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FINANCIAL SERVICES ROUND TABLE FORUM



Nigel Woodward
Global manager for capital markets
and securities, Sun Microsystems

Risk and compliance is top of the global financial services agenda, and will continue to be for the next 2-5 years as the market is challenged to respond to the demands of new regulations – regulatory compliance is never optional.

Technology will undoubtedly be a major enabler, underpinning business processes and practice. The issue is how to apply existing and emerging technologies to maximum benefit. To ensure this happens, the market must come together and through the sharing of best practice, learn how to apply its most useful capabilities.

As a major technology partner, Sun's role is to assist this navigation. Events such as this round table discussion help to contribute to the understanding of the issues and explore potential solutions.

Risk, compliance and technology – what do the industry leaders really think? Are we struggling with deadlines and demands that cannot be met, or are we reaching beyond compliance for greater rewards?

To provide an up-to-date view on financial industry issues, Sun Microsystems will be hosting a series of round table forums. The objective for this first round table was to take a snapshot of opinion on issues relating to risk, compliance and technology. The chairman posed a number of challenging questions – getting to the core of real issues such as:

- Is Basel II compliance still seen as a priority?
- Has the stove pipe (line of business) structure been changed at all?
- Is the compliance challenge being used as a performance improvement opportunity?
- What is so different about MiFID – should we be having sleepless nights?
- How many firms are likely to be ready for MiFID?
- Is there a reluctance to engage in the understanding of MiFID?
- Can the current market data vendors provide the services needed for compliance with MiFID article 27 covering pricing transparency?
- What are your predictions for the next 12 months for risk, compliance and technology?

Debating these questions was a panel representing major banks, market practitioners and technology suppliers. This is a précis of the round table debate.

ROUND TABLE MEMBERS

Accenture	Anthony Kirby (RDUG) and Steve O'Sullivan
Casetone	Ian Pearl
City Compass	Mike Jones
Goldman Sachs	Mark Taylor and Jo Hannaford
MPI Europe	John Cant
BT Radianz	Chris Pickles (MiFID Joint Working Group)
Sun Microsystems	Peter Cunningham, Peter Meinel and Brian Hackett
UBS	James Hope-Lang
Z/Yen	Mark Yeandle
Chairman	Nigel Woodward (Sun Microsystems)
Moderator	Patrick McVeigh (Riversix)

MIFID BEST EXECUTION

Article 21 of MiFID has set the ball rolling on one of the most significant new areas of operational practice.

The article states, “that investment firms shall take all reasonable steps to obtain, when executing orders, the best possible results for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution ...”, in fact pretty much everything.

The issues that arise in complying with this are far from straightforward.

The new article implies that financial institutions should create a new filter on the trade flow to demonstrate good practice. This would include new technology to analyse the trade details and provide comparisons to feed into an auditable framework.

Market participants are working closely to consider how this functionality can be best developed and deployed. Questions that are being examined include whether each firm should implement new technology, or if there is a viable option via a new quasi-securities utility through which trade flow volume would enable cross-market/participant comparative analysis.

This round table event helped to highlight the many issues and their possible solutions – this is stimulating thought and discussion across the industry so watch this space.

IS BASEL II COMPLIANCE STILL SEEN AS A PRIORITY FOR INVESTMENT FIRMS?

The majority of firms are continuing to invest in achieving better performance from risk management systems, but not necessarily to view their risks in real-time. Firms are doing this for their own competitive benefit and not purely as a response to compliance.

Compliance has certainly concentrated the minds of CEOs, particularly in the wake of Enron and Sarbanes Oxley, and budgets have increased to fund big projects. In practice, not that much has changed except there are more forms to fill in to describe customers. Do firms really ‘know’ their customers better? The panel was not convinced that they do. There is certainly much more data tied up for risk purposes but this information has not been integrated into the wider business.

IF THERE ARE STILL STOVE PIPES BY LINE OF BUSINESS AND TYPE OF RISK, ISN'T OUR BIGGEST REMAINING CHALLENGE TO INTEGRATE THEM?

There is enormous pressure inside organisations to meet compliance objectives, but acquiring complete data sets to prove compliance is much more complex than simply collecting data and storing it away. What is the appropriate technique for consolidation of data when there are uncertain definitions? For example, what constitutes an enterprise or operation? The view of the panel is that a life cycle approach has to be taken to transform data into useful information. Firms need to understand how to process data, re-access, store and retrieve it, and then present it in the right place at the right time and in the right format.

IS THE COMPLIANCE CHALLENGE SEEN AS A PERFORMANCE IMPROVEMENT OPPORTUNITY FOR INVESTMENT FIRMS?

Once the CEO is forced to sign off personally, the panel suggested they tend to want to push their obligations down through the organisation, which further embeds compliance throughout the organisation. This means that when an individual is promoted to a supervisory role they need to know what their compliance/performance obligations are and commit to meeting them.

Despite this, major projects such as launching and maintaining a CRM system seem to be implemented in isolation or at best in response to one specific compliance objective. When the budgets for these projects are already huge, the marginal cost for integrating them with other projects to achieve enterprise-wide economies of scale should not be too onerous. However, this means firms need to take a strategic approach to data in a way that they have never previously done – in that sense, MiFID is a timely catalyst.





WHAT ARE THE IMPLICATIONS OF MIFID – WHAT IS IT REALLY ABOUT AND WHY IS IT IMPORTANT?

At its most basic, MiFID is about re-structuring the market to create improved service to customers – end investors. In any industry undergoing such a large period of change, re-structuring pain will always occur and there are always winners and losers. This isn't compliance for the sake of it, like many other regulations, it aims to put in place a series of rules that level the playing field and provide the best results for the client.

Compliance projects are often seen as a need for an organisation to respond to a set of specific obligations by a certain date. Unless an organisation has a culture of compliance they will miss the point about MiFID, which revolves round the whole organisation, much like the Y2K project. In reality MiFID involves every aspect of an organisation; there will be a huge training requirement for investment firms to meet the varied aspects of MiFID.

What is becoming apparent is the lack of activity in the business lines with most knowledge – MiFID is being viewed as yet another compliance project and as such is being controlled by a firm's compliance functions. A possible reason for this is due to the missing level of detail required for organisations to decide on what exactly they should do, allowing firms to step back while the national regulators and the EC sort out the detail.

Another consideration is that many investment firms are simply overwhelmed with compliance requirements. It therefore becomes a challenge of whether to 'control' (to avoid breach and a fine) or 'manage' (to improve performance and service levels). The large firms will have up to 100 compliance staff in the UK alone whereas the medium sized operations may only have several individuals and consequently are forced to deal with the immediate compliance obligations.

HOW MANY FIRMS ARE LIKELY TO BE READY FOR MIFID?

The panel believed that 25% of investment firms will probably be ready with plans for tackling MiFID and see single passporting as a business opportunity. The expectation is that all firms affected by MiFID will be ready, but the early adopters will understand the market model that little bit better, anticipating opportunities and gain business advantage over others. There is a similar situation in the software standards industry with a quarter of the vendors ahead of the game and the rest wondering what their response should be.

“I suspect everyone will be ready, everyone will comply, but those ones who started thinking about it at board level today are the ones who are going to see that little chink of light, understand the market that little bit better and just be an inch ahead of everyone else. And that's an inch they will turn to a mile, then ten miles.”

Steve O'Sullivan, Accenture



OUTSOURCING REFERENCE DATA MANAGEMENT

Inconsistent reference data for uniquely identifying instruments and clients has long been the scourge of STP. Recent TowerGroup research indicates that over 38% of the survey respondents sourced reference data from more than 16 different vendors; for large firms this translated into infrastructure costs for managing reference data of \$10m per annum.

MiFID's reporting, price transparency and best execution requirements reinforce the need for investment firms to examine the financial instruments in which they trade and be able to publish, store and retrieve data effectively.

To help this process Accenture has teamed up with Sun and Asset Control to deliver clean reference data to customers on a managed service basis. The outsourced Managed Reference Data Service (MRDS), which is based on Asset Control's software and administered by Accenture's experienced data experts, compares and consolidates multiple data sources and creates a common data repository that can easily be distributed to consuming applications. The service is supported by a global network of regional support centres, which continually validates the central data repositories.

Managing reference data is about managing costs. "If you centralise data management within the enterprise, you create savings," says Ger Rosenkamp, Asset Control's CEO.



WHY IS THERE A RELUCTANCE TO ENGAGE IN UNDERSTANDING MIFID? SURELY THERE IS NO DOUBT THAT IT IS GOING TO HAPPEN AND INVESTMENT FIRMS WILL NEED TO RESPOND.

MiFID suffers from being difficult to describe. In the alphabet of regulation, the acronym comes across as an almost random project name as opposed to describing a clarifying purpose. Other major change projects like the Euro or Y2K have been easy to articulate and generate a commonly agreed understanding of the problem. MiFID is a moving train and not easy to understand. The European Securities Committee (ESC) and the national regulators have not always been aligned.

For example, at a high level the national regulators may wish to apply best execution more prescriptively to all asset classes from shares and OTC to complex exotic instruments. The commission, however, appears to be heading the other way, leaving it to the Level 3 processes prescribed by the Lamfalussy Process to interpret the articles of MiFID at a member state level. This, combined with the lack of clarity about what implementation means at a member state level, has encouraged firms to hold back.

There is an argument that says senior management is used to being told to head in a general direction and tasked at achieving unfair goals. In the MiFID case, firms may not know, for example, which specific shares are going to be deemed to be liquid but they do know that some will be and consequently there is an indication as to which direction to jump.

In the software industry there is a marked difference between the firms that have developed a board level strategy and are lobbying in a particular direction and those who haven't and are waiting reactively to see what is likely to emerge. In reality budgets and size may mean that a firm simply has to be reactive, because it can't afford to take the wrong decision.

WHAT MAKES MIFID SO DIFFERENT FROM OTHER FINANCE INDUSTRY COMPLIANCE DIRECTIVES?

MiFID is probably unlike other directives in that it combines compliance behaviours within firms that not only affect how they operate internally but also how they, and consequently the market itself, will interact.

It is not rocket science. In a period of change it's always more comfortable to be in the lead position than following and reacting. New regulations and compliance are guidelines – the objective is to improve market practice, causing change for the benefit of the market. Therefore, those who embrace the concept have the opportunity to manage the change.

MiFID also has a geopolitical dimension with France wanting everything on an exchange basis and the UK wanting everything distributed. Political decisions don't always go the way the national bodies thought they would. MiFID will force a redistribution of the markets like no other directive has managed to achieve so far. The political (lobby) tension versus the regulatory tension is going to be fascinating in the months ahead as the details and implications are thrashed out and become clear. Storm clouds are on the horizon and the industry hasn't worked out how much rain is going to fall, or even what protection to take.

At a high level, MiFID requires better client protection and more transparency, which is hard to disagree with. The challenge is that the regulators are going to demand information in such a way that it is accessible and understandable. This industry is expert in shrouding simplicity in complexity, and even charging fees for underperformance.

The biggest problem is that the industry has this information distributed within multiple systems. The home state is potentially going to require data from multiple systems in multiple offices and from multiple countries.

As with many other compliance projects, investment firms are probably going to have to forget regulation specifics. They will need to consider what sort of broad structure is required to run an efficient business in order to take maximum business advantage in the future. Organisations might not fail by not investing but they probably won't win either. The question to ask is what must be done in order to maximise the current position and take advantage of future changes imposed by directives such as MiFID.

Ironically the bigger firms are not necessarily the best at implementing innovative programmes for change. However, they are used to prescriptive regulation, which is prevalent in America. The worry is that they are going to be told to do something that cannot be implemented.

MIFID ATTEMPTS TO HARMONISE THE MARKET IN A NUMBER OF AREAS INCLUDING BEST EXECUTION. BUT HOW DO YOU RETROSPECTIVELY PROVE THAT YOU DID PROVIDE BEST EXECUTION – HOW DO YOU SET UP PROCESSES THAT SEEK OUT SUCH OPTIMISATION?

One problem investment firms will face is establishing if they have sufficient market data to prove best execution; it is expensive and difficult to acquire. In fact so expensive that investment firms will really have to justify the cost of getting data.

The challenge is not likely to be proving best execution in the vanilla liquid shares but the more complex fixed income and illiquid instruments. Consistent interpretation as to what constitutes best execution is going to be a challenge and that is just Article 21 of MiFID.

The Committee of European Securities Regulators (CESR) produced 40 pages on this topic, which has been reduced to four pages by the EC. The clever firms will be able to link to multiple systematic internalisers (SIs) and multi-lateral trading facilities (MTFs). They will want to be in a position to go where the market is and they will be able to link up quickly and change their information strategy on the fly.

ARE THE REQUIREMENTS TO MAINTAIN AND COMPLY WITH A BEST EXECUTION POLICY GOING TO BE ONEROUS FOR FIRMS?

Under MiFID, firms must ensure that they execute trades in accordance with their agreed execution policy. Communicating variations in execution policy might not be particularly complicated because financial service firms already have clever ways of communicating with their clients. The challenge might be in calculating transaction costs pre-trade as opposed to ex-trade. But if the right model is developed it becomes possible to do the calculation nearer the point of execution. This could become a reality if everyone is wired up for business with common standards.

The LSE is order-driven with a vengeance today, leaving market makers with tight margins. Currently 35% of trading liquidity in LSE stocks occurs outside LSE. Internalisation is happening now; the question is how many investment firms will be considered to be SIs? Is it 10 to 15, 300 to 400 or somewhere in the middle?

For investment firms, systematic internalisation is the area that is of most concern from an operational perspective. Of the 73 articles in MiFID Article 27, which defines the obligations of SIs, is the hardest to understand and interpret.



“Like the Clearing & Settlements Directive, MiFID could really be tectonic. It could change not merely the individual processes and behaviours within companies, but equally the way in which those organisations and practitioners interrelate with each other.”

Anthony Kirby Accenture

MIFID STATUS UPDATE

The Markets in Financial Instruments Directive (MiFID) due for implementation on 30 April 2007 is gathering pace and beginning to force investment firms to react.

However we are still waiting for some of the precise details on the directive, such as how many firms will be considered to be 'systematic internalisers', which shares are deemed to be liquid and how and where trades will be reported. The final Level 2 measures clarifying some of this detail will be agreed at the end of December 2005, although there are draft documents available on the European Commission web site now.

In the UK, H.M. Treasury are scheduled to define what MiFID means in UK law (Level 3 in European directive terminology) at the end of January 2006, allowing the FSA to define the changes required to the FSA Handbook. This means that it is not until Q1 2006 that suppliers and market participants will really know what they have to do in order to be MiFID compliant.

The other 24 EU countries will have to follow the same process for implementing the Level 2 MiFID details into their domestic financial legislation.



COULD THE CURRENT MARKET DATA VENDORS PROVIDE THE SERVICES THAT THE SIs NEED IN ORDER TO BECOME COMPLIANT WITH MIFID ARTICLE 27?

The Reference Data Users Group (RDUG) has been battling with reference data standards for years and the recently formed MiFID Joint Working Group is attracting up to 200 attendees in London. This indicates that firms are struggling to come up with a universal answer to these challenges because everybody is still in a discovery phase.

The panel suggested that it is probably too early to say how this will be played out, but the likelihood is that there will be market-led solutions for standards coupled with reference data and classifications for derived data. One challenge is that MiFID is occurring at the same time as the market moves to algorithmic and programme trading. This is likely to push up volumes by a factor of three or four, adding to the scale of the problem to be solved.

There is an appetite for the banks to join together to create a service utility which does not affect competitive positions and which would otherwise exert significant costs. This might work provided everyone had a consistent view of MiFID; firms could identify areas of common pain and cost. However, right now such market harmony is elusive; firms are seeing more areas of difference than similarity, particularly when it comes to servicing institutional versus retail or on exchange versus OTC-booked business. A good example would be transaction reporting and record keeping/retrieval, which might be more expensive than previously anticipated, and the full provisions are yet to be defined.

Initiatives such as RDUG are clearly relevant here – nobody disputes the need for agreement on standards, it's how to achieve the nirvana that is the problem.

MIFID REPORTING REQUIREMENTS SEEM TO RAISE CONSIDERABLE DEBATE – WHAT DON'T PEOPLE KNOW ABOUT REPORTING?

A good starting point would be the lack of clarity surrounding home and host price reporting. It is not clear how the regulators are going to communicate on- and off-exchange information to each other. The CESR produced 143 pages on the subject, which will need to be translated to Level 2. From a cost perspective why would an investment firm want to pay to do this twice – once in the domiciled country and once in the host country?

None of these requirements have filtered down to the technology system configuration side of the business. Given current project roadmaps it is probably a year away from being engineered into the system architectures.

If there was clarity on the policy then there is no technical reason why firms couldn't create consistency, the confusion is deciding on how the regulators are going to agree market practices when it comes to the Level 3 national implementation levels. The squabble is between regulators who want to consolidate into one area for reporting and then agree on who is going to pay for it.

The CESR technical committee has no solution of its own, so an initial thought was for a big central computer locally connected to everyone, such as SWIFT, but on a pan-European basis. The point that is perhaps being missed is there are standards that could be adopted, which would enable the regulators to communicate with each other, obviating the need for a centralised facility. The new online auditing infrastructure clearly has to be efficient and cost effective to implement.

There are also obvious problems with a central facility, such as governance, operation, cost and location. The realms of politics set against an industry with an indifferent track record for centralised organisation and the GSTPA was mentioned in passing. It was also commented that the existence of such a facility would introduce operational risk in itself.

Clearly the answer is to move to standards for the exchange of information. However, there are approximately 2,000 exchange members across Europe; of the existing 21 stock exchanges, no two exchanges use the same format for market data or message translation. MiFID is going to act as a catalyst for solving this problem; it provides a delivery date and the standards people will need to work towards this date. MiFID requires firms to keep lots of data, which will reinforce the need to understand the provenance and quality of this information. Without the market agreeing some standards, there is the strong possibility of transmitting bad data and the greater possibility of it being churned around and none being much use.

It's reasonably easy to build bigger data repositories – the technology is available and affordable through different consumption models. The challenge is to provide effective ways to retrieve it, particularly if the implementation requirements under MiFID call for storage of quotes, voice orders and trades in the correct sequence over considerable periods of time.

On the face of it, MiFID is a great opportunity to focus, but the risk is that if the price point is not viable for the business or too complex for the buy side, they will leave it to the sell side. There is a limit to what the market can afford to pay to effect the change that is being legislated – and the agenda is not to cause firms to fail, but to improve the market.

WHAT IS HAPPENING TO STANDARDS FOR MIFID CONNECTIVITY/PUBLISHING PROBLEMS? IS THIS THE CATALYST WE NEED FOR THE TAKE UP OF STANDARDS?

The MiFID Joint Working Group brings together all the standards interests (FIX Protocol, RDUG, SIIA/FISD and ISITC) into one group and offers some simple options for moving technology forward for MiFID. It gave an IT presentation to the EC in July 2005 and this was the first time the EC had been provided with a technology perspective on the impact of MiFID.

The problem was that the issues had been raised in different ways to the EC. The London Investment Banking Association (LIBA) is London-based and represents 46 banks and had one viewpoint on MiFID. By contrast the German saving bank structure represents 4,400 banks and believes MiFID doesn't apply to them, and consequently the EC was getting mixed message on the implementation consequences. This is compounded as the EC is not well equipped to understand the complexity of the technology industry – and how it could organise itself to be an efficient enabler. Clearly the MiFID Joint Working Group's efforts in this direction are welcomed.

By contrast, the directive for cross border settlement (CSD) seems to have a better grip on the practicalities, with standards work being promulgated more actively. However, the challenge remains the same with only half of the older EU member states using ISO standards at all and the traffic on these systems is relatively small.

When Giovannini published the ten barriers hindering cross-border trading six years ago, taxation was top and standards were rated ninth. When these barriers were re-published last year, standards had moved to the top. From a business perspective, firms need to be able to adopt standards that are sensible and applicable in all areas, clearly being able to identify the business line to which it can be applied.



“The entire global daily traffic on SWIFT is the equivalent of four DVDs downloaded from the Internet. Is this a good place to start building a real-time front office trading standard?”

Chris Pickles, BT Radianz & Chairman MiFID Joint Working Group

SUN TRADING ARCHITECTURE

As we look at new compliance regulation, and MiFID in particular, it is clear that technology will play a major role in the necessary transformation of business processes and ongoing operations. The challenge is how to select and deploy the most proficient technology partner.

Nigel Woodward, global head of Sun's capital markets business chaired the round table forum and believes that, “the ability to consume new technology” is at the heart of this challenge. With this in mind – STAR (Sun Trading ARchitecture) has been developed to enable new operationally-resilient trading environments to be built from today's PC-based trading rooms. Exposure to the operational risks of heat, virus and reliance on individual traders' spreadsheets can be replaced with powerful analytical trading environments, which incorporate built-in best-execution compliance checking, scalable storage and trade reporting for the new breed MiFID ‘systematic internalisers’.

SUNTone

Across Basel, MiFID, SOX and Reg NMS, the resilience of the operational infrastructure is attracting deeper scrutiny. The organic growth of the infrastructure built during the 1990s expansion (and piecemeal investment thereafter) has left a legacy of inconsistent trading room technology. This specifically manifests itself in overall design and architectural principles, which contribute to poor reliability and resilience.

Sun's SUNTone RM methodology delivers a self-assessment framework based on over 1,000 key questions designed to scrutinise the design and operational principles of technology. SUNTone groups these questions into 12 Key Risk Indicators; these in turn provide a framework for assessing an organisation's exposure across the IT function, demanding accurate and prudent management.

WHAT ABOUT AVAILABILITY, INFRASTRUCTURE RELIABILITY, TECHNOLOGY AND OPERATIONAL RISK?

The larger firms are being driven by what people need to see in order to manage the business. The challenge is to give people the information in terms of risk that they are required to manage in order to run the business. How do you apply the availability standard? Is it continuous in all areas? Which business streams does it apply to?

The regulators are driving operational risk compliance with Basel II and firms are motivated to comply in order to gain a reduction in the capital that must be set aside. MiFID is all about operational risk; therefore much of what is required for MiFID on operational risk would be required for Basel II compliance.

WHAT ARE THE PREDICTIONS FOR THE NEXT 12 MONTHS?

1. Data quality will come to the fore, with greater importance being placed on pre-trade information versus post-trade data. However there is no single overall banking data reference model that is going to magically appear and solve different lines of business requirements across an entire complex bank for 2006.
2. The vendor community, in its haste to sell solutions, sometimes forgets that bringing it all together for major change projects is very complex. This must really be taken into account when setting up project expectations for MiFID compliance.
3. As investment firms better understand their trading requirements, there are likely to be a multitude of trading venues across the various asset classes, with algorithmic trading, automated order management and direct market access becoming commonplace.
4. Pan-European trading practice standards will need to develop. Without these, the underlying data standards won't work. The regulators to a certain extent don't really have any control over how firms react to new regulation. In all likelihood this means that over the next 12 months the strong firms will get stronger, and second-tier businesses will divest or merge components that have become marginal.
5. In-house research will probably need to be considerably re-defined due to the conflict of interest articles within MiFID, and this will provide scope for new boutique suppliers to emerge that replace these in-house functions.

“If I had the choice of having to learn MiFID article 27 or all the other MiFID articles except 27, I'd learn all the other MiFID articles.”

Mike Jones City Compass

CONTACT US

Nigel Woodward

Global manager for capital markets

Sun Microsystems

nigel.woodward@sun.com

+44 (0)20 7256 3261

Corporate office

Sun Microsystems, Inc.

4150 Network Circle

Santa Clara, CA 95054

USA

www.sun.com

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