WHITEPAPER: THE REINVENTION OF POST-TRADE

IN MAY, FOW HELD ITS INAUGURAL POST TRADE EVENT AND SURVEYED SOME OF THE KEY MARKET PARTICIPANTS ACROSS BANKS AND BROKERAGES. THIS WHITEPAPER SETS OUT THE KEY FINDINGS OF THE EVENT, THE SURVEY AND SOME ADDITIONAL RESEARCH.

In association with:

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> "The basic need in the market in terms of post-trade is better means of more cost-effective post-trade infrastructures capable of delivering more timely and accurate outcomes across asset class."

The contrast between the sophistication of front office systems and the backwardness of the back office across the financial market is striking.

Front office systems are able to execute fully automated trades in nano-seconds across global markets processing vast quantities of data in real-time. Post-trade systems by contrast still frequently rely on overnight processing.

Investment in post-trade has lagged far behind the front office and today many post trade infrastructures are at breaking point.

Clients are bemoaning the inefficiencies of trade confirmations and systems are creaking under the pressure of increased regulatory requirements and the need to cut costs. Upcoming regulatory reform and the need for greater transparency will only add to the pressure.

The picture is being further complicated as traditional boundaries between OTC and ETD back offices are blurring. What was once run in silos is now coming together in the same process adding to the complexity and the need for a fundamental rethink of post-trade operations.

Across the industry, post-trade is being reinvented.

WHAT'S NEEDED?

The fundamental drivers of change in the back office today are cost and regulation. The costs and inefficiencies of current post-trade technology stacks weigh heavily on banks and brokers already under pressure on the costs of operations.

The basic need in the market in terms of post-trade is better means of more cost-effective post-trade infrastructures capable of delivering more timely and accurate outcomes across asset class.

Innovation is required, so too is standardisation that will in turn enable greater automation. Attitudes are changing and new technologies are emerging. Post-trade infrastructure stands on the edge of a new dawn.

HOLDING BACK CHANGE

Two things have held back change in the middle and back office: legacy infrastructure and a fear of change.

In part due to the size and complexity of back office operations, but also due to a historically slow pace of innovation, post-trade systems within many sell-side institutions have evolved over decades with new units bolted onto a core platform.

Fear of change has held back firms from changing back office system. The huge complexities of post-trade and the constant use and systemic importance of systems creates a risk of dislocation and disruption from any big changes in infrastructure.

Providers of post-trade technology too have been slow to develop next generation platforms. The Merlin project conducted by Rolf & Nolan in the mid-2000s sought to develop a next generation post trade architecture.

However, the ambition was not matched by results and instead of a wholesale new platform, smaller, modular improvements were developed.

THE COSTS OF INERTIA

The key result of this inertia and reluctance to change is post-trade infrastructures that are inefficient and prone to human error.

In today's market, volumes are picking up and the complexity of trade processing has increased with more data tags that have to be attached to each trade and tighter timeframes to process that data.

Reporting requirements and increased transparency is increasing this complexity at an exponential rate.

Legacy systems are often not designed to efficiently process modern data structures requiring a lot of workarounds to meet requirements.

A growing use of Excel over the past five years has provided some efficiencies and to some extent increased automation as brokers can use information from the spreadsheet with minimal manual input.

However, as complexity and volumes continue to rise, greater automation is required to mitigate errors and increase the timeliness of each trade confirmation.

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Currently, some communication between clients and prime brokers remains manual, relying on e-mail or instant messaging to confirm and allocate trades.

The process usually works but requires numerous inefficient manual interventions and is worryingly exposed to human error.

Clients are increasingly automating their post-trade workflows and are putting pressure on their prime brokers to deliver more timely information.

Almost 50% of the respondents to the FOW Post Trade survey said that the most common request from clients was for more accurate reports of trade and account information, followed by standardisation of the data and more timely trade reports.

INCREASED FOCUS ON OUTSOURCING

Anecdotal reports suggest that many firms that do use software to automate the reconciliation and trade confirmation process tend to rely on inhouse builds, dependent upon legacy software.

But as cleared OTC contracts move into the traditional futures workflow, the requirement for firms to streamline these processes is increasing.

All of this is changing attitudes to outsourced technology.

In this respect, the middle and back office is playing catch-up with the front office, where independent software vendors have revolutionised technology provision over the past 10 years.

The same trends that were seen in the front office are now apparent in post-trade.

The pressure to keep on top of regulatory change, the latest technological innovations and an ever more complex trading environment is pushing firms towards mutualising technology research and development via a third party.

Technology that was once an edge on rivals is becoming commoditised.

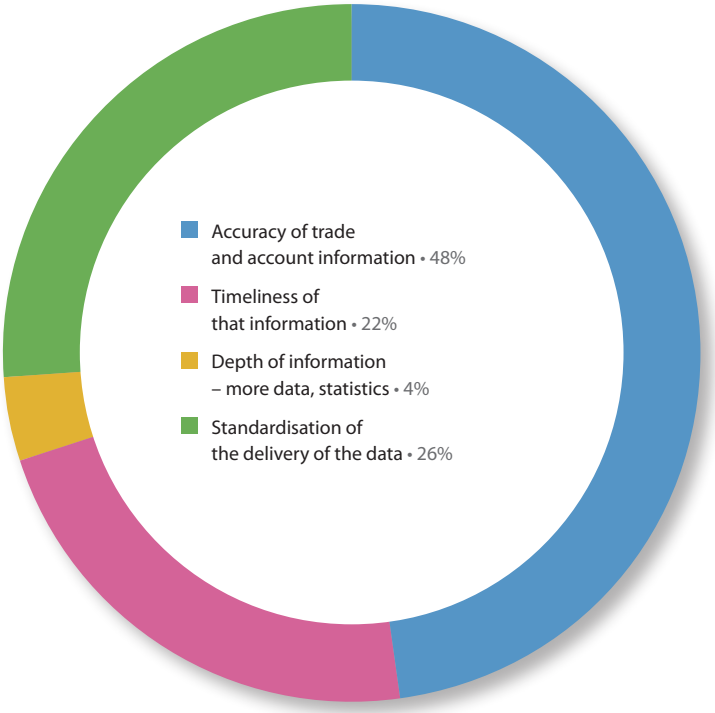
THE SPECTRUM OF OUTSOURCING

Of course, outsourced post-trade systems is not a new trend. The duopoly of Sungard and Rolf & Nolan have provided the basis for post-trade infrastructures across the industry for decades.

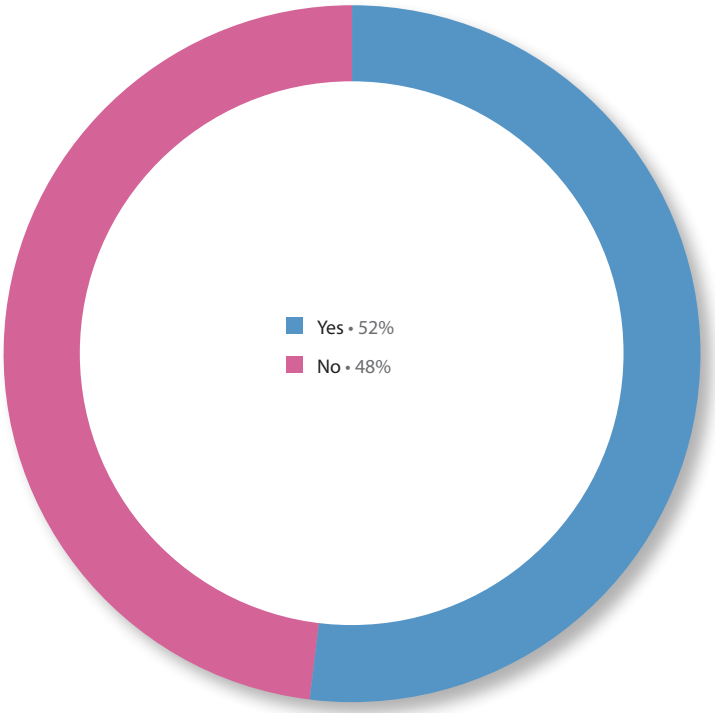
What is changing is an increased provision of disruptive technologies and the sell side's engagement with these companies.

In the survey, over half of respondents said they had engaged with a newly

WHICH AREA OF CLIENT SERVICE IS YOUR BUSINESS/CUSTOMER MOST COMMONLY ASKING TO IMPROVE?



HAS YOUR FIRM ENGAGED WITH A NEWLY LAUNCHED MIDDLE OR BACK-OFFICE TECHNOLOGY VENDOR IN THE PAST 24 MONTHS?



> As clients increasingly demand a real-time view on their derivatives trades, the sell-side will need to respond to that demand by adapting their technology and operational processes

A QUICK FIX?

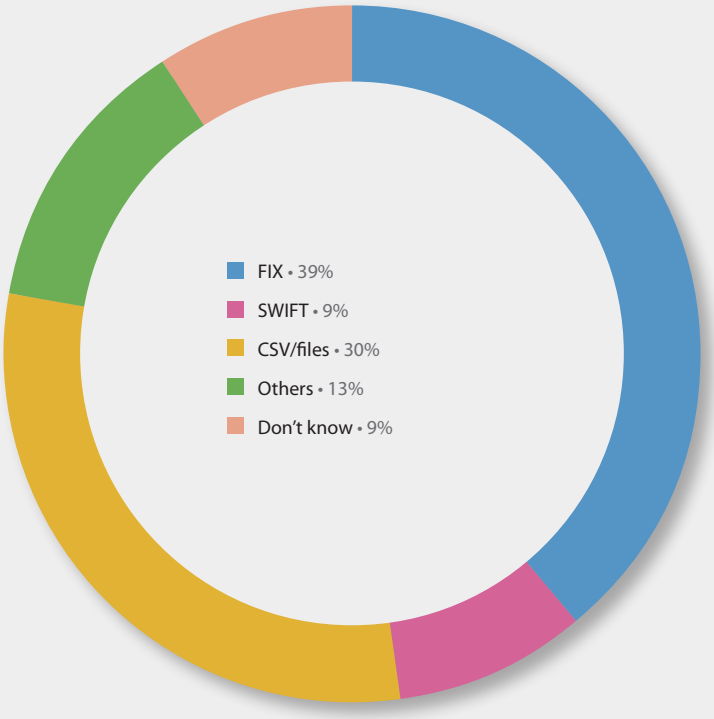
While Excel provides some level of automation, it does not offer the Holy Grail that will be required in tomorrow's post trade environment. To fully automate the post trade cycle across the industry, standardisation is essential.

While few doubt the need for greater standardisation, the question remains on which standards should the new post trade environment build upon. Swift, FIX and Omgeo's CTM are all vying to be the dominant protocol.

FIX tags have become the dominant standard in executing trade orders and it logically follows that extending FIX to the back office would create the greatest efficiencies. Indeed, a majority of respondents to the survey said that FIX would experience the biggest rise in usage in the back office.

FIX is increasingly used in the middle office in equities and fixed income and there is an increasing focus by the asset managers on improving the post-trade efficiency in exchange traded derivatives. As clients increasingly demand a real-time view on their derivatives trades, the sell-side will need to respond to that demand by adapting their technology and operational processes.

WHICH ELECTRONIC DATA DELIVERY MODELS DO YOU THINK WILL INCREASE THE MOST IN YOUR COMMUNICATIONS WITH CLIENTS?



launched technology company in the past 12 months.

In terms of outsourcing, there are currently three broad options available to firms looking to invest in post-trade technology: component replacement, investment in a next generation platform and the complete outsourcing of back office functions.

COMPONENT REPLACEMENT

The growth of software-as-a-service has fulled the growth a numher of new disruptive technology companies across the financial markets.

A number of recent entrants have focused on post-trade processes and are seeking to launch products to increase efficiencies and lower costs.

Outsourcing enables firms to mutualise R&D to lower the costs of development, improve efficiencies and keep on top of regulatory reform.

One example of the latter is Impendium, a Deutsche Bourse owned provider of reporting software. In a world of ever changing reporting requirements the benefits of outsourcing development to a specialist cloud-based provider are clear.

Other firms are targeting efficiencies. In post-trade reconciliation, Duco has launched Duco Cube, a tool designed to be agnostic to the structure of the files and offer data transformation processes to standardise and order trade data. It has signed up around 25 clients since it launched last year.

Another example is Cloud Margin, an end-to-end collateral management tool that the firm claims can optimise the collateral process for a fraction of the cost of incumbent technologies.

The changing architecture of how software is delivered to client, in particular the increased use of cloud hosting, is reducing the risk and the fear of change.

Through component replacement, firms can increase efficiencies in parts of the cycle without the overhaul of a new system.

New trading architectures are being designed to accommodate this trend based around an open API.

Firms can implement a multi-phased programme to overhaul their entire back office in steps rather than in one go.

Open Gamma operates an open source margining API designed to fit in with any existing technology stack. The product allows sell-side and buy-side firms to forecast, understand, and

optimise their CCP margin requirements across multiple clearing houses (see box).

Fidessa has taken a completely different approach to the operational challenges that the post-trade requirements pose by focusing on the operational workflows of both the sell-side and buy-side.

The firm is expanding its Affirmation Management Service (AMS) and provides a fully outsourced solution that lowers operational risk and brings operational efficiency gains to the buy-side.

By leveraging its global reach and distribution Fidessa is able to offer this managed service to the post-trade operations of hundreds of brokers and investment managers worldwide.

Having long recognised the importance of industry standards and collaboration, and the business and technology advantages that these bring, it has worked closely with global industry bodies like the FIX Trading Community to align the workflow and business process with the day-to-day operational necessities of the business.

That understanding is bringing tangible and significant benefits to its clients.

NEXT GENERATION SYSTEMS

Due in the main to the huge complexities of the post-trade cycle and the inertia surrounding legacy systems, the road to the launch of a next generation post-trade platform from the incumbents has been long and arduous.

But the wait is over.

After five years of development, ION, which acquired Rolf & Nolan in 2008 is now in the market with its next generation platform, XTP.

The new platform will offer real-time processing and post-trade analysis. While there are intraday updates in the back office cycle, many firms still rely on overnight batch processing.

The advantage of real-time is a firm gets a complete holistic view of the overall business and client position instantaneously. In a world where a market can move in nanoseconds this is clearly desirable.

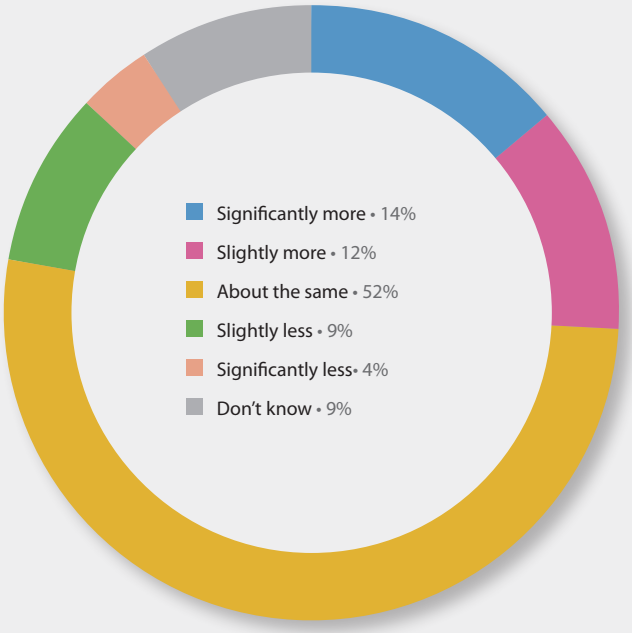
It will also increase the efficiency of cash flow around margin payments. Margin is paid out twice a day in usual circumstances and more often than not the banks don't collect from clients until later.

A real time back office will enable firms to re-engineer cash flows and how

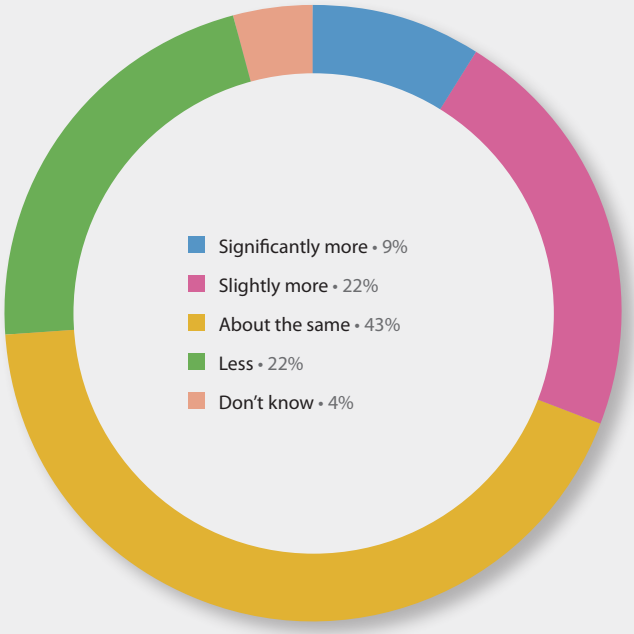
INCREASED SPEND ON POST TRADE

Only 13% of respondents to the survey said they planned to spend less money on post trade over the next 12 months with 26% saying they would spend more or significantly more. Considering the many investments made in reporting infrastructure in 2014, this represents a significant upturn in investment. 30.4% of respondents said they would spend slightly or considerably more on outsourced software in the coming year.

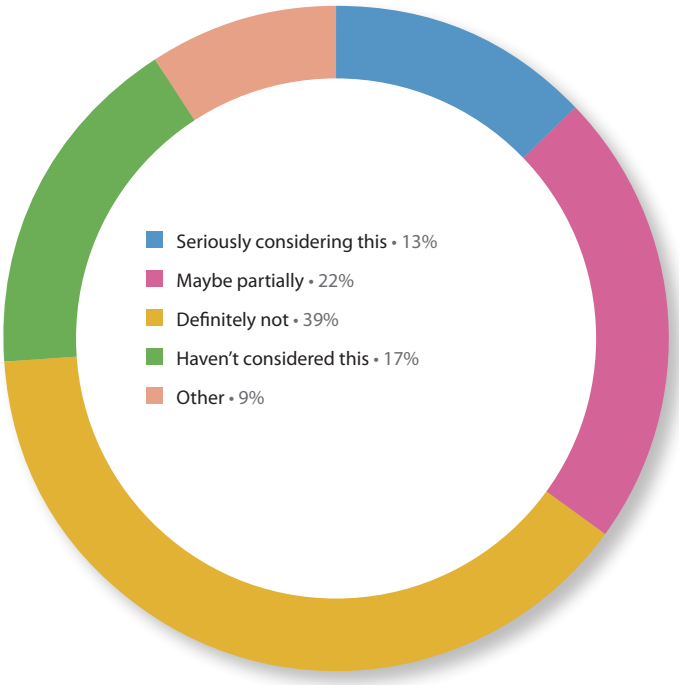
ARE YOU FORECAST TO SPEND MORE ON POST-TRADE TECHNOLOGY THIS YEAR THAN LAST?



OF THAT SPEND, WILL YOU BE SPENDING MORE ON EXTERNAL SUPPLIERS THAN IN THE PAST?



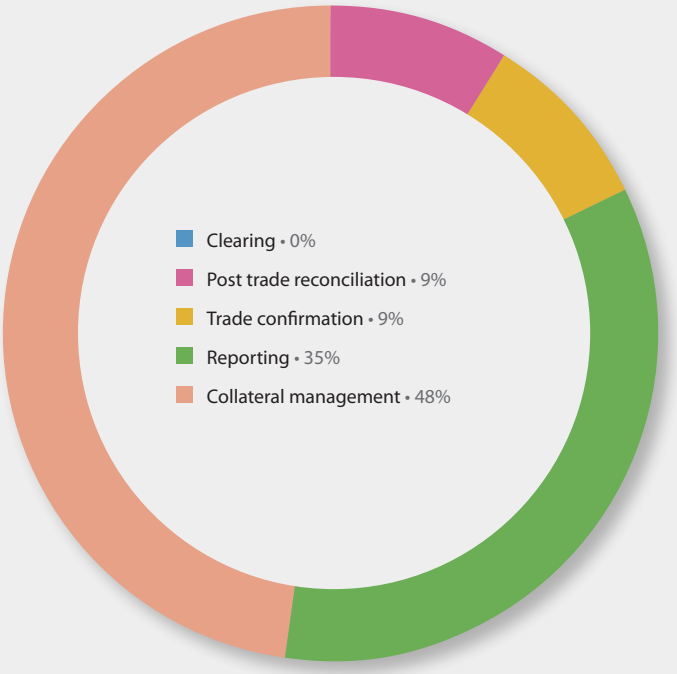
GIVEN ALL THE NEW REGULATIONS, HOW SERIOUSLY WOULD YOU CONSIDER OUTSOURCING YOUR ENTIRE OTC MIDDLE AND BACK OFFICE?



POST TRADE TECHNOLOGY CHALLENGES

48% of the survey respondents listed collateral management as the biggest technology challenge in the back office.

WHICH AREA OF THE POST TRADE CYCLE DO YOU FEEL POSES THE MOST TECHNOLOGY CHALLENGES?



margin is passed between the client and the FCM.

Sungard, one of the two giants of the post-trade world, is also in the process of developing its next generation platform.

But the incumbents will have new challengers to face in the battle for next generation post-trade dominance.

Broadridge is one firm that is seeking expansion in derivatives post-trade via Gloss, a real-time, multi-currency, transaction processing engine which automates the trade processing lifecycle from trade capture through to confirmation, clearing agency reporting and settlement.

Like Fidessa, Broadridge has long specialised outside derivatives and is seeking to replicate its successes in the securities market in the derivatives market.

It is investing in adding cross-asset capabilities and has signed up a number of global clients replacing incumbent technology infrastructures.

COMPLETE OUTSOURCING

A third option being pioneered by one of the two post-trade system incumbents, Sungard, is for firms to completely outsource post-trade operations.

In March, Sungard announced the launch of its Derivatives Processing Utility. The goal is to offer a utility into which FCMs can move common, non-differentiating functions that will be operated by Sungard.

It says that the services include trade clearing, trade lifecycle management, margin processing, brokerage, reconciliation, data management and regulatory reporting. Barclays was announced as the anchor customer and some staff will move over to Sungard as part of the deal.

The utility is intended to provide greater economies of scale as more FCMs outsource their operations. 35% of respondents to the FOW survey said they were look at or seriously considering outsourcing on the scale envisaged by Sungard's new utility.

CONCLUSION: WINDS OF CHANGE

Investment in post-trade has long lagged behind pre-trade and trading infrastructure. However, that is changing as the inefficiencies of the current post-trade environments become apparent in the face of increased regulatory requirements and the drive to cut costs.

Automation in post-trade is getting

better and there is far less paper and manual intervention in the trade cycle today than five years ago.

Firms are increasingly processing trades through STP but the audit trail remains sluggish. A lot of automation is reliant on spreadsheets still and prone to human error.

For all but the largest firms, outsourcing is the only way to meet the demands of the modern trading environment.

Smaller firms are springing up to offer solutions to parts of the post-trade cycle and utilising the software-as-a-service model to reduce onboarding timeframes and increase the efficiency of change.

Larger firms are also turning their attention to derivatives post-trade having captured market share in other parts of the trade cycle and other asset classes.

At the same time, incumbent providers are launching next generation post-trade platforms and radical alternatives to the status quo.

CLEARING UP MARGIN INEFFICIENCIES

With initial margin requirements soaring in the face of increased regulation and more instruments being subject to central clearing, collateral efficiencies are under the spotlight.

The FOW survey found that 48% of respondents cited collateral management as the biggest post trade technology challenge but it also revealed that around a third of respondents did not validate or challenge CCP margin calls.

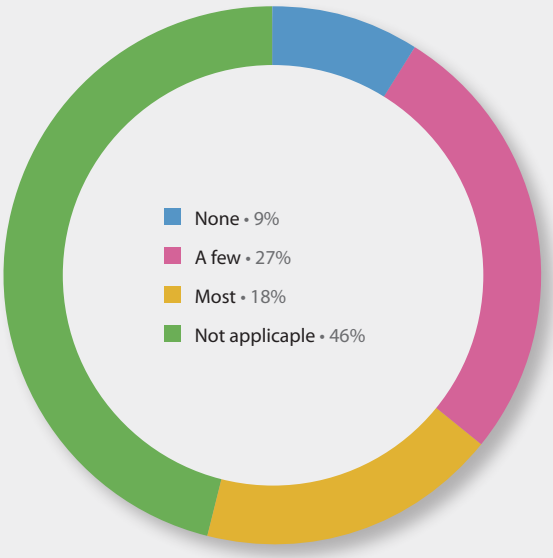
At the same time, the costs of a trade are becoming more complex. Two thirds of respondents now factor margin, capital and liquidity into the cost of a trade.

But with a real-time view of a total portfolio still largely illusive, accurately pricing trades remains a significant challenge for the buy and the sell-side.

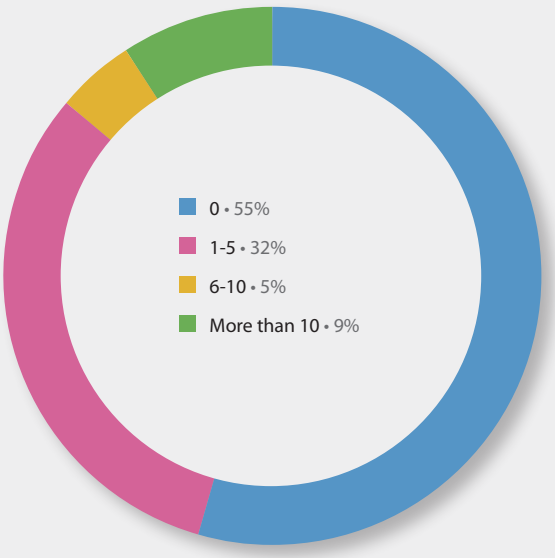
57% of respondents hold excess collateral at a CCP in order to reduce the risk of a trade being rejected but there is an opportunity cost to this with the excess collateral not generating any returns for the clearer.

Software vendors, such as OpenGamma, are launching products to validate and pre-empt initial margin requirements resulting in a more efficient use of collateral across the industry.

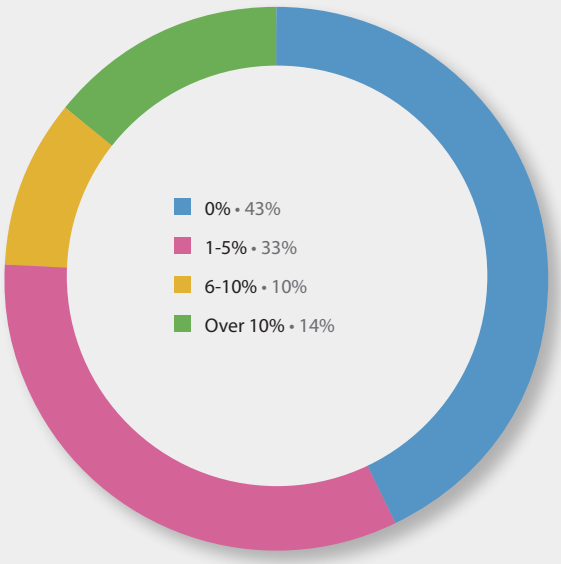
HOW MANY OF THESE CHALLENGES WERE SUCCESSFUL?



HOW FREQUENTLY HAVE YOU CHALLENGED THE CCP MARGIN CALLS IN THE LAST THREE MONTHS?



WHAT PERCENTAGE OF EXCESS COLLATERAL ARE YOU HOLDING AT THE MAJOR CCPS?



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