

July 2004

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**UPCOMING EVENTS**

- **July 22nd**  
Lunch and Learn Event hosted by AMF, TBMA and FIX Protocol Ltd. (SEC official to speak)
- **August 3rd**  
AMF Golf Outing
- **August 10th**  
BCP Lunch and Learn Session

**STP Educational Event: SEC to Speak to AMF**

The Asset Managers Forum is partnering together with The Bond Market Association and FIX Protocol Ltd. in sponsoring an educational event on July 22, 2004 to discuss industry STP best practices. At this event, buy-side and sell-side professionals will comment on representations that the industry itself can make progress regarding the automation of institutional trade processing. Michael Wyne, Managing Director of Fischer Francis Trees & Watts, and Julie Warren, Managing Director of New York Life Investment Management will serve as buy-side speakers at this event.

In the past several years, Mr. Wyne and Ms. Warren have helped to define the Street's goals concerning automating the clearance and settlement of institutional trades. The SEC will also be present to speak on STP from a regulatory point of view. Vendors will describe how their success to date can be further employed by market participants, including asset managers and custodians. Questions that will be addressed include: What is the likely follow-up to the SEC's Concept Release? How do industry members envision the development of best practices concerning STP? And, how is The Asset Managers Forum driving the STP solution?

For more information or to register for this event, please click on the following link:  
<http://www.bondmarkets.com/story.asp?id=1226>.

**Omgeo Sponsors AMF Membership Networking Event**

On June 23<sup>rd</sup>, Omgeo, together with the AMF Membership Committee, sponsored a networking event for current and prospective AMF members. The event, held at the Marriott East Side, included around 50 attendees representing about 25 firms. AMF Membership Committee chairperson Mike Wyne and AMF Vice Chairperson, Lisa Ilaria spoke on the recent accomplishments of the AMF and its committees. They outlined such efforts as the recent response to the SEC on the STP Concept release, the best practices document of the Swaps Committee, and the COO Forum. Also in attendance were several members of the AMF Steering and Membership Committee and AMF staff members.

**U.S. Treasury to Address Members on BCP Update**

The Bond Market Association's Business Continuity Management Council is sponsoring an educational event on August 10, 2004 to review critical information that fixed-income securities professionals need to know about industry business continuity planning. Accordingly, Scott Parsons, Deputy Assistant Secretary for Critical Infrastructure Protection and Compliance Policy of the U.S. Treasury will address AMF and BMA members on issues relating to the fixed income industry's resiliency from a disruption. In addition, a panel of BCP professionals will discuss the Street's crisis management escalation strategies and how different firms manage the business continuity process. Professionals from industry utilities will also be in attendance to answer any questions from the audience. This lunch and learn event is meant to bolster the Street's understanding of business continuity issues so that the fixed income industry is better prepared for emergencies. Asset Managers and Broker/Dealers are encouraged to attend. For more information or to register, please click on the following link: <http://www.bondmarkets.com/story.asp?id=1262>

**Second Annual Golf Outing**

The Asset Managers Forum is hosting its second annual golf outing on Tuesday, August 3, 2004 at Ardsley Country Club in Ardsley-on-Hudson, NY. Immediately following golf, there will be dinner and awards. You can register for golf and dinner, or just dinner at the AMF web site or by clicking on the following link: <http://www.bondmarkets.com/story.asp?id=1116>. Space is limited, so sign-up today. Both members and non-members are welcome to attend.

## Educational Series: STP and the Lifecycle of a Trade Part III: Trade Execution and Allocation

By Joan Cheney, FFTW

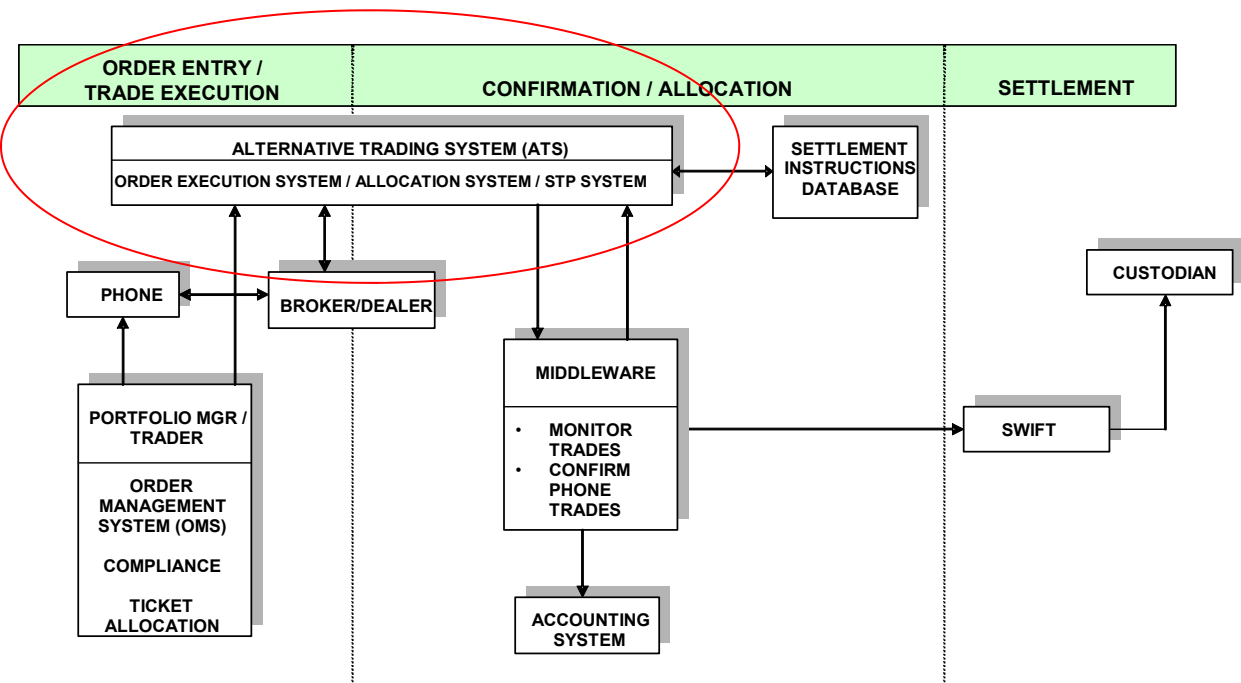
Picture this – three portfolio managers sit side-by-side on a trading desk. The senior manager decides he'd like to buy 100MM 2-year treasury notes. At relatively the same time, he places a call to counterparty A while having another manager and an analyst call counterparties B and C, respectively. Counterparty A makes a bid of 99-25, counterparty B 99-28 and counterparty C 99-22. The senior PM indicates to the analyst speaking to counterparty C that she should accept that offer, which she does. After hanging up, a paper ticket is completed with the counterparty information and price and a manual compliance check is done. Later that day, the counterparty is called with the allocation for the trade and the ticket is passed to Operations for manual input. The two sides of the trade don't meet again until the settlement date.

If you think this process sounds outdated, that's a good sign of where your firm is in automating its trade execution process. The industry has come a long way in its ability to automate the trade execution, allocation, and matching process. In today's automated environment, it is possible for a trade to be straight-through-processed from entry all the way through to confirmation.

To begin, in the ideal STP trade execution process, a portfolio manager needs only to know the amount of risk she'd like to

take in certain given portfolios. This basic information is what is entered into the trade entry screen of the order management system (OMS). The OMS can then determine what the trade is that needs to be executed. Using the example above, the system would have determined that the portfolio manager wanted to execute a buy trade of 100MM 2-year notes. After the system determines the trade, the trade information and allocation flows through the STP system and is sent out to a predetermined list of the PM's counterparties (usually 3-5), through an Alternative Trading System (ATS). Frequently used fixed income ATS's include TradeWeb and MarketAxess. The PM receives offers back from the dealers, which show up on the OMS screen, and chooses the best price. The trade is matched automatically in the STP system and flows through to the middleware system for confirmation.

As noted, the STP flow outlined above is ideal for trade execution. Most firms use any combination of automation in their own systems. Sometimes they have ATS's in place, but the trade information does not flow automatically between the ATS and STP System. Trades could be executed electronically and entered manually into the OMS and/or the accounting system. This requires additional manual intervention, such as manually sending the allocation information to the counterparty and possibly manual confirmation.



## AMF Swaps Committee Update

In continuing with its mission to document industry best practices for swaps, the AMF Swaps Committee has created five subcommittees and named heads of each subcommittee to address the various aspects of a swaps trade, namely, compliance, maintenance, trade execution, valuation and confirmation/legal documentation. In a meeting on June 30, 2004, the subcommittee heads met with the entire swaps committee to offer an initial outline of the approach in addressing the five segments, respectively. Since the meeting at the end of last month, nearly 40 Forum members have joined a subcommittee. The five subcommittees will meet as groups before reassembling the full swaps committee on July 28, 2004. The ultimate goal of this initiative is to map out the life cycle of a trade in order to identify possible areas for greater efficiency through a set of industry best practices documentation.

If you are interested in joining the AMF Swaps Committee, please contact Diane Trupia at (646) 637-9270.

## AMF Attends SEC & Senate Meeting on Hedge Funds

On July 14<sup>th</sup> and 15<sup>th</sup>, the Securities and Exchange Commission and the U.S. Senate Banking Committee held a meeting and hearing, respectively, on the possibility of increasing the Commission's oversight of hedge funds. In a 3-2 vote, the Commission approved proposing a rule that would require hedge fund advisers to register with the SEC. According to Chairman Donaldson, the purpose of adviser registration would be to gather basic information about the rapidly expanding hedge fund industry and to disclose such information to investors through the Commission's ADV form. The proposed registration rule is also intended to deter hedge funds from violating securities laws and to ensure that funds follow required compliance and policy procedures.

On the day following the SEC's vote, Chairman Donaldson testified and answered questions relating to the Commission's proposed rule before the Senate Banking Committee over the course of a two and one-half hour period. Some of the committee members praised the Commission for its proactive approach while others questioned the effectiveness of the action, citing concern that regulation could affect market liquidity and would be unduly burdensome for hedge fund advisers.

The staff of The Asset Managers Forum attended both meetings to monitor developments that might affect the business of asset management firms. For a more detailed description of these matters, please refer to the July 15, 2004 AMF COO Weekly Report ([http://www.theassetmanager.com/docs/Weekly\\_Report\\_071504.pdf](http://www.theassetmanager.com/docs/Weekly_Report_071504.pdf)). The AMF COO Group will address this issue and follow-up on other relevant regulatory matters at the Group's next meeting and discuss the possibility of submitting a comment letter.

## FIX Protocol Celebrates 10 Years

In an event in New York City, FIX Protocol Ltd. celebrated the 10<sup>th</sup> anniversary of the launch of the Financial Information eXchange (FIX) protocol. FIX, which is an electronic messaging standard, was developed specifically for the real-time electronic exchange of securities transactions.

Since its development, FIX has made great improvements to global trade processing. In recognition, FIX Protocol Ltd., the organization that owns and maintains FIX, honored James Lehman, Jacques Perold, Bob Lamoureaux and Chris Morstatt who together established the first FIX Americas Committee.

For the past four years, The Bond Market Association has had a working relationship with FPL defined by a Statement of Understanding that describes the partnership between the two organizations. The Bond Market Association has worked with FIX in developing plain English documentation in many fixed income asset classes, which has been instrumental in improving the new versions of FIX and has helped to set the stage for using the protocol in the fixed-income marketplace. The Technology and Operations Department of The Bond Market Association attended the anniversary event and is currently working with FPL in developing industry best practices.

## CDOs—Strong Market Acceptance

By Don Eng, IBT

Not long ago, collateralized debt obligations (CDOs) were characterized as a "new breed" of asset-backed securities (ABS). Today, CDOs are the third largest type of ABS. According to the Bond Market Association, CDO securities outstanding totaled over \$250 billion in 2003.

CDOs continue to gain wide market acceptance because they are one of the most innovative types of structured finance vehicles with distinct advantages for issuers, asset managers and investors. At their most basic level, CDOs convert what are typically illiquid loans and debt instruments into liquid, marketable securities through a process called securitization.

### Product Evolution

During the late 1980s, CDOs were first issued using bank loans and high-yield bonds as underlying assets. In the late 1990s, CDO activity grew quickly as the market extended to 20 types of assets. Examples include emerging market bonds, leveraged loans, mortgage-backed securities, project finance, REITs, convertible bonds, trust preferred securities, middle market loans, private equity and hedge funds.

### Tranching Redistributes Risk

CDOs employ a creative diversification method called tranching, which takes the cash flow of the underlying collateral and divides it into investment grade and non-investment grade components.

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## CDOs—Strong Market Acceptance

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Debt tranches are rated based on seniority (i.e. priority level in repayment) while equity tranches are the most junior and are not rated. As a result, tranching separates the credit risk of a CDO portfolio and each tranche is sold to different categories of investors based on their risk/return preferences.

### Balance Sheet or Arbitrage

CDOs offer tremendous flexibility in the purposes they serve and the way they can be structured. Typically, CDOs can be classified as either balance sheet or arbitrage transactions.

- **Balance Sheet CDOs** help financial institutions remove loans or other assets from their balance sheets, reduce regulatory capital requirements and improve their return on risk capital.
- **Arbitrage CDOs** provide investors with the opportunity to capture the difference between income from high-return, higher-risk assets and lower-cost, highly rated liabilities in a CDO portfolio. Asset managers earn portfolio management fees, increase assets under management, gain relative insulation from market volatility and lock in committed funds for up to 5 years or more (through non-call provisions).

### Cash Flow or Market Value

Generally, CDOs employ one of these credit structures:

- **Cash Flow CDOs** use the ongoing cash flow from the underlying collateral to repay interest and principal to investors.
- **Market Value CDOs** use the proceeds from the trading and sale of collateral, along with cash flow, to repay interest and principal on the securities. Essentially, the ability to pay expenses, service the liabilities and provide an attractive return to the equity investor is based on the market value and/or total return of the collateral, not just the cash flow.

### Synthetic CDOs

Funding for CDOs often results from the sale of debt and equity securities and uses the proceeds to purchase collateral. CDOs can also be structured as non-funded or partially funded through synthetic CDOs. These transactions use credit derivatives to transfer the credit risk of assets from balance sheets to CDOs without physically transferring the assets.

### Flexible Transaction Types

Over the years, product innovation has created many varying CDO structures. For instance, CDOs can:

- Acquire assets through cash purchase or synthetically
- Be created for arbitrage or balance sheet purposes
- Employ a cash flow or market value credit structure

When you add the extensive range of underlying asset classes, intricate payment priorities, multiple hedges, eligibility criteria and collateral tests, CDOs present more complex requirements than typical asset-backed securities (ABS) for trustees. Additionally, active trading adds another layer of complexity, especially in preparing daily, monthly and payment date status reports on CDO portfolios and distributions.

### Trustee Services

The role of trustees in CDO structures is important in supporting CDO activity. Fundamentally, a trustee's job is to protect investors' interests and provide other fiduciary functions. For instance, the trustee:

- Provides custody services related to the CDO's underlying collateral
- Buys and sells securities based on direction from the collateral manager
- Performs compliance tests covering eligibility and rating agency criteria
- Collects payments generated by the assets
- Ensures correct allocation of proceeds to investors
- Calculates and allocates payments based on the CDO's priority of payments (also called the "waterfall")
- Confirms that the covenants of the CDO are maintained
- Prepares customized daily, monthly and payment date status reports
- Supplies data feeds to all interested parties

Ideally, a trustee should bring deep expertise in all types of CDO transactions combined with a technology platform that provides integrated custody/fund accounting, advanced loan servicing capabilities and robust analytics and reporting tools.

## ASK THE AMF

*Dear Ask the AMF,  
Given that Order Management Systems are so integral to the STP process, how do I go about getting one? Is it better to buy one or build one?*

This is a hard question to answer because you don't say whether this is for fixed income or equities. First, let me state that my response offers suggestions and each firm must decide for itself which approach is most beneficial based upon the firm's unique facts and circumstances. Let's assume that it is for fixed income since it would be pretty embarrassing for an institutional equity manager to just wake up now and realize that they didn't have an OMS. The issue for fixed income is that there are not many choices out there for vendor supplied OMS's. Historically fixed income did not need the workflow control of an OMS because the trader and the Portfolio Manager were often the same person. In this age of heightened interest in real-time compliance, there is more of a need for routing orders through a guideline checking system which leads to more interest in fixed income OMS's.

So, it seems that the buy vs build decision is not your classic MBA or CFA textbook example (sorry to all of you out there waiting for your results from level 1). Companies need to look at what they want out of an OMS and what the vendors can provide. Some of the vendors started with compliance, so their systems tend to be more valuable if that is your need. Others link up well with analytics and some link well with ATS's or VMU's. If your reason for getting an OMS is based on one of these, then you might lean toward a vendor supplied system. If not, then it goes back to the basic rules of buy vs build, and all of those hours spent studying for the CFA can be brought to bear!

**Special thanks to the following people for their contribution to this month's AMF Newsletter**

**Joan Cheney, FFTW**

**Mike Wyne, FFTW**

**Don Eng, Investors Bank and Trust**

**Douglas Taggart, TBMA**

**Joseph W. Sack, TBMA**

**If you have submissions for the next AMF newsletter, please e-mail Diane Trupia**

## JOIN THE AMF!

**The AMF is now accepting applications for membership from asset managers, custodian banks and vendors.**

**For more information on joining the Forum, please contact Diane Trupia.**

## ASSET MANAGERS FORUM

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