Canadian regulators propose matching on T to foster STP – How can FIX and electronic trading help?

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Canadian securities regulators recently published proposals to require institutional trade matching on trade date to foster Straight-Through Processing. This article discusses the proposed regulatory changes and suggests market participants take advantage of electronic trading and the FIX protocol to cope with the impending changes and improve operational efficiency.

Canadian regulators propose matching on T requirements

Canadian securities regulators (CSA) recently published proposals to require institutional securities trades to be matched between investment managers, broker-dealers and custodians on trade day (T) effective July 1, 2005. The proposals cover securities traded in public secondary markets, which essentially mean equities. In addition to matching on T, proposed measures also include exception reporting requirements, a written trade-matching compliance agreement between broker-dealers and their investment manager clients, and a mandatory STP readiness certificate. (For more information about the CSA proposals, visit: www.osc.gov.on.ca/en/Regulation/Rulemaking/Notices/conceptpro/cp_20040416_24-401_csa-roc.htm)

Is the Canadian industry ready for matching on T?

Matching institutional trades on T is a key milestone on the path to Straight-Through Processing (STP). Canadian securities markets, as with securities industries around the world, are moving to adopt STP to improve efficiency, reduce costs and mitigate risks. An industry body, the Canadian Capital Markets Association (CCMA), was formed in 2000 with one of its mandates being to coordinate industry-wide, inter-firm post-trade STP. Significant work had been done by the CCMA in establishing STP best practices and standards for institutional trade processing. Investment managers are also undertaking data cleansing/consolidation, order management and system integration/process design initiatives to improve internal operational efficiency. However, it is unlikely that the Canadian capital markets will be ready for matching on T for a July 1, 2005 implementation.

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The Canadian securities industry has a long way to go to become fully STP-enabled. Recent statistics published by the CCMA indicate that the current matching on T rate is only 6.01% for equity trades and 9.32% for fixed income trades. It is unlikely that market participants will be able to increase their trade date matching rates to achieve 100% matching on T in less than a year. Such an attempt could lead to substantial matching failure rates. We believe that a phased approach will eventually be used to reach the matching on T goal.

It is also important to factor in the major electronic trading and post-trade processing changes needed to achieve the matching on T goal as well as the implementation of common trade messaging standards such as the Financial Information eXchange (FIX) protocol. In this regard, Canada appears to be lagging behind other capital markets. A 2003 eClientscope/IDC study on investment manager operational efficiency in which executives of 23 investment management firms who collectively conduct 9 million allocated trades annually were interviewed found that only 1 in 4 buy-side firms have new generation order management systems (OMS) installed or in pilot; and only 23% of investment managers have completed implementation or are rolling out the FIX protocol in Canada.

CCMA provides strong industry leadership

The STP movement has obviously gained momentum in the Canadian marketplace. However, the industry is moving slowly to address external STP issues such as external connectivity, or the lack thereof, identified by investment managers as a major impediment to their STP progress in the eClientscope/IDC study. Market participants will realize on the bulk of the expected STP efficiency gains only when a majority of the industry is STP-enabled.

To get to matching on T, strong industry leadership is required. The Canadian Capital Markets Association (CCMA) has taken the leadership role by realigning its efforts recently to focus on institutional trade matching. As Gerry O'Mahoney, CCMA Chair pointed out in a CCMA announcement: "it is now necessary to focus immediate CCMA resources on the one area currently of greatest risk and greatest benefit for the Canadian securities industry." The CCMA's strategic re-focus is an encouraging sign for the industry. Prompt, accurate matching of securities trades is critical to the capital markets' integrity, efficiency and competitiveness.

Electronic trading and FIX protocol can help

Securities industry participants see electronic trading and common trade messaging standards such as the FIX protocol as key to STP operational efficiency. Electronic trading and FIX can also help buy and sell-sides achieve compliance with matching on T requirements.

In view of the Canadian markets' increasing interest in FIX and electronic trading, the FIX Protocol organization and eClientscope Inc. put together the first FIX user meeting in Canada in mid-July. This cross-industry meeting was attended by trading and operations representatives from buy- and sell-side firms, the exchanges, technology vendors and the FIX Protocol organization. Participants reviewed their current usage and future plans for electronic trading and FIX and discussed implications of the regulators' matching on T proposals, and how FIX and electronic trading can help. Firms concluded that educating market participants about the usage and benefits of electronic trading and FIX will help the securities industry reap further benefits from these STP enablers.

Benefits of electronic trading and FIX

The benefits provided by electronic trading and FIX extend across front, middle and back-office activities and span internal and external connectivity. The use of electronic trading and FIX not only increases access to liquidity and improves the order routing process; it can also enhance pre-trade decision support and offer STP efficiencies in post-trade processing via trade confirm/affirm automation, timely error identification, trade fail reduction and exception management enhancements, thereby shortening the settlement cycle.

In addition, FIX 4.4 (the latest version of FIX) has broadened its application beyond equities into fixed income, foreign exchange and derivatives, allowing firms to consider taking advantage of an integrated operation approach via FIX to achieve STP efficiencies.

Some key benefits of electronic trading and FIX are discussed below:

1. Enhance liquidity access and external connectivity:

The use of electronic trading and a standards-based protocol such as FIX allows investment managers to simultaneously interface with multiple brokers and other sources of liquidity including ECNs and ATS. Electronic connectivity and enhanced liquidity access permit investment managers to act on high-quality Indications of Interest (IOIs) in real-time.

2. Reduce trade fails via faster error identification and manual intervention reduction:

The FIX protocol can now be used for the allocation, confirmation and affirmation process in addition to pre-trade messaging and trade routing. The use of electronic trading and FIX 4.4 enables investment managers and brokers to match trade details automatically without human interventions early in the trading life cycle. (See the "point of trade matching" described by UBS Investment Bank's Alvin Mullan in FIXGlobal Vol. 1 Issue 2 Q2 2004.) Errors and exceptions can then be identified and corrected sooner, thus reducing trade delays and fails, and shortens the settlement time.

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3. Increase trading desk productivity and foster best execution:

Timely access to information via electronic trading and FIX messaging improves trading desk information and order management efficiency. FIX 4.4's built-in automated confirm/affirm also helps buy and sell-side traders to reduce manual data entry and processing tasks to focus on achieving better, faster and more favorably priced executions. If the order flow is timely and accurate within the front-office systems, then things will likely go smoothly in the middle and back offices. In addition, the electronic audit trails will help firms comply with regulatory requirements.

4. Enhance utilization of resources:

In addition to increasing trading desk efficiency, FIX-based process automation allows firms to free up resources currently performing manual re-keying, reporting and reconciliation for such critical and analytical functions as exception management and decision support.

5. Enable integrated, centralized operation to achieve STP efficiencies:
As buy and sell-side firms install sophisticated order management systems (OMS) with FIX capability, and as FIX extends its usage from equities into other asset classes and from pre-trade messaging and order routing into allocation/confirmation/affirmation, firms can potentially track and manage all securities trades in one central source through a new generation OMS that supports all asset classes and currencies traded for virtually the entire trading life cycle.

6. Enhance decision support via business intelligence possibilities:
For those firms that have already invested in a FIX infrastructure and standard internal and external connectivity, the information transparency and centralized operation possibility enables investment managers and brokers to integrate and analyze business data such as order and execution flows, market data and compliance data to measure execution quality, transaction costs and processing capability, and detect bottlenecks in real-time.

Industry will still benefit even if matching on T is delayed

In view of the advantages offered by electronic trading and FIX, the Canadian securities industry can still benefit from their adoption even if there is a delay in the July 1, 2005 date for matching on T.

Like other global capital markets, the Canadian marketplace is undergoing major changes as market forces induce change in securities practices. The industry is adopting new technological and operational developments to improve efficiencies, reduce operating costs and maintain its global competitiveness. Although FIX and electronic trading are still emerging phenomena in Canada, they are already adopted by leading investment managers and broker-dealers globally. The regulators' proposed changes should serve as a catalyst to instill a sense of urgency for process enhancements among market participants.

What drives electronic trading and FIX adoption

Investment managers' adoption of electronic trading and the FIX protocol has been instrumental to their growth in the last decade. Several developments are accelerating industry-wide adoption:

1. Buy-side adoption of new generation order management systems (OMS) with FIX capability will help investment managers prepare for 'real-time' external connectivity.

2. Vendors have developed advanced applications that enable investment managers to integrate information across systems via FIX messages. OMS vendors in particular have expanded their product functionality upstream to include portfolio analytics, modeling, risk analytics and pre-trade compliance, and downstream to incorporate allocation, confirmation and affirmation via FIX messaging, thus providing investment managers the possibility to centralize operation for the entire trade life cycle around an integrated solution. OMS' expanding functionality will increase buy-side adoption.

3. FIX 4.4 has transformed the protocol into a multi-asset class, cross-phase messaging standard that facilitates buy and sell-side efforts to consolidate their product silo-based front and middle-office operations.

4. The single linkage provided by concentrators and intermediaries that run routing networks eliminates the costs and operational complexity for investment managers to establish and maintain multiple bilateral links with their brokers. This will help extend the reach of electronic trading and FIX into firms of all sizes.

5. Integration of FIX and SWIFT transaction types into the ISO 15022 data dictionary facilitates compatibility of FIX allocation confirmation messages and SWIFT MT54X settlement instruction messages in the trade processing/settlement cycle.

6. The developments in FIXML, a version of the FIX message specification implemented using XML, has permitted the FIX protocol to support web services, making it easier for smaller investment managers to benefit from FIX.

Where the Canadian markets stand right now

The Canadian industry is moving ahead with OMS adoption. In addition to existing OMS installations, 23% of the firms in the eClientscope/IDC study have planned sophisticated OMS implementation or upgrade projects. The majority of the OMS initiatives involve FIX connectivity and dual equities/fixed income capability.

Some routing network intermediaries have started to provide single linkages for interfaces between investment managers and brokers in Canada. Concentrator solutions are also beginning to surface.

FIXML is still a new phenomenon in the Canadian securities industry. However, 59% of the investment managers interviewed in the eClientscope/IDC study said they are considering adopting this web-based version of the FIX protocol in the next 12-18 months.

Areas the industry will focus on going forward

In order to realize the full benefits of electronic trading and FIX usage, the Canadian securities markets will focus their efforts on these areas in the future:

1. Improve data quality and integrity:

Accessibility to clean data on a timely basis is key to trading and post-trade processing and settlement. Investment managers' operational problems with their counterparties on reference data used in transactions and settlement can be largely addressed by common industry databases such as a common Delivery Instruction database (DIDB) or Standing Settlement Instruction database (SSI) or Security Master File. The possibility provided by FIX 4.4 for investment managers and brokers to attach their SSIs on the FIX Confirmation message is just the beginning.

2. Increase sell-side adoption:

Brokers in the Canadian marketplace will need to gear up their system automation/ integration efforts and FIX adoption as buy-side managers move to embrace new generation OMS. Both the sending and the receiving ends need to be ready for the entire industry to benefit from the use of FIX and electronic trading.

3. Get the routing connection into the custodians' shop:

Custodians servicing the Canadian securities industry need to be more automated and FIX-enabled for the industry to fully benefit from FIX's post-trade capability. As agents of the securities owners, custodians are key to the trade matching and settlement process.

4. Vendors can make a difference:

Technology vendors can help by providing applications that address the idiosyncrasies of the local Canadian market structure which is more concentrated than the U.S. capital markets.

Conclusions

Global market forces are already inducing changes in capital markets in Canada. The regulators' matching on T proposals serve as a catalyst to instill a sense of urgency among market participants.

STP is a dynamic, evolving process. Investment managers, broker-dealers, custodians and other market participants in Canada, like their peers in other major capital markets, need to continue their quest for operational efficiency and risk mitigation. Electronic trading and FIX are here to stay and will become basic business requirements for securities industry participants globally.

The proliferation of electronic trading venues, coupled with FIX protocol's expansion across asset classes and across pre-trade, trade and post-trade, will accelerate the adoption of electronic trading and FIX as a common messaging standard throughout the entire trading life cycle.

The impact of FIX is far-reaching. Securities regulators in Canada will likely expand their current STP and trade matching regulatory focus beyond equities into other asset classes supported by FIX in the foreseeable future. Securities industry participants must get ready for this eventuality. **FIX**

eClientscope Inc. is a Toronto-based specialized consultancy serving the financial industry. The firm has been involved in establishing and managing the STP Program Office of the Canadian Capital Markets Association (CCMA) and has served on a number of CCMA committees. eClientscope's current focus is securities operational efficiency, and the innovative possibilities that end-to-end automation can bring to capital market securities processes.