

OPERATIONAL EFFICIENCY

*Implications of Financial Regulatory Reform
on Buy-side OTC Derivatives Market*

About the authors



Scott Alintoff,
Chief Operating Officer, VPM, SunGard's Alternative Investments business

Scott Alintoff is the Chief Operating Officer of SunGard's VPM solution, which provides portfolio accounting solutions for the alternative investments community. At SunGard, he works in multiple capacities, including Client Services and Project Development, and oversees all aspects of the firm's services and software development. Scott also works closely with VPM's clients to develop new software for the rapidly changing world of complex trading instruments, including swaps, bank debt, CDS and other types of securities. He has extensive knowledge of hedge fund back-office operations, systems, investment products and fund structures, and he recently assisted in the creation and rollout of FAS 157 reporting.

Boasting more than 15 years of experience in the financial services industry, Scott began his career at Ernst & Young, participating in the audits of large financial firms and subsequently working in the M&A and Bankruptcy groups. Scott has also worked with numerous companies in traditional asset management roles. Prior to joining SunGard, he was employed at one of the largest options market making firms on the American Stock Exchange and was the Head of Finance for a Commodity Pool Operator.

Scott holds his Series 3, 7, 63 and 65 licenses. He was also a licensed American Stock Exchange Market Maker and holds a BBA in Accounting from the University of Wisconsin-Madison.



John Avery,
Partner, SunGard Consulting Services

John Avery is a Partner in the Financial Services practice of SunGard Consulting Services, currently representing SunGard. In this role, John provides delivery oversight on client-facing engagements for industry-wide initiatives that require strong leadership, program management, development, integration and testing. Most recently, John and his team have been focused on helping clients assess and manage the business, operational and technical impacts of OTC derivatives regulatory reform and assisting them in transforming proposed regulatory changes into opportunities.

John has been building, managing, integrating and testing software applications in the front-, middle- and back-office at both sell-side and buy-side Wall Street firms for more than 13 years. His diverse experience spans a wide range of functional areas across the complete trade lifecycle, with a particular focus on pre-trade analytics, market data management, risk management, regulatory capital and OTC derivatives operations.

John has been quoted in numerous industry publications including Wall Street & Technology, Hedge Funds Review, Global Investment Technology, Waters and Securities Industry News. He has also appeared as a participant on panel discussions for SIFMA and IAFE. John holds a BA in Information Systems from Rutgers University and is a member of IAFE, ACM and the IEEE.

INTRODUCTION

In response to the most severe financial crisis in the United States since the Great Depression, the Obama Administration released a Financial Regulatory Overhaul Plan, called Financial Regulatory Reform: A New Foundation - Rebuilding Financial Supervision and Regulation.

This landmark position paper sought “to restore confidence in the integrity of our financial system and put the national economy on track to a sustainable recovery,” and stated that “we must build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market...” in the five key areas of:

1. Requiring Strong Supervision and Appropriate Regulation of all Financial Firms
2. Strengthening Regulation of Core Markets and Market Infrastructure
3. Strengthening Consumer Protection
4. Providing the Government with Tools to Effectively Manage Failing Institutions
5. Improving International Regulatory Standards and Cooperation

Although all are ultimately concerned with mitigating systemic risk and helping avoid similar economic events, the second objective squarely impacts the alternative investments market—where there has traditionally been a “lack of transparency and standards.” Meanwhile credit default swaps and other similar derivative products have become critical elements of our financial system. Regulation has not kept pace with financial innovations like these and governing bodies were unable to track or prevent the massive buildup of leverage and risk in these markets prior to the collapse. The federal government is determined to put additional checks and balances in place to avoid a similar scenario in the future.

Under the President’s plan (hereto referred to as “the Proposal”—an 88-page white paper that is accompanied by separate summary documents for each of the five focus areas), credit default swaps and other OTC derivatives will be made subject to comprehensive regulation. A new Financial Services Oversight Council will be given broad authority to collect information about activities in financial markets that may pose a threat to financial stability. And, the Federal Reserve will be given authority to oversee and reinforce the infrastructure of financial markets—including payment, clearing and settlement systems.

Separate bills were introduced in the House of Representatives and Senate, Treasury Secretary Timothy F. Geithner testified before the Senate Banking Committee regarding the Proposal on June 18, 2009, and the House passed its formal legislation on December 10, 2009. (Just five days later, on Dec 15, 2009, CDS clearing for buy-side participants went live in the US.)

It is not an overstatement to say that the Proposal will prove to present significant and new responsibilities for market participants. While these responsibilities dictate technology and operational changes, they also create important competitive opportunities because of the improvements required in valuations, collateral management, reconciliation, control, reporting and auditing.

“As part of the President’s plan, credit default swap (and interest rate swap) markets and all other ‘over-the-counter’ (OTC) derivatives markets will be subject to comprehensive regulation in order to:

- Prevent activities in those markets from posing risks to the financial system*
- Promote transparency and efficiency of those markets*
- Prevent market manipulation, fraud and other market abuses*
- Prevent OTC derivatives from being marketed inappropriately to unsophisticated parties”*

– from Strengthening Regulation Of Core Markets And Market Infrastructure, a summary companion document for Financial Regulatory Reform: A New Foundation - Rebuilding Financial Supervision and Regulation, June 16, 2009

GETTING SET FOR SUCCESS

The time to act is now. Although the final legislation has not been turned into law for market participants, the Obama Administration has devoted an enormous amount of time and resources to developing the framework reflected in the Proposal and OTC reform has enjoyed bipartisan support from the onset. While the final laws will certainly reflect changes typical of the legislative process, these will likely not differ much from the advice document issued by the Executive Branch on June 16, 2009.

The first market opportunity is in preparing for OTC derivatives clearing and transparency in advance of the final legislation. The key to being prepared is in taking an evolutionary approach that includes three steps for technology and operations in the following order:

- 1. Understand** - Assess impacts on your trading strategies, operations and accounting processes and systems
- 2. Plan** - Create a dynamic response plan that covers the internal changes that are necessary now and over the next 12 months
- 3. Execute** - Activate an iterative and incremental plan to support the evolution of the OTC markets for buy-side participants

FUTURE HORIZONS FOR THE ALTERNATIVE INVESTMENT COMMUNITY

What will the aftermath be? Five years to the date subsequent to required compliance with the final legislation for Financial Regulatory Reform: A New Foundation - Rebuilding Financial Supervision and Regulation, SunGard envisions a world where cleared OTC Derivatives markets and operations will ultimately behave much more like the listed derivatives, futures and options markets.

"I commend the House for passing H.R. 4173 - The Wall Street Reform and Consumer Protection Act of 2009. President Obama called on Congress to enact comprehensive reform of our Nation's financial regulatory system in response to last year's financial collapse. The President set forth clear objectives and principles for reform that were endorsed by Congressional leaders. House passage of this bill moves us an important step closer to meeting the President's objectives for reform. Comprehensive reform must establish clear rules of the road with strong enforcement for our nation's financial institutions and markets; end loopholes that allowed big Wall Street firms to escape supervision; make it clear that no firm is 'too big to fail;' and provide strong consumer and investor protections for American families. As with any legislation of this scale and complexity, the Administration looks forward to continuing its close work with Congress to strengthen key provisions as the legislation moves toward final passage."

– Treasury Secretary Timothy F. Geithner on the passage of The Wall Street Reform and Consumer Protection Act of 2009

"In essence, a CDS is really an option on credit" says Scott Alintoff, Chief Operations Officer, VPM, part of SunGard's Alternative Investments business. "OTC Derivatives are going to become more transparently priced. As such, they will require the same margining and additional operational processes and controls as exchange traded futures and options contracts do today."

John Avery, Partner, SunGard Consulting Services, adds "The Alternative Investment community will likely be trading more standardized, cleared OTC derivatives contracts over the next three to five years. As a result, this community will seek to take advantage of pricing and liquidity opportunities in these cleared markets, as well as incorporate cleared OTC products into new and existing trading strategies."

Specific areas of impact SunGard is already seeing as a result of the Proposal are in:

- Portfolio management and valuations
- Margining and collateral management, particularly focused on collateral segregation and the role of custodians and tri-party collateral agents in the process
- Prime brokerage relationships and offerings, including the cost of funding and availability of cross-asset portfolio and risk-based margining
- The OTC trading and post-trade operations lifecycle
- Portfolio accounting rules to account for changes to margin/collateral and new lifecycle events for cleared OTC trades
- Solutions to streamline and increase the use of managed accounts and the challenges in mapping OTC derivatives into these structures

"A credit default swap is really an option on credit," says Scott Alintoff. "So, it works the same way as an option, it trades like an option, and, historically because these were private party transactions, you could aggregate yourself into a position of significant counterparty risk. Cleared CDS contracts and the clearing house model reduce systemic risk by taking all of that bi-lateral counterparty risk and transparently managing it at the clearinghouse."

THE THREE-PRONGED APPROACH

Employing a comprehensive program for evaluating, designing and implementing appropriate infrastructure solutions for this changing world of OTC derivatives on the buy-side will help affected organizations assess their current environments and institute any necessary operational and/or IT changes. This is important because, while the final legislation will most certainly dictate institutional changes for most market participants, these very same modifications can also create important competitive opportunities and capabilities noted earlier.

Understand

In assessing organizational action in response to the proposed legislation, market participants must first review and interpret the expected requirements and then take stock of their existing operations and technology capabilities with regard to such areas as:

- Valuations
- Collateral management
- Reconciliation and control
- Reporting and transparency
- Portfolio accounting
- Auditing

Plan

Upon review of both required capabilities and existing capabilities, market participants should create a detailed blueprint for evolving their current state to the desired state. Because many affected processes and systems will be business-critical and essential to continued operations, SunGard believes that a phased approach will be the most prudent in order to manage the risk of change.

Execute

Implementing the changes required to take advantage of opportunities in the reformed OTC derivatives markets will be an iterative and incremental effort. Each phase of deployment should ensure that adequate testing and quality controls are used to mitigate operational risks.

HOW SUNGARD CAN HELP

Transparency of data is key in how SunGard approaches all of its solutions for alternative investments. From back-office systems like VPM, InvesTier and Investran for partnership and portfolio accounting and reporting to front-office systems, such as Front Arena, APT and FastVal for risk management, portfolio optimization and independent valuation, SunGard solutions aim to provide customers with real-time, actionable information.

SunGard's accounting and reporting solutions maintain a data repository and true physical general ledgers that embody in-depth knowledge of the entire accounting process. With SunGard's back-office solutions, users have the ability to mine this data, down to actual general ledger level detail, in an automated fashion—increasing efficiency and ensuring further clarity around investments.

Enhanced reporting through Microsoft's SQL Server Reporting Services (SSRS) and Crystal Reports helps put actionable information at the fingertips of key decision-makers. Through these enhanced reporting engines, users can easily access mission-critical information and slice and dice data for quick analysis and distribution. Additionally, each solution supports a complete audit trail of the general ledger, delivering visibility on all activity and positions, both historical and current.

For the front-office, SunGard's portfolio of risk and valuation solutions helps firms to effectively monitor and manage investment risk in real-time. Specifically, they enable customers to value their holdings in an independent and transparent, timely and cost-effective manner, in addition to providing on-demand access to exposure figures, as well as stress testing, sensitivity analysis, scenario analysis, sector analysis and liquidity risk analysis.

By utilizing a service, such as FastVal, for independent valuations, users can attain early warning signs for an imbalance in exposure and take corrective action on long positions before they become a problem. Additionally, these solutions complement and validate institutions' own valuation systems, and because they are independent in that the provider has no vested interest in their levels, they strengthen the valuation in an audit.

SunGard Consulting Services provides additional globally available capabilities to help firms augment their "Regulatory IQ" in operations and technology. Skilled consulting teams comprised of both functional and technical experts can be deployed to help firms assess impacts, plan for the future and ultimately implement technology and operational changes for all types of vendor solutions and in-house proprietary systems.

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About SunGard, SunGard Alternative Investments and SunGard Consulting

With annual revenue of \$4 billion, SunGard is a global leader in software and processing solutions for financial services, higher education and the public sector. SunGard also helps information-dependent enterprises of all types to ensure the continuity of their business. SunGard serves more than 25,000 customers in more than 50 countries, including the world's 50 largest financial services companies. SunGard Alternative Investments and SunGard Consulting Services are operating units of the SunGard Financial Systems business.

With one of the largest footprints of any software and processing vendor serving the alternative investment community—including over 400 hedge funds and asset management firms and over 350 private equity sponsors and investors, in addition to fund administrators, funds of funds, and other alternative investment businesses—SunGard Alternative Investments provides specialized solutions designed specifically to address the primary business requirements of the alternative investment space.

Solutions range from front office analysis, trading, portfolio construction and portfolio management, and specialist support for private equity transactions; through independent valuation, risk management and daily P&L; to accounting, records and investor reporting. Many SunGard Alternative Investments solutions are available both as locally installed applications and as outsourced services (e.g. over an Application Service Provider interface (ASP) or Software as a Service (SaaS).)

SunGard Consulting Services' deep understanding of business processes in financial services and energy, combined with our expertise in operations and technology and knowledge of SunGard products and beyond, help us mitigate project risk and provide a single point of accountability for SunGard projects that differentiates us from other consulting organizations. SunGard Consulting Services helps clients improve their operations and technology "Regulatory IQ" by leveraging the best that SunGard has to offer given its important role in many financial markets and processes.

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