. But how many institutions have reviewed their current infrastructure and taken into account the ensuing market and reference data problem? The focus on front office capabilities has hidden the many problems that engulf the middle and back office, lack of LOB integration, expensive legacy technology and poor data quality. With electronic trading generating revenues based on pennies, will firms be able to maintain their legacy technologies that cost millions to support?

Many firms have to address these burning issues more quickly than they realize. According to analyst studies 60 per cent of today’s IT budgets are spent on the maintenance of yesterday’s technology which in the majority of circumstances happens to be the bottleneck to today’s electronic trading reality. We are in the midst of an “electronic arms race” where agility and the ability to deliver services through Web services and Service Orientated Architectures is the differentiator.

“Technology provided under an application service provider model can save financial institutions money”

The industry needs far more Toto’s and less Wizards hiding behind green curtains, if we all wish to walk the yellow brick road of success. All firms need to address the infrastructure on a holistic basis and be ready to accommodate the massive increase in data volumes, in all asset classes, that are coming down the pipe.

Kenny McBride, Managing Director, Securities & Capital Markets, Financial Services Group, Microsoft Corp.

An Ideal Model

Technology provided under an application service provider (ASP) model can save financial institutions money. The initial set-up costs are lower than for licensed technology, whilst innovative pricing models can ensure that pricing scales up and down in line with the performance of the business. Upgrades are not an issue, 24/7 resilience and global reach can all be contracted through a solid service level agreement. All of these reasons explain why SunGard has such a strong ASP business, with solutions including Adaptive Credit Risk building a significant global customer base.

Financial institutions still have concerns regarding security, technology integration and the ability to customise outsourced solutions.

“The potential introduction of a third party providing hosting is often viewed as increasing complexity, in an environment where vendor relations are being rationalised. Larger institutions may also feel that their own infrastructure is more robust than that of the outsourcing vendor.

It is the challenge of vendors offering ASP solutions to both counter these concerns and provide clear benefits to the institution. How is this best done? Robust service level agreements should clearly identify operational procedures and support, and provide a clear understanding that much of the risk associated with managing mission-critical systems resides with the vendor. A willingness to be flexible can also help. Could the solution be hosted in-house but managed by the vendor, and how will issues surrounding customisation be addressed?

Costings should also be laid out clearly, identifying where savings can be made (such as in reduced hardware maintenance). Vendors can provide additional reassurance, through deferring billing until systems are operational. With lower costs of ownership enticing financial institutions towards ASP models, we have been able to address these concerns, which is why we have seen such success with the model.

Sally Clarke, Vice President, Strategic Marketing, SunGard Adaptiv

Zero impact

A few weeks ago, the electorates of France and the Netherlands resoundingly rejected the proposed constitution for the European Union. Despite the vote’s non-passage, new research from TowerGroup, published it a new report intitled: “Failure to Ratify Europe’s Constitution Won’t Derail Financial Services Integration,” asserts that while the failure to ratify the EU constitution will not doubt complicate the integration of the European financial services industry, and necessitate the revisiting the financial services integration plan and debt harmonisation, it will not ultimately derail the many processes that are already underway.

The foundation for consolidating the financial services industry in Europe is based on the 1999 Financial Services Action Plan (FSAP) and the Lisbon agenda. These bills are not linked to the constitution as the FSAP focuses on economic rather than political unification. Therefore the apparent collapse of the ratification process should have limited effect on the implementation of future financial services directives”

the apparent collapse of the (EU) ratification process should have limited effect on the implementation of future financial services directives

s, we have been able to address these concerns, which is why we have seen such success with the model.

Sally Clarke, Vice President, Strategic Marketing, SunGard Adaptiv

Letters (continued)
Moving & Shaking

HSBC’s Alternative Fund Services has appointed Paolo Lippolis as manager of a newly opened custody operation for alternative investment funds in Milan. The appointment follows HSBC’s Alternative Fund Services’ Bank of Italy approval to open the operation. Lippolis will be based in Milan overseeing the development of the office, which includes acting as custodian for local hedge funds and funds of hedge funds with immediate effect, and recruiting a team of accounting specialists to offer fund administration outsourcing services from early next year. HSBC will use this global reach to support and encourage the hedge fund market in Italy, which grew by 180 per cent last year. Paolo Lippolis said: “New Bank of Italy regulations, issued in April 2005, allow managers to outsource the calculation of the net asset value of their funds to their custodian. This is an important step for the Italian funds industry and will encourage growth in outsourced fund administration.”

HSBC Group also announced two executive appointments within its newly restructured Global Transaction Banking (GTB) unit. Marilyn Spearing is appointed Global Head of Sales for GTB with a focus on exploiting revenue growth opportunities across the full range of GTB services across both Corporates and Financial Institutions, including payments, cash management, securities services, trade and supply chain. She will report to Iain Stewart, Global Head of GTB. Formerly Marilyn was Head of Global Payments and Cash Management having joined the bank in 1995 to create this as a unified business across the HSBC Group. Douglas Maclean was also appointed as Chief Operating Officer (COO) of GTB. As part of his new role Douglas will focus on and be functionally accountable for all processing operations globally for GTB divisions.

Global hedge fund administrator Custom House Administration & Corporate Services Limited hired Thomas J. B. Kelly as a Consultant and Representative of Custom House to market the firm’s services in the Middle East and North Africa region. With 15 years experience in the Gulf region, Kelly will market Custom House’s services to emerging and established hedge funds, fund-of-funds and private equity funds in the Middle East. He reports to Dermot Butler, Custom House Chairman. “The region is shaping up to be a substantial growth area for the hedge fund industry,” said Mr Butler. “Having someone with Thomas’ experience and knowledge is a tremendous opportunity and development for Custom House.”

Euroclear has appointed John Trundle as managing director and head of Risk Management for the Euroclear group Trundle, who joins Euroclear from the Bank of England, will become a member of the Euroclear Group Management Team. Trundle joins the Bank of England where he was head of the Business Continuity Division. He began his career with the central bank in 1979.

F&C Asset Management has appointed Adrian Hickey as Director, Japanese Equities. Hickey, who has fourteen years experience covering Japanese equities, joins from Shell Pensions Management Services. He is a graduate of the universities of Birmingham and Lancaster. He is a fluent Japanese speaker having spent two years teaching English in Northern Japan immediately after graduating from his first degree. He began his investment career in 1991 with Scottish Equitable, initially as a buy-side analyst before moving into a portfolio management role.

GoldenSource Corporation, a global software provider of Enterprise Data Management (EDM) solutions to the securities and financial services industry, has appointed Pat Dolan as vice president, EMEA sales and marketing. Reporting to CEO Mike Meriton, Dolan, brings more than 21 years of financial services industry expertise and software solutions experience to his role and will be based at the company’s London headquarters. Dolan is responsible for the leadership and development of GoldenSource sales and marketing strategy across EMEA. Previously Dolan was the head of sales at Strategic Communications Software PLC.

Mutual Fund Technologies (MFT) has appointed Jane Day as head of its Client Relationship Team. Day comes to MFT from parent company Fidelity Investments where she held a number of senior roles spanning nine years. Most recently she headed up the Programme Office within Fidelity’s Investment Administration operation. Prior to that she held a number of other management positions within Fidelity’s client facing operations groups. Before joining Fidelity, Day was customer service manager for Alliance & Leicester. In total she has over twenty years of experience within the banking and fund management industry.

Northern Trust has concentrated its business development efforts on the Nordic region with the appointment of Allan Nedergaard as vice president, Nordic Business Development for the group’s institutional custody and asset servicing business. Nedergaard will have direct responsibility for growing Northern Trust’s global custody and asset servicing client base in the Nordic markets. Based in London, he will report to Anne-Lise Winge, senior vice president, head of European Business Development. Nedergaard joins Northern Trust from Danske Bank, where he worked for 20 years, most recently in the Securities Services division as head of Sales and Client Relations, First Vice President, serving the bank’s international custody clients since 1999.

Northern Trust has also appointed Ray Bloom as senior vice president, head of UK Corporate Pension Funds to its client service team within it’s asset servicing business in London. He will report directly to Nigel Bloomer, senior vice president, head of Client Services. Bloom joins Northern Trust from The Bank of New York where he was a Senior Relationship Manager for UK pension fund business.

Panopticon, suppliers of real-time visualisation tools to the world’s financial markets, hired three new sales people in the UK organisation. Panopticon’s UK sales force will now cover the following verticals: FI, Equities, Prime Brokerage, Asset Management, Private Wealth, Research, Risk and Performance. Says Willem De Geer, CEO, Panopticon: Derek Flanagan, Russell Davis and Martin Porter are all experienced in the industry, and I am very happy to welcome them onboard.”

Berwin Leighton Paisner (BLP) has enhanced its Funds group with the appointment of Peter McGowan from Clifford Chance. McGowan is currently a senior partner in Clifford Chance’s Financial Institutions group. His appointment is part of the Funds group’s strategy to develop a full service offering across a broad range of asset classes and deals to investment managers and service providers. The service offering includes funds structuring, outsourcing, corporate finance and regulatory advice. This follows the appointments last year of Tim Spangler and Simon Firth as partners in the group. McGowan qualified in Australia in 1988 and joined Clifford Chance in 1990, becoming a partner in 1998.

RBC Global Services Australia has appointed Kate Homewood as Regional Head, Relationship Management, and Rob Chowdhury as Director, Business Development. “Both Kate and Rob are very qualified professionals with extensive experience in the investor services industry,” said Tony Johnson, Global Head of Sales & Relationship Management, RBC Global Services. “Kate has been a consistently high performer for our sales and relationship management team, since she joined us three years ago. Rob has a strong track record in developing new business and expanding market share, most recently in the global custody market with Omgeo.” Homewood will assume responsibilities for the RBC Global Services Australia relationship management
Consulting’s Rohit Bhagat as its new chief operating and technology consulting firm. Booz-Allen & Hamilton, a strategic management and general management consulting firm, where he ran the west coast financial services group from San Francisco. Prior to that, he was with Booz-Allen & Hamilton, a strategic management and technology consulting firm.

Xcitek, a provider of corporate actions automation, has appointed Wendy Gyngell as European Account Relationship Manager for the company’s flagship software solution, XSP.

Wendy Gyngell brings a wealth of investment banking, information technology, pre-sales support and post-sale account management experience to this new role. Working closely with the sales and client support teams, she will be responsible for building strategic relationships with the growing XSP European client base to identify and prioritize operational issues and future business requirements. Gyngell has previously held account management positions at Pershing Securities, peterEvans, Thomson Financial Ltd., ACT Financial Systems Ltd/MisyS Group, and Synopsys Ltd.

Barclays Global Investors has recruited Boston Consulting’s Rohit Bhagat as its new chief operating officer. He replaces Rich Ricci, who became chief operating officer at sister firm Barclays Capital in January this year.

Ricci rejoined BarCap after two years at BGI, filling the gap left by Paul Idzik, who became chief operating officer of Barclays Group. Bhagat will take charge of technology, operations, finance, strategic planning, human resources, legal, compliance and risk.

He will report to co-chief executives Blake Grossman and Andrew Skirton and be based in San Francisco. Bhagat was a senior vice president at Boston Consulting, an international strategy and general management consulting firm, where he ran the west coast financial services group from San Francisco. Prior to that, he was with Booz-Allen & Hamilton, a strategic management and technology consulting firm.
THE 10TH ANNUAL EUROPEAN BENEFICIAL OWNERS’
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Australia and New Zealand Banking Group Limited (ANZ) is one of the leading financial institutions in the Australian and New Zealand markets. We provide an extensive range of Retail, Corporate, Institutional and Private Banking services in addition to a range of specialised functions including Custody Services through ANZ Custodian Services. ANZ Custodian Services is committed to our home markets and continuously seeks to provide our clients with highly competitive service through our customer-focused and experienced teams, extended business hours and ongoing investment in technology. Our capabilities incorporate core Custody and Clearing of securities, Investment Administration Services, Cash, Foreign Exchange and Securities Lending.

Assets under Custody: AUD$90 billion

BHF-BANK is one of the leading German commercial banks which operates as an advisory, service and commercial bank on the areas of Asset Management & Financial Services, Financial Markets & Corporates and Private Banking. Financial Services comprises the bank’s custody services, investment company (depotbank) services and its securities and derivatives clearing business. Through the combination of its local market know-how with an in-depth product expertise it aims to serve its clients in an individual and flexible way. The bank’s longstanding experience in the German securities services market goes hand in hand with a corporate culture that values prompt acknowledgements and short decision-making channels.

Assets under Custody: EUR 160 bn
No of funds: 244

Crédit Agricole Investor Services is the Securities and Financial Services arm of the Crédit Agricole Group, providing a whole range of products and services to institutional clients including Depositary/Custody/Trustee, Fund Administration, and Corporate Trust. Innovation, technology, local expertise and strong commitment to clients enable our European network to be a leading player in the European industry and to excel in servicing Institutional Investors, Banks and Corporate clients. Our position in the market place is reinforced by a strong local presence, particularly demonstrated by the specialised subsidiaries, set up in Paris, Luxembourg and Dublin. The Group also operates a European network of fund administration centres, the Fastnet network, with local operations in Luxembourg, France, Ireland, the Netherlands and Belgium. The Fastnet network is a joint venture with the Fortis Group.

Assets under Custody: EUR 616 bn

DnB NOR is the largest and leading provider of Custody, Clearing and Remote Member Service in Norway. In addition, DnB NOR provides a wide range of value added services to both Foreign and Domestic clients. Through an Alliance solution with banks in Sweden, Finland and Denmark, DnB NOR can offer seamless regional products, which can be customized to our individual client’s needs.

Assets under Custody: EUR 616 bn

JPMorgan Worldwide Securities Services, a division of JPMorgan Chase Bank, N.A., is a global leader in providing innovative products and services to the world's largest institutional investors and debt and equity issuers. JPMorgan Worldwide Securities Services leverages its scale and capabilities in more than 80 markets to help clients optimize efficiency, mitigate risk and enhance revenue through custody and investor services as well as securities clearance and trust services.

ARBC Global Services is the corporate and institutional custody arm of RBC Financial Group. We are the largest global custodian in Canada and among the 10 largest in the world. We have been serving institutional investors for more than 100 years, including 22 years in the global custody business. RBC Global Services, along with RBC Global Private Banking, provides a broad range of value-added services and tailored solutions to institutional investors internationally. RBC provides the full range of fund administration and global custody services.

Assets under Administration: US$1.3 trillion
Number of sub-custodians: 78
**Fund Administration**

**Butterfield Fund Services (Bahamas) Limited**

Butterfield Fund Services (Bahamas) Limited boasts a team of experienced professionals dedicated exclusively to serving investment managers. **Fund administration is Butterfield Fund Services' sole business**, allowing us to demonstrate our commitment to fund administration.

**SG GSSI**

SG GSSI offers a complete range of value added securities services for all institutional investors: clearing, custody and trustee, fund administration, transfer agent and registrar services. Société Générale ranks 4th securities custodian in Europe and 10th worldwide with USD 1,500 billion in assets held. SG GSSI provides custody & trustee services to 2,175 funds and its subsidiary Euro-VL provides valuations for over 3,460 funds representing assets of USD 346 bn. The quality of these services is acclaimed by the world’s leading agencies: - Trustee and custody – Paris: Aa2 (MQ) (Moody’s); CU2 rating by Fitch Ratings: Global Custody Paris and TR2+ rating by Fitch Ratings: Trustee Paris. SG GSSI also provides collateral management and securities lending services.

**Crédit Agricole Investor Services**

Crédit Agricole Investor Services is the Securities Services arm of the Crédit Agricole Group, servicing Institutional Investors and Corporate Clients. CAIS provides a full range of services including Product Structuring, Accounting, Portfolio Valuation, NAV Calculation, Third Party Distribution Platform and Shareholders Services, Corporate Trust and Employee Saving Schemes, Capital Markets Services, Private Equity, as well as Communication and On-Line Transaction Tools. Specialising in the provision of the above services, CAIS is well known for its expertise in asset and liability allocation and globalisation techniques such as multi-manager and multi-class structures. Funds of Funds, Pooling, Master Feeder and Cloning. Some of the above services are outsourced to the Fastnet network, a partnership with the Fortis group. The Fastnet network, operated by Crédit Agricole Investor Services, is present in France, Luxembourg, Ireland, Belgium and The Netherlands. **Assets under Administration: EUR 446 bn**

**DPM**

Derivatives Portfolio Management provides onshore and offshore alternative asset fund administration, back and middle office outsourcing, portfolio valuation, daily NAVs, risk administration and portfolio transparency solutions for fund managers, asset allocators, institutional investors and proprietary traders. **DPM’s services are designed to solve complex administrative needs and improve operational efficiency.** DPM has the systems, infrastructure and experience to handle your toughest administrative challenges. DPM has a world-wide staff of 200 employees. DPM's HQ is in Somerset, New Jersey with offices in London, the Bahamas, and the Cayman Islands. A Mellon Financial Company. **Contact:** Andrew Collins **E:** contact@bntb.com **W:** www.bntb.bm

**UBS Fund Services**

UBS Fund Services offers comprehensive fund administration services including fund set-up, registration and support around the world (currently 28 countries), fund accounting, NAV calculation, compliance management, risk control and reporting. We provide a flexible offering from the full range of services, including Private Labelling, to selected functions. Services are based on leading fund administration architecture, multi-source pricing and powerful compliance tools. Our capabilities also extend to services for hedge funds through our teams in Cayman and Ireland. In times when management attention is increasingly focused on value creation, it may be rewarding to re-evaluate whether asset administration remains a strategic core business to you.

**Contact:** Patrick Lemuet (Paris) **T:** + 33 1 43 23 84 68 **Contact:** José-Benjamin Longrè (Luxembourg) **T:** +33 1 53 05 45 09 **Contact:** Markus Steiner, Switzerland **T:** +41-61-289 04 92 **Contact:** Mike Marsh, UK **T:** +44-20-7901 5229 **W:** www.ubs.com/fundservices

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# Securities Lending

## IFBS

IFBS offers the financial industry a wide range of consulting services as well as individual and standard software solutions. The firm supports clients along the entire security value chain - from business modelling to change management processes.

IFBS’s IT solutions range from FINACE®, a Security Finance and Collateral Management Platform, to the development of tailor-made IT applications.

## eSecLending

eSecLending is a global securities lending manager servicing large institutional lenders, including pension funds, mutual funds, insurance companies and investment managers. eSecLending’s model is based on the premise that exclusive principal relationships generally offer greater value and significantly higher returns to a lender than traditional custodial or third-party agency lending programs. The firm, which has auctioned over $450 billion since inception, awards principal business through an auction process to ensure greater competition and price transparency. eSecLending is majority-owned by Old Mutual plc and maintains offices in Boston, London and Burlington, Vermont.

## ADP Brokerage Services Group

ADP Brokerage Services Group is an industry leading outsourcing vendor for global transaction processing systems, desktop productivity applications and investor communication services to banks and brokerages worldwide.

- Proxy Edge – comprehensive solution for institutional global proxy voting management.
- Gloss – leading international STP system which automates the trade processing lifecycle from trade capture through confirmation, clearing agency reporting and settlement.
- Tarot - a UK retail and private client stockbroking, custody and fund management solution.
- Securities Data Management – outsourced data services for securities operations.

## Advent Software EMEA

Advent Software EMEA, established in 1998, provides trusted solutions for the front through to back office operations, based on a true real-time fund/portfolio accounting platform, to the investment management community throughout Europe, Middle East and Africa. Advent has an established network of offices across the region serving a growing client base of asset managers, hedge fund managers, prime brokers, fund administrators, wealth managers, private banks and family offices who continue to improve their businesses using Advent’s suite of integrated investment management solutions. Advent Software EMEA is part of Advent Software Inc. Nasdaq: ADVS), a global organisation that has been providing solutions to the world's leading financial professionals since 1983. Firms in more than 50 countries using Advent technology manage investments totaling more than US $8 trillion.

## Data Solutions You Can Bank On

Asset Control’s Total Data Management offers seamlessly compatible in-house software and out-sourced services. Asset Control solutions manage prices, reference data, risk factors, credit risk data, corporate actions and research data. The solutions support market risk, Basel II, portfolio management, trading and enterprise-wide operational coherence.

Asset Control is the only firm in its class offering turnkey solutions with guaranteed delivery dates. These ready-to-work solutions eliminate development time and risk. As a future-proof technology investment, Asset Control has been certified by a unique track record of long-standing customer implementations in leading financial firms around the world.

## Financial Models Corporation

Financial Models Corporation (FMC) is a leading provider of high quality software and services to the investment management community. With 28 years experience, six offices worldwide and supporting over 500 clients, FMC can justly claim to be one of the true, global providers to the industry. FMC prides itself on its comprehensive range of front to back office products, its high quality client service and its commitment to innovation through advanced technology solutions. FMC provides solutions on both an integrated (front-to-back) as well as “best-of-breed” (standalone) basis.
FUNDsoft: With offices in London, Glasgow, Jersey and Luxembourg; FUNDsoft provides one of the most technically advanced Fund Administration platforms available. The COBAS range of solutions are designed exclusively for Fund and Investment Managers, BPO providers and TPA's. Various acquisition models are offered covering the following areas:
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Princeton Financial Systems, a wholly owned subsidiary of State Street Corporation, is a leading provider of investment management and accounting systems and ASP services for global institutional investors. Its flagship PAM® investment management systems provide comprehensive STP-ready functionality that can be licensed for in-house use or accessed via the Internet. PAM systems are currently used worldwide by over 350 leading investment managers, insurance companies, mutual funds and unit trusts, pension funds, hedge funds, endowments, banks, and corporations, which manage combined total assets over US $3 trillion. Princeton Financial has offices located in the United States, United Kingdom, Belgium, Australia, Singapore, and Canada. For more information, visit Princeton Financial's website at www.pfs.com.

SimCorp Dimension is a powerful, comprehensive and truly seamless investment management system. It can handle NAV and other calculations, with complete related accounting, for a huge variety of fund structures and product types, including regional specialities. Support for broader functions, such as performance attribution and risk management, are particular strengths of the system.

SimCorp Dimension has been designed from scratch as a total straight through processing system, handling all aspects of the investment management process, consistently. Data is recorded into a single database so that reporting is made easy, there is no reconciliation of data and no duplication of procedures.

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Prime Brokerage

Dresdner Kleinwort Wasserstein (DrKW) launched its Prime Brokerage platform in June 2002 and now offers services across all asset classes from traditional Equity Prime Brokerage to Fixed Income and Credit, FX and Listed Products to single manager and fund-of-fund clients of various sizes and strategies. The core package of services provided by DrKW's Prime Brokerage unit includes: margin lending/portfolio financing; securities lending; custody services; account risk / margin management; execution and consolidated reporting; and cross-product margining. For more information see http://primebrokerage.drkw.com

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Training & Educational Services

BI Norwegian School of Management was established in 1943 and has been an important part of the Norwegian educational system, with strong links to both the Norwegian and international business and academic communities. The school has developed into a first-class, future-oriented “School of Management” and attracted an ever-growing number of students: with 10,000 full-time and 11,000 part-time students, BI is one of the largest academic institutions in Norway and one of the largest business school in Europe. BI was the first academic institution in Norway to receive international accreditation when awarded the EQUIS accreditation by the European Foundation for Management Development in 1999. The school is constantly improving and expanding its course offerings for international students and now offers a full range of undergraduate and postgraduate degree programs taught entirely in English: BSc, Msc, MBA Executive MBA and Ph.D - WWW.BI.EDU

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