

Talking the same language

By Kathy Ball-Tonic, Omgeo

When considering the governance of France, Charles de Gaulle once famously asked, 'How can you govern a country with 265 types of cheese?' It seems that the need for standardisation is not new. Standards in any environment are always sought as a way to enable better communication between disparate parts. The global securities industry is no exception. For many years now, we have been moving slowly but surely towards the adoption of common standards. Whether it's ETC, SWIFT or FIX, standards are looked upon as critical to the success of a global trading community and have evolved in line with the growth and sophistication of the industry. But the path has not been an easy one and there are still many challenges ahead.

In particular, the buy-side is still generally more reluctant to fully embrace the use of standards and is seen by some as a barrier to achieving uniform communication in trade processing. This is true for a variety of reasons – including that it's difficult for the investment manager to bet on and embrace one particular standard when they're not sure which one is going to 'win'. In addition, broker/dealers and banks are supporting their own standards and methods of communications. As a result, some industry commentators have gone so far as to suggest that regulators such as the SEC in the US and the FSA in the UK should now step in to mandate the use of standards. In a global securities industry that is only as strong as its weakest link, they argue that this would allow all trade counterparties to benefit from single standards in trade processing, and reduce cost and risk for the entire industry.

However, before we hear the point of view of some industry analysts about the potential role for regulators, let's first take a step back and ask why is the implementation of standards always such a challenge? A standard's success is most often measured by its usage and as we all know, getting a critical mass to adopt a particular standard is a tough job. Think about Esperanto, which, in theory, is a great idea: a single language to unite the world. But in reality it never took off, as nations and individuals were reluctant to give up their own language to learn something new. This has also been the case in securities processing, with firms and markets preferring to use their own proprietary systems. These proprietary systems often provide a business advantage for the firm and are frequently so entrenched within a particular firm that it is difficult to use anything else. What works best in the UK does not necessarily work in Germany, for example. Each market will claim that it has its own special needs and that it is necessary to tweak a standard to meet its regional requirements. On top of the market intricacies, there are also specific requirements for each of the multiple instrument types that must be met.

But without a common message, standard trades are more likely to fail, as critical pieces of information will not be recognised. In his report on STP, entitled 'It's about time', Richard Greensted uses the analogy of the telephone call to explain this. He writes 'When you make an international call from, say, Tokyo to Toronto, you don't care how many cables are used, who owns them or how many telecoms carriers are

involved in the process of getting you connected. You just want to dial the number and talk to your buddy. That would be impossible if the world's telecoms companies hadn't unanimously agreed on a standard method of handling international calls. It is precisely the same with securities: if everyone uses a different methodology for formatting their messages, the trade will undoubtedly fail.'

Getting agreement on global message standards has been a priority for the industry for at least ten years, but it's not a simple task. There have, however, been a variety of industry initiatives, which have enjoyed varying levels of success. Included in this group is the formation of The Industry Standardisation for Institutional Trade Communication (ISITC). It was set up in 1992 to standardise the format of trade settlement instructions and other messages, so that at least everyone would be speaking in roughly the same language. ISITC now has a separate European arm and a strong Asia-Pacific contingent and has done a great deal to further electronic trade confirmation and promote the use of standards, for example by producing an ETC Code of Best Practice.

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SWIFT is another well-known industry-owned co-operative that has been very successful in progressing the usage of standards. It supplies standardised messaging services and interface software to banks, broker/dealers and investment managers in 200 countries, as well as their market infrastructures in payments, securities, treasury and trade.

However, an area of securities processing that has failed to reach any consensus is securities identification. It has been an ongoing challenge for the industry. Every security in the world has a unique identification code assigned to it by a national numbering agency such as stock exchange or regulatory body. But the format of these codes, such as CUSIPs in the US and SEDOLs in the UK, differs widely from market to market. Unfortunately, despite a report from the G30 group, offering recommendations about how to

standardise this procedure, little progress has been made. Instead, firms often have to maintain cross-reference internally at considerable expense or utilise cross-referencing functionality, for example in Omgeo Alert.

A standard that has enjoyed more success is FIX (which is after all what this publication is all about). Originally developed for front-office use in the US by Salomon Smith Barney and Fidelity in the 1990s, the FIX Protocol has been adopted by many firms. It has been particularly widely used in the US as a standardised way of delivering pre-trade and trade information, including indications of interest (IOI) orders, executions, allocations and confirmations. It has become the de-facto protocol for trading and is supported by connections from Order Management Systems, middleware providers, as well as proprietary connections. Fund managers are now increasingly regarding FIX as the most common open standard for sending orders between the buy- and sell-side.

However, as I mentioned before, standards like FIX are only as effective as their usage, so the industry is finding new ways for firms to progress with their implementations of FIX without being impeded by others' ongoing adherence to alternates. Specifically, services are emerging that translate between standards and which offer the potential to insulate firms from the complexities of trying to retain the capability to natively communicate in each one. For example, the Omgeo CTM FIX Interface allows Omgeo solutions to accept and support FIX allocations and confirmations, acting like a translation hub. It will, in real terms, facilitate that single link: connection of front-office FIX Protocols with back-office ISO 15022 standards, which aids in the reduction of fragmentation in industry processes. It also enables investment managers to send automated FIX allocations to Omgeo's community of broker dealers, irrespective of their counterparties' current ability to process FIX allocations, thereby allowing buy-side firms to accelerate their use of FIX throughout the trade life cycle. This will greatly improve the community of users being accommodated by FIX messages in the electronic allocations space and will mean that investment managers will not have to maintain as many individual FIX connections with their broker counterparties.

But in addition to simplifying implementation, what other drivers are out there to further incentivise the buy-side

to adopt these standards? As mentioned above, some have said that regulation is needed in the future to streamline trade communications and reduce cost and risk for the whole industry. But what would this regulation look like, and is it really feasible or realistic?

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I asked three industry analysts – Aneet Shah, Analyst & Practice Leader of the Capital Markets Business Services at Bloor Research; David Furlonger, Vice-President & Research Director at Gartner Group and Tim Lind, Senior Analyst of TowerGroup – for their opinions on this matter.

Should regulation force the buy-side to adopt standards in trade processing e.g. FIX?

Aneet Shah, Bloor Research: It would be a good idea, just look what it is doing for credit and operational risk; they can turn a discretionary spend into a non-discretionary spend. Generally, regulators would get involved where there is risk involved that would impact the small man on the street, cause systemic risk or lead to market failures; unfortunately standards do not fall into these types of categories.

Tim Lind, TowerGroup: No. Regulators should only be involved in matters where the integrity of the market is at stake or where certain behaviour would result in systemic risk that ultimately threatened retail investors. I don't believe the use of messaging standards (or lack thereof) is a matter of systemic risk and I would argue that in terms of being an advocate for the investing public, regulators have much bigger fish to fry these days. Our notion of free markets must preserve the right of all businesses to allocate their technology budgets according to their own best judgment. Free and fair markets tend to seek equilibrium and will eventually ensure that the source of inefficiency will ultimately have to pay for it.

David Furlonger, Gartner Group: No. In general, market forces should dictate the adoption of messaging

standards as opposed to regulation. In essence, the sell-side – which are the major proponents and beneficiaries of buy-side standard adoption – should provide incentives to the buy-side for standard adoption and utilisation.

Should regulators, rather than industry participants, be responsible for the standards, to ensure consistency?

Shah: No. I think the industry needs to be responsible for the standards as they have the right technical knowledge and understanding to move them forward. However, if there was an overseeing body like the G10 group that have some influence, then I am sure consistency would be achievable. The other idea is to introduce differential pricing based on quality.

Lind: No, industry practitioners are in the best position to define the right standards to suit their business requirements. Regulators have very smart people working for them but they come from legal backgrounds, not

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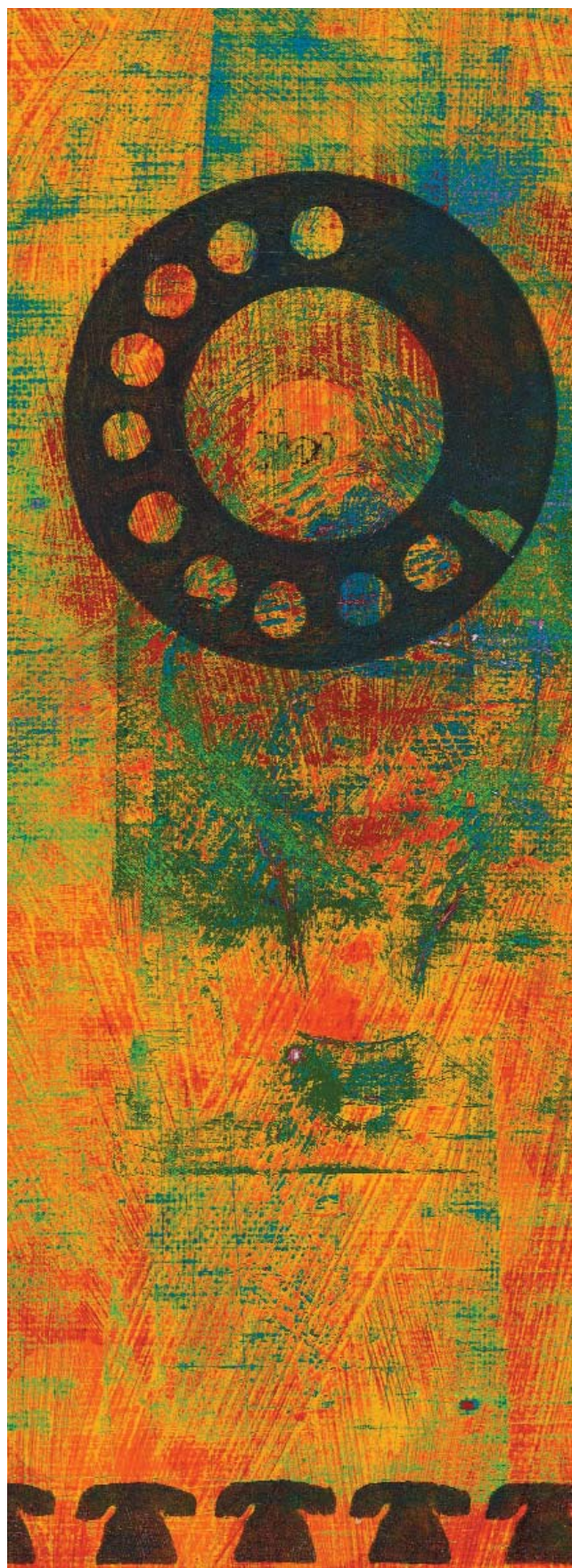
securities operations. The additional bureaucracy that regulatory control of messaging standards would bring will not ensure consistent interpretation and implementation of electronic messaging by institutions.

Furlonger: No. Regulators have no domain expertise in establishing, managing and monitoring standards usage in this area. Market requirements should determine standards evolution. Regulators would introduce market inflexibility, inhibiting business value.

What role do regulators play with industry organisations such as the SIA in the U.S. or the FSA in the UK?

Shah: I think it is more a consultative role.

Lind: To better understand the environment of their constituents, I would see regulators becoming more interested in the activities of the SIA, but not necessarily taking any official role. The SIA has shown leadership in defining best practice and as a forum to help its members improve their operations. So regulators will look to industry associations like the SIA for its sell-side



expertise and as a source for comments on any impending proposals.

Furlonger: They should be active participants, representing the regulator's interest. They are one more participant, and should be represented, as should all interested parties in standards formation. An example is the participation of government agencies in the formation and development of the XBRL standard (an industry standard for the tagging of financial information). These agencies are active in the XBRL organisation, but they do not assume a dictatorial or controlling role.

Should we be aiming for one, global standard in trade processing?

Shah: A single global standard in trade processing is a bit like trying to find one universal language of communication in a society of different cultures and practices. Something to aim at, but in reality there are always going to be differences.

Lind: One global standard is a lofty goal, but it we need to be realistic on how much effort it will take to get there. As standards organisations increase the scope of their messages with each release, we move further away from a common standard, not closer. In financial services, we will always live in a multi-dialect world that is often in silos according to function, geography, asset class and line of business. Is it better to spend years lobbying various standards groups across all silos to abandon their own standard in favour of another? Should we embrace the expertise offered by each standard and use the integration technology currently at our disposal to manage different methods of tagging business information? While it's hard to argue with the principle of one standard, institutions don't have the luxury of waiting for a perfect world and will be forced to invest in integration tools anyway. In a world of operational silos, pragmatism will force us to embrace the differences.

Furlonger: No. We should be aiming for interoperability and consistency across standards and their versions to maintain flexibility and encourage innovation.

There does seem to be a consensus within all sides of the securities industry that standards are important, but the adoption of standards is often slow in coming. Whether the fund management industry does this itself or regulators step in remains to be seen – it is likely that rising volumes in the

future will drive the buy-side to further increase the efficiency of their trade processing through standards before the regulators need to act. As we have seen in the past with T+1, regulation often acts as an accelerator, rather than a driver, for embracing new methods of trade processing. The real drivers – providing increased levels of customer service and transparency and reducing cost, risk and inefficiencies – remain constant. **FIX**