



Wealth Management

Domain Certification

Reference Material



Careers ▶ Banking • Financial Services • Insurance

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Chapter Overview: The Wealth Management Business

This chapter is designed to help the participants get a sound understanding of the Wealth Management business of the USA. We start with a brief overview of WM business, its characteristics and the differentiating factor from other businesses. We then focus on the products and services offered by WM business. We will also look at Regulatory status in WM in the USA. We will also know how BoFA is faring in WM business. At the end we will look at the Risk and recent trends in WM.

1 Overview of Wealth Management

Wealth management is, by definition, a holistic approach to understanding and providing solutions to all of the major financial challenges of an investor's financial life. From a client's perspective, this means having all financial challenges solved. From the bank's perspective, it means the ability to profitably provide a wide range of products and services in a consultative way. There are three essential components to true wealth management:

- A. **A consultative process:** The wealth management process must enable the bank to gain a detailed understanding of clients' goals and their most significant financial wants and needs. This allows the bank to establish close relationships with clients that help the bank serve them better and retain them over time.
- B. **Customized choices and solutions:** What the bank offer clients must be designed to fit the full range of each individual's needs. The select group of services the bank uses / deploys might include investment management, insurance, estate planning and retirement planning.
- C. **Delivery in close consultation with the bank's clients:** top wealth managers provide their services by working closely with clients on an ongoing basis. The key is that they know how to identify clients' specific needs and how those needs change over time. And they don't just identify needs – they proactively design solutions around those needs.

If, up until now, the banks have been focusing solely on investment management, the bank can see that the bank need to expand the scope of offerings to be a wealth manager.

1.1 The Range of Services and Products

1.1.1 From Banking

Banks can offer a range of services which might include the following which are relevant to an individual:

On transactions

- 1. Transaction capabilities such as checking accounts
- 2. Simple deposit and money market products
- 3. International transaction banking capability

On Lending

- 1. Credit cards
- 2. Auto loans
- 3. Mortgages

None of these is offered at the low end of the spectrum as might be seen in retail / consumer banking operations.

Particularly in relation to lending, the card product tends to have no credit limit, the auto loans includes loan for yachts and the mortgages might involve funding a very large property purchase.

Therefore, everything that is seen in consumer banking is offered to the Wealth Management Customer at the high end of the spectrum.

Conversely, from the wholesale banking capability, ‘retail’ versions of the products are offered.

Thus, wealth customers are often offered structured products and alternate investment (hedge fund-like) strategies.

1.1.2 From Investment Banking and Broking

The industry can be considered to consist of three main market segments: advisory, discretionary, and execution-only. Although brokers tend to specialize in one of these three segments, some are full-service brokers, such as Merrill Lynch, offering all the main types of service.

Advisory services are where clients receive personalized advice on their investment strategies including advice on stock selection, while discretionary services tend to be offered to high net worth investors, where brokers are responsible for managing the client’s equity portfolio. Finally, execution-only services are essentially “no frills” services: in return for lower costs, investors do not receive investment advice and a broker will simply act upon the investor’s trading instructions.

Investment Banks also have brokerage desks. These brokerage desks help customers’ complete transactions of customers in the stock exchanges or other markets. Brokerage earns the Investment Bank commissions.

For Investment Banks, one of the large groups of potential clients are the insurance companies, pension funds, mutual funds and other fund managers. These entities are provided investment research and advice by Investment Banks. These entities are the source of a large proportion of the buy and sell orders that they get at the brokerage desk.

As noted earlier, high end portfolio management services are offered by such firms to their wealth management clients.

Thus, from this industry the following main capabilities are on offer:

1. Advisory processes
2. Portfolio planning
3. Discretionary portfolio management
4. Range of fund products
5. Transaction execution
6. Alternate investment management strategies
7. Structured products

1.1.3 Certain offerings unique to Wealth Management

While a number of services from Commercial Banking and Investment Banking do go into the product suite, some offerings are completely unique to Wealth Management. These typically include Trust and Succession Planning.

The succession planning challenge in the USA relates to the taxation of the estate of a person who dies - estate duties take away a large component of one generation would like to pass to the next by way of wealth.

Trusts, in addition to helping solve the taxation issue also help in ensuring that the wishes of a person (in financial matters) are followed in his lifetime.

Some of these issues arise because wealthy persons particularly in the USA, often feel the need to contribute to charitable causes. These causes typically cover:

- Education for the poor
- Housing for the homeless
- Food for those in poverty
- Other social objectives

The money for the cause is initially put up by the Wealth Management Customer. Thereafter, the Wealth Manager / Private Banker is asked to carry out Investment Management activities to manage this initial corpus and grow it.

The cashflow from the invested corpus services to fund the cause. These entities are required to this in perpetuity; there is no end date and go well beyond the life time of one individual and even generations.

Here are some prominent examples:

The Ford Foundation: this was established by Henry Ford the automobile tycoon to support leaders and organizations working in the area of social change.

The J. Paul Getty Trust was founded by an oil tycoon of the same name and is dedicated to art.

The Church Commission of England is set up to preserve Churches in England.

The Children's Health Fund (CHF) was founded by singer/songwriter Paul Simon (of Simon & Garfunkel fame) and pediatrician Irwin Redlener to provide health care to homeless and medically under-served children.

In addition, wealthy persons also need to plan on how their wealth shall pass on to the next generation. This requirement, often called succession planning, is specific to:

- Tax considerations
- How the wealth is to be used by the receiver
- Ensuring specific amounts reach specific persons

Trusts and Foundations achieve these results efficiently.

A Trust is an arrangement where one party entrusts a second party to hold assets or property and use it for the benefit of a third party, as specified by the first party.

Naming the Parties in a Trust:

Settlor or Grantor: The first party, who thought up of the idea behind the Trust

Trustee: the second party, on whom the Settlor relies to work as per the goal

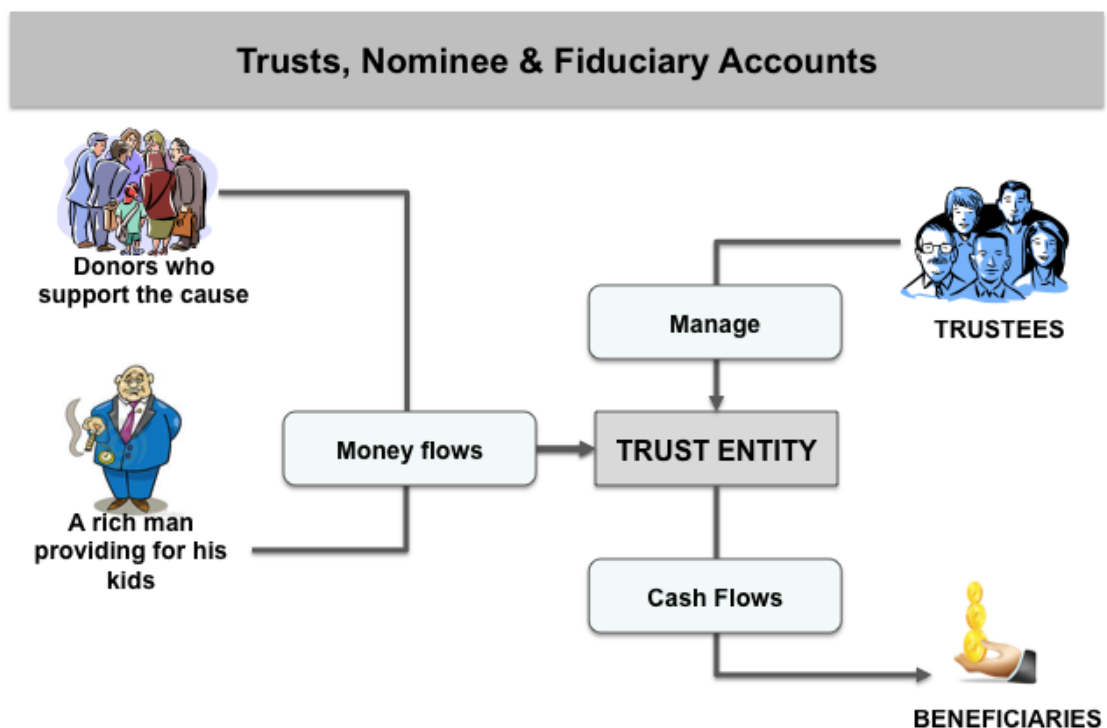
Beneficiary: the third party for whom the Trust was set up.

The Trust itself is a separate legal entity. Trustees are associated with the Trust. Setting up of the Trust is often done by one of the following agencies which help out the Settlor with its plan:

- A legal firm
- A Bank, especially its Wealth Management division
- Specialist Wealth Management firms
- Specialist Trust practitioners

Each of these agencies often provide Trusteeship services. The Trustee would typically be an officer of that agency. Whichever person works in the Trust department serves as a Trustee of the Trust. In such cases the Trustee is an organization rather than an individual.

The typical structure looks like this:



1.2 Seamlessness of Offering

Offering a full range of services, drawn from commercial banking, investment banking and from specialist services is one thing.

However, the Wealth Management customer cannot be made to deal with multiple persons and entities within the organization.

Wealth Management/ Private Banking to that extent has also to do with the seamlessness of the offer.

This is definitely the job of the Relationship Manager/ Private Banker (RM/PB) who provides the customer the single point of contact and serves as the face of the organization.

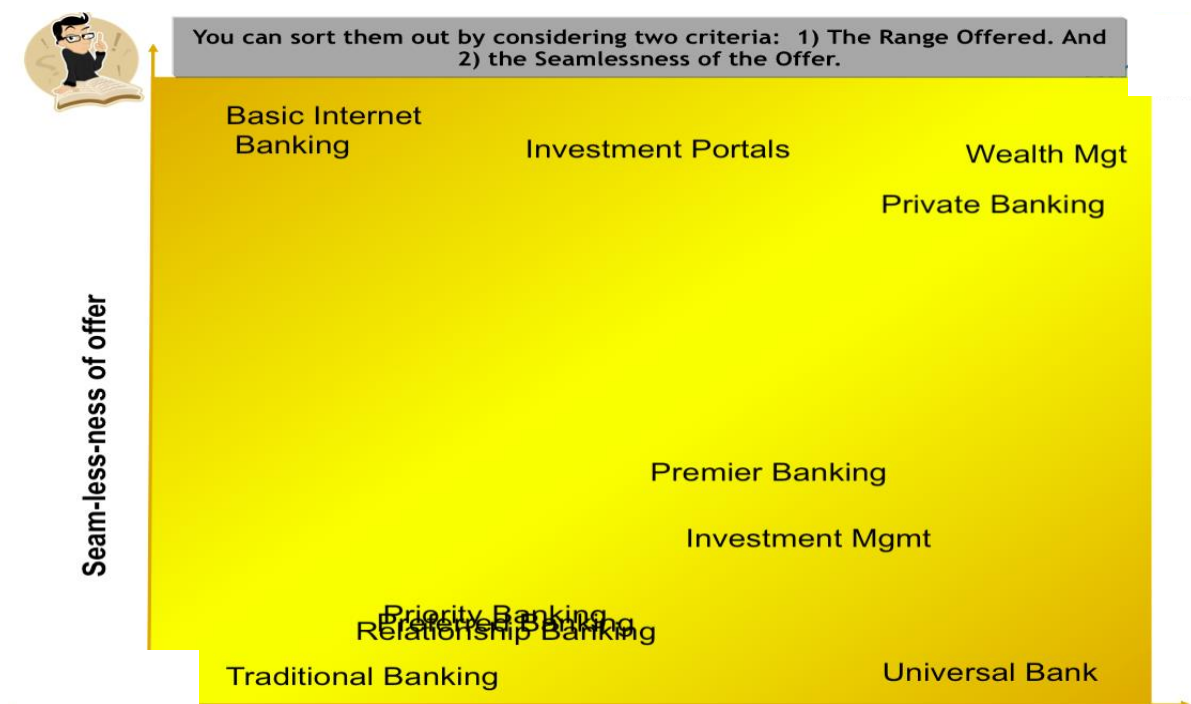
However, the RM / PB needs to be backed up by an organization that is capable of supporting the full range of issues relating to providing the client with smooth interface and operations.

To this extent the organization needs to be geared on the following counts:

1. Providing expert support to RM/ PB on market information
2. Facilitate interface between client and product experts
3. Allow client to place all instructions with RM/PB ; and help the RM/ PB route those instructions to whoever at the back-end needs to process the instructions and transactions
4. Seamless execution and confirmation of execution
5. Perfect record maintenance: for audit, taxations and reporting purposes
6. Performance reporting
7. Producing account statements and holding statements which accurately reflect the client's holdings to the client's satisfaction

We can thus say that Wealth Management is a combination of a full range of services and the seamlessness of offerings.

In a chart, wealth management compared to various pretenders can be presented as follows:



1.3 Business Structures in Wealth Management

Consider the range of services offered. Each is supplied by a different core competence.

1.3.1 Specialists

Some entities are specialist wealth managers. The core strength is in relationship management, investment planning and portfolio management.

They outsource:

1. Core commercial banking
2. Broking and execution
3. Anything in the nature of administration and support services.

Julius Baer and a whole host of Swiss Private Banks come to mind.

These entities project the fact that all non-core activities are outsourced as evidence that they have no bias and are not trying to sell any product: just find and provide the best in class to the client.

“The Group is completely independent in each and every aspect of its business - from the focused business model and sound financials to the dedicated investment management, open product platform and expert research. Hence, it is the trusted partner of choice and a leading premium brand in global wealth management, offering best-in-class investment solutions and advice.” (www.juliusbaer.com)

Whether this company will retain this tag needs to be seen because it is expanding from its limited and specialist role through the acquisition of Merrill Lynch’s non-USA wealth management business, which allows it to expand to 25 countries and 50 locations.

Such a geographical spread is not the conventional framework of a specialist Swiss Private Bank.

1.3.2 Wealth Managers with their own IB/ Broking unit

Such entities focus on providing high end wealth management with strong backing from their in-house Investment Banking unit on the deals and transaction side of the business.

Goldman Sachs would be a leading example.

We work closely with high-net-worth individuals, families and select foundations and endowments to develop wealth and investment management strategies. We then identify investment opportunities to help them reach their objectives. We complement these services with robust execution capabilities and attentive client service. Where appropriate, we introduce our clients to the broader network and resources of Goldman Sachs. (<http://www.goldmansachs.com/what-we-do/investment-management/private-wealth-management/>)

The strength of Goldman Sachs was on display in the case of Facebook’s impending IPO.

In early 2011, Goldman got Fb shares through a private placement. These shares were held in a special purpose vehicle. The intent was to provide Fb shares to Goldman’s Wealth Management clients on a preferential basis.

Thus, it paid to be a Goldman Sachs Wealth Management client! This typifies the comment GS makes about an introduction to the broader network of clients and broader range of strategies.

(The Face Book IPO turned out to be an initial disaster; but that does not dilute how people felt about this strategy of GS in 2011. Also as an aside, owing to some negative publicity around that time, GS shelved - at least temporarily - the idea of offering these shares to own clients; and not in the public glare.)

1.3.3 Universal Bankers as Wealth Managers

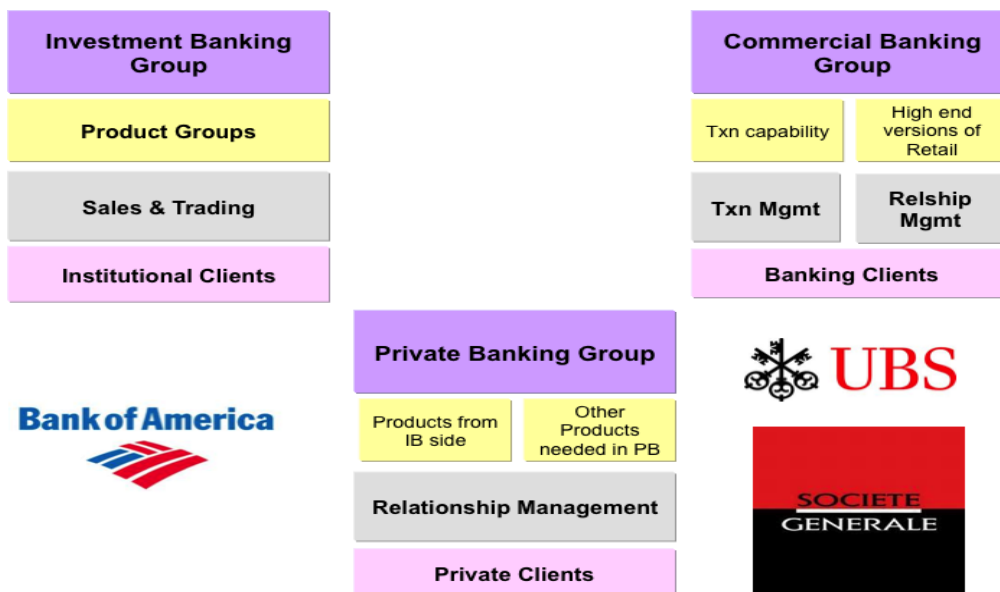
Add to the Goldman capability the full range of transaction capabilities and branch reach of a commercial bank; the bank is able to provide the full range and retain most of the fees resulting.

The bank that comes to mind as a leader in this space is UBS.

UBS boasts:

- Advisory approach
- Investment processes
- Investment solutions AND
- An International banking network

Structurally, the three components look as follows:



As seen in this chart, while UBS is the name that comes to mind in the international wealth management arena, BoAML is actually the world's largest in this field.

One of the reasons is the ML franchise. The other is that while BoAML is not known outside USA for Wealth Management, the US has the largest number of millionaires in the world. The country is less skewed: it does not have ONLY billionaires/ ULTRA high network individuals. (Russia, India, China) but it has a large segment of high network individuals.

In aggregate terms the total wealth to be managed is large. The USA is not a market to be ignored!

1.4 US Regulatory Statuses of WM

1.4.1 Registered Investment Adviser

Definition of Investment Adviser

Section 202(a)(11) of the Act defines an investment adviser as any person or firm that:

- for compensation;
- is engaged in the business of;
- Providing advice to others or issuing reports or analyses regarding securities.

A person must satisfy all three elements to fall within the definition of “investment adviser,” Customers who take end to end wealth management services: their providers qualify as RIAs.

1.4.2 Registered Investment Adviser Implications

A registered adviser needs to ensure compliance with the additional reporting requirements introduced by the Dodd Frank Act. Section 404 of the SEC Act entitles the SEC to require a registered investment adviser to maintain records and file reports regarding the private funds it advises, including, at a minimum, for each such private fund:

- The amount of AUM (Assets Under Management)
- The use of leverage (including off-balance-sheet leverage);
- Counterparty credit risk exposures;
- Trading and investment positions;
- Valuation policies and practices;
- Types of assets held;
- Side arrangements or side letters;
- Trading practices; and
- Any other information the SEC determines is necessary and appropriate for the Protection of investors or the assessment of systemic risk.

1.4.3 Who is a Broker Dealer

A broker or dealer that is registered with the SEC under the Securities and Exchange Act of 1934 (“Exchange Act”)

They are exempt from regulation as “Investment Adviser” if the advice given is:

- Solely incidental to the conduct of its business as broker or dealer, and
- It does not receive any “special compensation” for providing investment advice.

Bundled Fees. The SEC has stated a broker or dealer that receives a fee based on a percentage of assets that compensates the broker or dealer for both advisory and brokerage services receives “special compensation.”

Separate or Identifiable Charge. The SEC has stated that a broker- dealer charges “special compensation” when it charges its customer a separate fee for investment advice, or when it charges its customers different commission rates, one with advice and one without, because the difference represents a clearly definable charge for investment advice.

1.4.4 Broker Dealer - as a Wealth Manager

The SEC has stated that a broker-dealer does not have to treat its brokerage customers to whom it provides investment advice as advisory clients simply because it is registered under the Advisers Act.

It must treat as an advisory client only those accounts for which it provides advice (i.e., non-incidental advice) or receives compensation (i.e., special compensation) that subjects the broker-dealer to the Advisers Act.

1.5 CASE:

- ✓ Adolf Merckle, a leading industrialist in Germany committed suicide on January 5th, 2009. Shortly before 5pm on Monday night, Adolf Merckle quietly put on his coat, told his wife "I have to go to the office for a while", and drove to a railway embankment near his home, where he lay on the frozen tracks and waited patiently for death
- ✓ His holding company had lost £400 million by betting on the falling price of VW shares in October, just before Porsche announced that it had secretly built up a controlling stake in the company and sent share prices rocketing
- ✓ He was a call-writer on VW shares. (or he had shorted VW futures). VW share prices were rising when the automotive industry was looking at an extremely bad future. It seemed like a good idea to make money writing calls or shorting the stock. The logic is: the rise in price is unsustainable; therefore the stock price will crash. When the stock price crashes, the Calls will go unused and the writer will make the premium as a profit; shorters will make profit.
- ✓ However, unknown to anyone, the Calls were being purchased by a competitor car company Porsche; this company had also bought VW shares in futures; and in cash.
- ✓ All told at some point, 85 to 94% of the shares in VW were directly or indirectly under Porsche's control: a process known as "cornering". It led to VW shares spiking

Anybody that was a call-writer or a seller of VW futures. Any one "short". Merckle was one of them and his bet was large.

Merckle was not insolvent, but the \$ 360 million loss required him to hand-over control of his baby which he created (generics giant Ratiopharm) to the banks that had funded him for this trade.

On January 5th, he drove to a railway line behind his house and lay down on the tracks. At the thought of losing his company, he killed himself.

Key Learnings:

At the end of this chapter one should be conversant with the following fundamental concepts:

- The BFSI landscape is a dominant part of every economy and that it plays an important role in the economic well-being of a nation.
- Wealth management range of products
 - From Banking - Wealth customers are often offered structured products and alternate investment strategies.
 - From Investment Banking & Brokerage - Advisory, Discretionary & Execution only
 - Unique to Wealth Management - Trusts and Succession Planning
- Trusts, Nominees & Fiduciary Accounts
- Seamlessness of offering - Wealth Management is a combination of a full range of services and the seamlessness of offerings.
- Business structures in Wealth Management
 - Specialists
 - IB / Broking Unit
 - Universal Bankers
- US Regulatory statuses in WM
 - Definition of Investment Adviser Section 202(a)(11) of the Act defines an investment adviser as any person or firm
 - A registered adviser needs to ensure compliance with the additional reporting requirements introduced by the Dodd Frank Act
 - A broker or dealer that is registered with the SEC under the Securities and Exchange Act of 1934 (“Exchange Act”)
- HNWI behaviour and preferences.

1.6 Test Your Understanding

1. Specific needs of high net worth individuals and general retail investors that cannot be met by standardised financial instruments available in the markets are met with _____.
 - a. Derivatives
 - b. Collective Investment Schemes
 - c. Structured Products
 - d. None of the given options
2. Services of this category of banks are normally targeted at clients with a certain minimum sum of investable cash- or minimum net worth.
 - a. Commercial Banks
 - b. Investment Banks
 - c. Public Banks
 - d. Private Banks
3. Which of the following are valid goals of wealth management?
 - a. Helping a client become wealthy
 - b. Gracefully accepting losses
 - c. Preserving and enhancing a client's wealth
 - d. Ensure the client earns more than what fund management might offer
4. Which of the following statements reflects wealth management as a business?
 - a. Standardized products
 - b. Investment in mutual funds
 - c. High-end banking
 - d. Tailor-made solutions
5. Which of the following is NOT a part of Wealth Management services bouquet?
 - a. Customized Banking Products
 - b. Investment Management
 - c. Trusts and Estate Management
 - d. Tax and Estate Planning
 - e. Checking Accounts

Chapter Overview: Wealth Management Products

This Chapter will deal with Common Financial Assets viz. Equity, Debt, Forex and Funds. We start with trade-able Financial Asset Equity in which we learn about some features & benefits of Equity, analyzing tools and Life-cycle of Equity. In Debt, we learn about Bonds and FIS, its features and benefits of FIS, Bond issuers and Life-cycle of Debt instrument. The topic on MMI deals with importance and types of Cash instruments in the market. In connection to Equity and Debt, we would know their role in Asset allocation, Planning and the risk-return of these instruments.

The last trade-able financial asset dealt with is Funds, where we will learn about the structure and constituents of Mutual Fund. Towards the end, we will also get to know about the types of Funds.

2 Common Financial Assets

2.1 Tradable Financial products - Equity/Stocks/Shares

Stocks are a type of security that gives stockholders a share of ownership in a company. Stocks also are called “equities.” In the modern economy the difference between the terms stocks and shares is blurred. They can be used interchangeably with no loss of value or meaning. From a language perspective, the following usage throws some light on the how these terms might be employed.

“I have shares in Microsoft.” “I own the Microsoft stock.”

“I have 15 shares in Microsoft and am looking to increase my exposure to that stock.”

Generally speaking ‘stocks’ as a term is more prevalent in the USA. A share is more the used term in UK, India and some other parts of the world.

Investors buy stocks for various reasons. Here are some of them:

- Capital appreciation, which occurs when a stock rises in price
- Dividend payments, which come when the company distributes some of its earnings to stockholders
- Ability to vote shares and influence the company

Companies issue stock to get money for various things, which may include:

- Paying off debt
- Launching new products
- Expanding into new markets or regions
- Enlarging facilities or building new ones

2.1.1 Benefits and risks of stocks

Stocks offer investors the greatest potential for growth (capital appreciation) over the long haul. Investors willing to stick with stocks over long periods of time, say 15 years, generally have been rewarded with strong, positive returns.

But stock prices move down as well as up. There’s no guarantee that the company whose stock you hold will grow and do well, so you can lose money you invest in stocks.

If a company goes bankrupt and its assets are liquidated, common stockholders are the last in line to share in the proceeds. The company’s bondholders will be paid first, then holders of preferred stock. If you are a common stockholder, you get whatever is left, which may be nothing.

Even when companies aren’t in danger of failing, their stock price may fluctuate up or down. Large company stocks as a group, for example, have lost money on average about one out of every three years. If you have to sell shares on a day when the stock price is below the price you paid for the shares, you will lose money on the sale.

Market fluctuations can be unnerving to some investors. A stock’s price can be affected by factors inside the company, such as a faulty product, or by events the company has no control over, such as political or market events. Stocks usually are one part of an investor’s holdings. If you are young and saving for a long-term goal such as retirement, you may want to hold more stocks than bonds. Investors nearing or in retirement may want to hold more bonds than stocks. The risks of stock holdings can be offset in part by investing in a number of different stocks. Investing in other kinds of assets that are not stocks, such as bonds, is another way to offset some of the risks of owning stocks.

A public company or publicly traded company is a company that offers its securities (stock, bonds, etc.) for sale to the general public, typically through a stock exchange, or through market makers operating in over the counter markets. A company with many shareholders is not necessarily a publicly traded company. Publicly traded companies are able to raise funds and capital through the sale of its securities. This is the reason publicly traded corporations are important: prior to their existence, it was very difficult to obtain large amounts of capital for private enterprises.

Few important dimensions of Equity are given below:

A. Face Value (or Par Value) The nominal value of a security stated by the issuer. For stocks, it is the original cost of the stock shown on the certificate

It used to be that the par value of common stock was equal to the amount invested (as with fixed-income securities). However, today most stocks are issued with either a very low par value (such as \$0.01 per share) or no par value at all.

You might be asking yourself why a company would issue shares with no par value. Corporations do this because it helps them avoid a liability to stockholders should the stock price take a turn for the worse. For example, if a stock was trading at \$5 per share and the par value on the stock was \$10, theoretically, the company would have a \$5-per-share liability. Par value has no relation to the market value of a stock. A no par value stock can still trade for tens or hundreds of dollars - it all depends on what the market feels the company is worth.

B. Class Of Shares: Types of listed company stock that are differentiated by the level of voting rights shareholders receive. For example, a listed company might have two share classes, or classes of stock, designated as Class A and Class B.

Owners of companies that have been privately owned and go public often create class A and B share structures with different voting rights in order to maintain control and/or to make the company a more difficult target for a takeover. Obviously, it's the original owners that end up with the preferential voting class of stock.

C. Dividend: The simple answer is that Dividends are payments by a company to its shareholders. For more detailed answers, about cash dividends please find several definitions below. Please also refer to our stock dividend, dividend reinvestment plan and cash stock option pages.

- The part of the profits made by a company that it pays to its shareholders.
- A distribution wealth to the shareholders of a company, made out of the earnings during a period (year, half year, quarter or month).
- The reward an investor receives for investing in the company. The higher the dividend, the higher the reward.
- A taxable payment from a company to its shareholders.

Companies pay dividends -Companies are not required to pay dividends. Companies that chose to do so, often have grown sufficiently and see no opportunities to invest in themselves to obtain growth. So rather than retaining the money, they give it to the shareholders.

Start-up companies however, might chose to retain their income and use it to grow their business, meaning that shareholders will not receive payments in cash.

A third option to increase value for the shareholders is to pay off the debt of the company (especially debt with unattractive terms and conditions).

A company could also chose to use its profits to buy back its own stock (and by doing so increasing the value of the remaining outstanding shares).

Investors interested in dividends - Investors seek to maximize the value of their money. They might choose to put the money in a bank account and receive interest on it. But if they think certain shares will pay them a higher rate than the interest on a bank account, they might want to invest their money in those shares. The difference between putting your money in a bank account and investing it in shares is the risk you're taking. When putting money in a bank account an investor knows beforehand how much interest they are going to get. When investing in securities, an investor has to take a gamble and wait and see how well the company is going to perform in the coming period and how much of the profit the company is transferring back to its owners (the company could decide to not pay a dividend at all).

- D. **Equity Dilution:** Equity Dilution is a general term that results from the issue of additional common shares by a company. The company can dilute the equity capital by issuing shares through a rights issue, conversion of debt into equity, private placement of shares, QIBs, GDR issues, domestic public issue and issuance of stock options among others.
- E. **American Depositary Receipt** - ADR A negotiable certificate issued by a U.S. bank representing a specified number of shares (or one share) in a foreign stock that is traded on a U.S. exchange. ADRs are denominated in U.S. dollars, with the underlying security held by a U.S. financial institution overseas. ADRs help to reduce administration and duty costs that would otherwise be levied on each transaction.
- F. **Global Depositary Receipt** - GDR A bank certificate issued in more than one country for shares in a foreign company. The shares are held by a foreign branch of an international bank. The shares trade as domestic shares, but are offered for sale globally through the various bank branches.

“American” or “Global” apply on the basis of the country in which the ‘receipt’ is issued to investors. For instance, Standard Chartered Bank issued IDRs: Indian Depositary receipts in the Indian market though the company itself is listed in UK.

What Does Equity Derivative Mean? A derivative instrument with underlying assets based on equity securities. An equity derivative's value will fluctuate with changes in its underlying asset's equity, which is usually measured by share price.

G. Earnings Per Share (EPS) -

EPS is the total net income of the company divided by the number of shares outstanding. They usually have a GAAP EPS number (which means that it is computed using all of mutually agreed upon accounting rules) and a Pro Forma EPS figure (which means that they have adjusted the income to exclude any one time items as well as some non-cash items like amortization of goodwill or stock option expenses). The most important thing to look for in the EPS figure is the overall quality of earnings. Make sure the company is not trying to manipulate their EPS numbers to make it look like they are more profitable. Also, look at the growth in EPS over the past several quarters / years to understand how volatile their EPS is, and to see if they are an underachiever or an overachiever. In other words, have they consistently beaten expectations or are they constantly restating and lowering their forecasts?

The EPS number that most analysts use is the pro forma EPS. To compute this number, use the net income that excludes any one-time gains or losses and excludes any non-cash expenses like stock options or amortization of goodwill. Then divide this number by the number of fully diluted shares outstanding. You can easily find historical EPS figures and to see forecasts for the next 1-2 years by visiting free financial sites such as Yahoo Finance (enter the ticker and then click on "estimates").

By doing your fundamental investment research you'll be able to arrive at your own EPS forecasts, which you can then apply to the other valuation techniques below.

- H. **Price to Earnings (P/E):** Now that you have several EPS figures (historical and forecasts), you'll be able to look at the most common valuation technique used by analysts, the price to earnings ratio, or P/E. To compute this figure, take the stock price and divide it by the annual EPS figure. For example, if the stock is trading at \$10 and the EPS is \$0.50, the P/E is 20 times. To get a good feeling of what P/E multiple a stock trades at, be sure to look at the historical and forward ratios.

Historical P/Es are computed by taking the current price divided by the sum of the EPS for the last four quarters, or for the previous year. You should also look at the historical trends of the P/E by viewing a chart of its historical P/E over the last several years (you can find on most finance sites like Yahoo Finance). Specifically you want to find out what range the P/E has traded in so that you can determine if the current P/E is high or low versus its historical average.

Forward P/Es reflect the future growth of the company into the figure. Forward P/Es are computed by taking the current stock price divided by the sum of the EPS estimates for the next four quarters, or for the EPS estimate for next calendar of fiscal year or two.

P/Es change constantly. If there is a large price change in a stock you are watching, or if the earnings (EPS) estimates change, the ratio is recomputed.

- I. **Growth Rate:** Valuations rely very heavily on the expected growth rate of a company. For starters, you can look at the historical growth rate of both sales and income to get a feeling for what type of future growth that you can expect. However, companies are constantly changing, as well as the economy, so don't rely on historical growth rates to predict the future, but instead use them as a guideline for what future growth could look like if similar circumstances are encountered by the company. To calculate your future growth rate, you'll need to do your own investment research. The easiest way to arrive at this forecast is to listen to the company's quarterly conference call, or if it has already happened, then read a press release or other company article that discusses the company's growth guidance. However, remember that although companies are in the best position to forecast their own growth, they are not very accurate, and things change rapidly in the economy and in their industry. So before you forecast a growth rate, try to take all of these factors into account.
- J. **PEG Ratio:** This valuation technique has really become popular over the past decade or so. It is better than just looking at a P/E because it takes three factors into account; the price, earnings, and earnings growth rates. To compute the PEG ratio (a.k.a. Price Earnings to Growth ratio) divide the Forward P/E by the expected earnings growth rate (you can also use historical P/E and historical growth rate to see where it's traded in the past). This will yield a ratio that is usually expressed as a percentage. The theory goes that as the percentage rises over 100% the stock becomes more and more overvalued, and as the PEG ratio falls below 100% the stock becomes more and more undervalued. The theory is based on a belief that P/E ratios should approximate the long-term growth rate of a company's earnings. Whether or not this is true will never be proven and the theory is therefore just a rule of thumb to use in the overall valuation process.
- K. **Replacement Value of a company** The price that will have to be paid to replace all the assets of the company. This is relevant because the replacement cost will most likely be different than fair market value or net realizable value.

L. Book Value of a Company

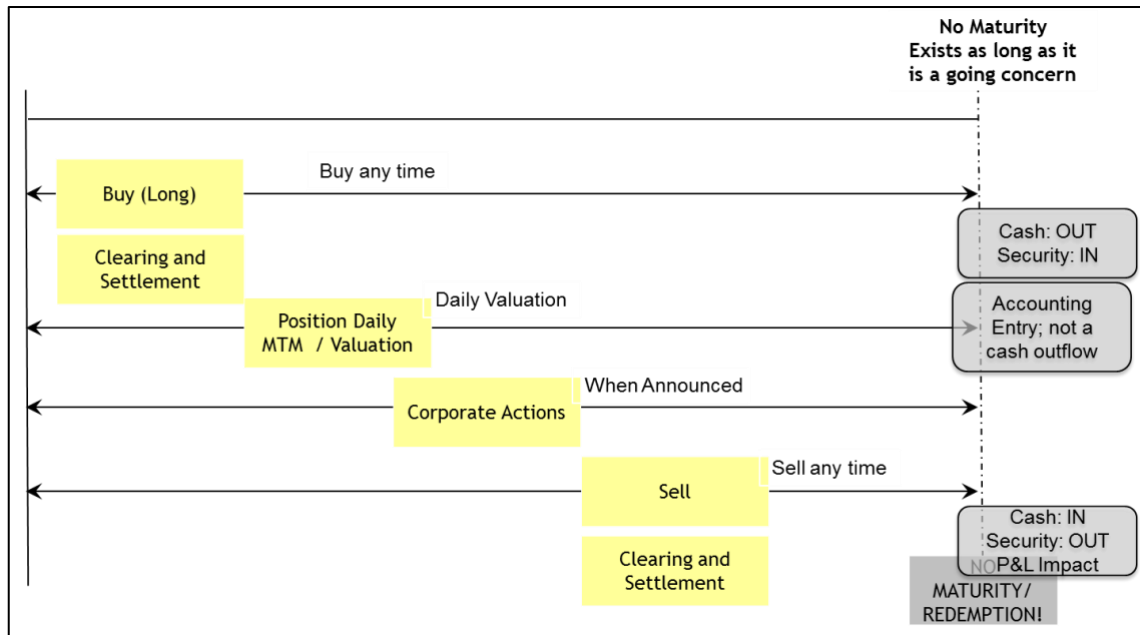
1. The value at which an asset is carried on a balance sheet. To calculate, take the cost of an asset minus the accumulated depreciation.
2. The net asset value of a company, calculated by total assets minus intangible assets (patents, goodwill) and liabilities.

M. Fundamental Analysis: Fundamental analysis is a stock valuation method that uses financial and economic analysis to predict the movement of stock prices.

The fundamental information that is analyzed can include a company's financial reports, and non-financial information such as estimates of the growth of demand for products sold by the company, industry comparisons, and economy-wide changes, changes in government policies etc.. To a fundamentalist, the market price of a stock tends to move towards its “real value” or “intrinsic value”. If the “intrinsic/real value” of a stock is above the current market price, the investor would purchase the stock because he knows that the stock price would rise and move towards its “intrinsic or real value”

If the intrinsic value of a stock was below the market price, the investor would sell the stock because he knows that the stock price is going to fall and come closer to its intrinsic value.

N. Technical analysis is a financial term used to denote a security analysis discipline for forecasting the direction of prices through the study of past market data, primarily price and volume.[1] Behavioural economics and quantitative analysis incorporate technical analysis, which being an aspect of active management stands in contradiction to much of modern portfolio theory. The efficacy of technical analysis is disputed by efficient-market hypothesis which states that stock market prices are essentially unpredictable



Equity – Required Fields & Data

TRADE	POSITION	CORPORATE ACTIONS
- Buy/Sell - Security Reference - Quantity - Price - Commissions - Fees - Gross Proceeds - Net Proceeds - Account (Proprietary/ Customer) - Exchange - Broker - Client Id - Trade Date - Settlement Date	- Security Reference - Quantity - Location (Depository/ Custodian) - Market or Valuation Price - Market Value (MTM) - Daily MTM P/L - Account - Client Id - Valuation Date	- Corporate Action Event Type - Announcement Date - Record Date - Ex-Date - Payment Date - Cash / Non-Cash - Mandatory/Voluntary

2.2 Tradable Financial products - FIS

2.2.1 Bond / FIS

A debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate. Bonds are used by companies, municipalities, states and U.S. and foreign governments to finance a variety of projects and activities.

Bonds are commonly referred to as fixed-income securities and are one of the three main asset classes, along with stocks and cash equivalents. Bonds are issued by public authorities, credit institutions, companies and supranational institutions in the primary markets.

- This chart captures the essence of the entire debt market in one snapshot

		Who took the loan		
		Corporate	Government	Others
Tenor of Loan	Short Term	Commercial Paper	T-bills	Certificates of Deposit (Issuer: bank)
	Medium Term	Fixed Income Securities	T-Notes	-
	Long Term	Bonds	T-Bonds	Munis etc. (municipalities: USA)

In conversation, when the term 'bond' is used it includes both medium and long term instruments. But it never includes short term instruments which are strictly referred to as 'money market instruments' only.

The most common process of issuing bonds is through underwriting. In underwriting, one or more securities firms or banks, forming a syndicate, buy an entire issue of bonds from an issuer and re-sell them to investors. The security firm takes the risk of being unable to sell on the issue to end investors. Primary issuance is arranged by book runners who arrange the bond issue, have the direct contact with investors and act as advisors to the bond issuer in terms of timing and price of the bond issue. The book runners' willingness to underwrite must be discussed prior to opening books on a bond issue as there may be limited appetite to do so.

In the case of government bonds, these are usually issued by auctions, called a public sale, where both members of the public and banks may bid for bond. Since the coupon is fixed, but the price is not, the percent return is a function both of the prices paid as well as the coupon. However, because the cost of issuance for a publicly auctioned bond can be cost prohibitive for a smaller loan, it is also common for smaller bonds to avoid the underwriting and auction process through the use of a private placement bond. In the case of a private placement bond, the bond is held by the lender and does not enter the large bond market.

2.2.2 Important Features of Bonds:

- A. Nominal, principal or face amount – the amount on which the issuer pays interest, and which, most commonly, has to be repaid at the end of the term. Some structured bonds can have a redemption amount which is different from the face amount and can be linked to performance of particular assets such as a stock or commodity index, foreign exchange rate or a fund. This can result in an investor receiving less or more than his original investment at maturity.
- B. Issue price – the price at which investor's buy the bonds when they are first issued, which will typically be approximately equal to the nominal amount. The net proceeds that the issuer receives are thus the issue price, less issuance fees.
- C. Maturity date – the date on which the issuer has to repay the nominal amount. As long as all payments have been made, the issuer has no more obligations to the bond holders after the maturity date. The length of time until the maturity date is often referred to as the term or tenor or maturity of a bond. The maturity can be any length of time, although debt securities with a term of less than one year are generally designated money market instruments rather than bonds. Most bonds have a term of up to thirty years. Some bonds have been issued with maturities of up to one hundred years, and some even do not mature at all. In the market for U.S. Treasury securities, there are three groups of bond maturities:
 - Short term (bills): maturities between one to five year; (instruments with maturities less than one year are called Money Market Instruments)
 - Medium term (notes): maturities between six to twelve years;
 - Long term (bonds): maturities greater than twelve years.
- D. Coupon – the interest rate that the issuer pays to the bond holders. Usually this rate is fixed throughout the life of the bond. It can also vary with a money market index, such as LIBOR, or it can be even more exotic. The name coupon originates from the fact that in the past, physical bonds were issued which had coupons attached to them. On coupon dates the bond holder would give the coupon to a bank in exchange for the interest payment.

2.2.3 Bond Issuers

As the major determiner of a bond's credit quality, the issuer is one of the most important characteristics of a bond. There are significant differences between bonds issued by corporations and those issued by a state government/municipality or national government. In general, securities issued by the federal government have the lowest risk of default while corporate bonds are considered to be riskier ventures. Of course there are always exceptions to the rule. In rare instances, a very large and stable company could have a bond rating that is better than that of a municipality. It is important for us to point out, however, that like corporate bonds, government bonds carry various levels of risk; because all national governments are different, so are the bonds they issue.

Companies use debt to increase the owners' profits.

Typically, a company will borrow money - either through a loan from the bank, or through bonds sold to investors - in order to expand. If a company wants to open a new factory, or a new store, but doesn't have enough money on hand to do so, then it may borrow the money to finance its growth.

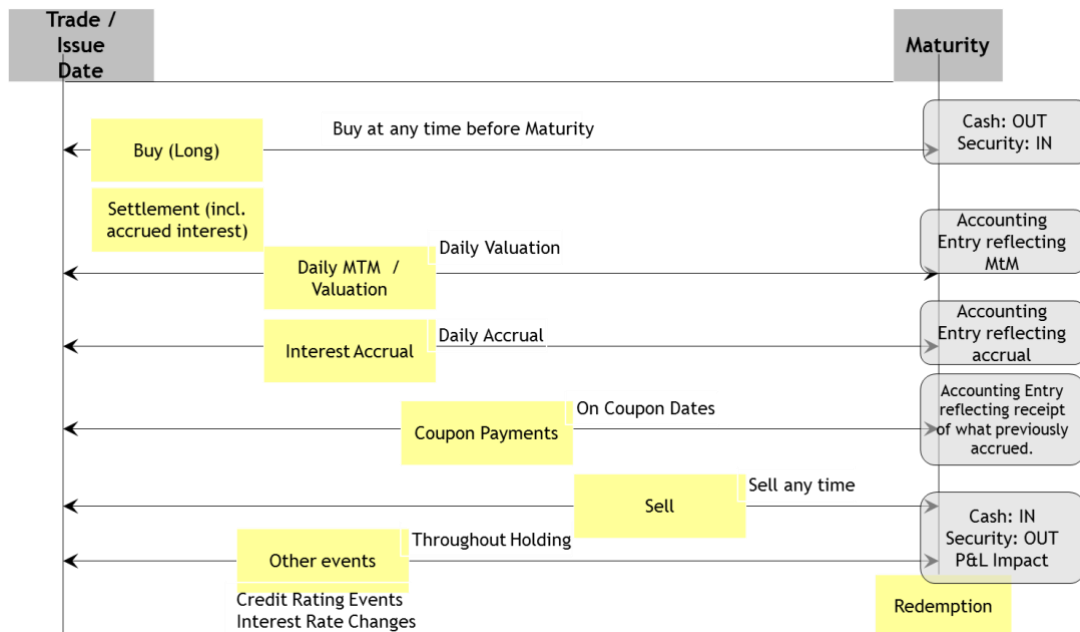
Companies with little or no growth can still use debt to increase owners' profits, however. A company with little or no growth obviously doesn't need to borrow money to expand. However, sometimes a slow-growing but stable company can borrow money in order to reduce the amount of money the owners have to keep tied up in the business. This allows the owners to invest that money elsewhere, increasing their profits.

The trouble with borrowing money, of course, is that eventually it has to be paid back. The company that borrows money in order to expand is taking the risk that the expansion will turn out to be unprofitable. Even if it is unprofitable, the company still has to repay its loans. If it cannot generate enough income to keep making the payments on its debt, then its lenders may take over some (or all) of the company, leaving the original owners with little or nothing.

- **Corporate Bond** A debt security issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations. In some cases, the company's physical assets may be used as collateral for bonds.

Corporate bonds are considered higher risk than government bonds. As a result, interest rates are almost always higher, even for top-flight credit quality companies.

- **Government bond** is a bond issued by a national government denominated in the country's own currency. Bonds are debt investments whereby an investor loans a certain amount of money, for a certain amount of time, with a certain interest rate, to a company or country. Bonds issued by national governments in foreign currencies are normally referred to as sovereign bonds. The first ever government bond was issued by the English government in 1693 to raise money to fund a war against France.
- **Municipal Bond** - A debt security issued by a state, municipality or county to finance its capital expenditures. Municipal bonds are exempt from federal taxes and from most state and local taxes, especially if the investor lives in the state in which the bond is issued.



Bonds - Required Fields & Data

TRADE	POSITION	LOAN MASTER
▪ Borrow/Lend ▪ Principal Amount ▪ Currency ▪ Gross Amount ▪ Interest Rate ▪ Fixed or Float ▪ Interest Rate Benchmark ▪ Interest Payment Dates ▪ Maturity Date ▪ Account (Proprietary/ Customer) ▪ Broker ▪ Client Id ▪ Collateral Type ▪ Collateral Amount ▪ Transaction Date ▪ Settlement Date	▪ Issuer ▪ Serial Number ▪ Original Principal ▪ Outstanding Amount ▪ Accrued Interest ▪ Current value of Loan ▪ Interest Rate ▪ Daily P/L ▪ Account ▪ Client Id ▪ Total Interest Received ▪ Collateral Value	▪ Previous Interest Date ▪ Next Interest Date ▪ Maturity Date ▪ Day Count Fraction ▪ Interest Rate ▪ Accrued Interest ▪ Credit Rating ▪ Interest Rate Benchmark ▪ Rate Reset Dates ▪ Collateral Type

2.3 Trade-able Financial Products Money Market Instruments

		Who took the loan		
		Corporate	Government	Others
Tenor of Loan	Short Term	Commercial Paper	T-bills	Certificates of Deposit (Issuer: bank)
	Medium Term	Fixed Income Securities	T-Notes	-
	Long Term	Bonds	T-Bonds	Munis etc. (municipalities: USA)

Money market securities are securities with maturities of up to twelve months, so they are short-term debt obligations. Money market debt is an important segment of the global financial markets, and facilitates the smooth running of the banking industry as well as providing working capital for industrial and commercial corporate institutions. The market allows issuers, who are financial organizations as well as corporates, to raise funds for short-term periods at relatively low interest rates. These issuers include sovereign governments, who issue Treasury bills, corporates issuing commercial paper and banks issuing bills and certificates of deposit. At the same time, investors are attracted to the market because the instruments are highly liquid and carry relatively low credit risk. Investors in the money market include banks, local authorities, corporations, money market investment funds and individuals; however, the money market essentially is a wholesale market and the denominations of individual instruments are relatively large.

Although the money market is traditionally defined as the market for instruments maturing in one year or less, frequently the money market desks of banks trade instruments with maturities of up to two years, both cash and off balance-sheet. In addition to the cash instruments that go to make up the market, the money markets also consist of a wide range of over-the counter off-balance sheet derivative instruments. These instruments are used mainly to establish future borrowing and lending rates, and to hedge or change existing interest rate exposure. This activity is carried out by banks, central banks and corporates. The main derivatives are short-term interest rate futures, forward rate agreements, and short-dated interest rate swaps.

The cash instruments traded in the money market include the following:

- A. **Treasury Bill (T-Bill):** T-bills are non-interest bearing, direct obligations of the United States government. They have an initial maturity of one year or less and are regularly sold at auction (in competitive and non-competitive bidding) by the Federal government. They are sold at discount from their maturity (par, face) value, which ranges from \$10,000 to \$1 million. The investor's entire return comes in the form of the appreciation in price that occurs as the bill approaches maturity.
- B. **Negotiable Bank CDs:** Negotiable certificates of deposit are money market instruments sold by banks, typically in maturities less than six months. They are issued in denominations ranging from \$100,000 to \$10 million. The standard round-lot trading unit among dealers is \$1 million. These negotiable instruments are traded in the secondary market and are a major tool used by large banks to manage their liquidity.

- C. **Commercial Paper (CP):** Commercial paper is unsecured, short-term, discount securities issued by financial organizations (about 75 percent) and corporations with high credit ratings. CP is a cheap alternative to borrowing from banks or other lending institutions. CP is generally sold in denominations of \$100,000 or more and maturities are limited to 270 days or less, allowing corporations to avoid the registration requirements in the Securities Act of 1933. Typical maturities are around 30 days. Commercial paper can be sold directly to investors or to commercial paper dealers.
- D. **Eurodollar CDs:** Eurodollar CDs are certificates of deposit issued by banks outside the U.S. and denominated in U.S. dollars. (Technically, any certificate of deposit that is denominated in a currency outside the bank of origin can be called a Eurodollar Cd. However, the great majority are in U.S. dollars). They are short-term CDs (less than 12 months maturity) and typically yield a higher interest rate than the domestic CDs of U.S. banks.
- E. **Repurchase Agreements:** “Repos” are transactions in which one party sells securities to another party (usually at a discount from the fair market value) and agrees to buy the securities back at a later date. Repos may be overnight or on a term basis, ranging from a few days to over 30 days, but most are for a term not exceeding two weeks. The securities used in repos are known as “collaterals” and may be Treasury securities, other money market instruments, federal agency securities, or mortgage-backed securities. Repo rates may be lower than the Federal funds rate due to the collateralized nature of the transaction.
- F. **Bankers’ Acceptances:** Bankers’ acceptances are short-term, negotiable securities issued by a bank for a customer, usually to finance export/import financing. The “draft” can be traded in the secondary market and represents an outstanding liability of the issuing bank. They are typically traded at a discount from face value.
- G. **Federal Funds:** Federal funds are reserve balances of insured banks at Federal Reserve Banks that are used to meet reserve requirements. Excess funds are loaned overnight by banks at the “fed funds rate” to other banks with insufficient reserve balances.

2.4 Tradable Financial products - Funds

2.4.1 International Background to Fund Industry

Investors have a range of investments to choose from and can buy them directly or indirectly. Direct investment is where an individual personally buys shares in a company, such as buying shares in BP, the oil company. Indirect investment is where an individual buys a stake in a collective investment vehicle, like a unit trust that invests in the shares of a range of different types of companies, including BP.

Achieving an adequate spread of investments through holding direct investments can require a significant amount of money and, as a result, many investors find indirect investment very attractive.

There are a range of funds available that pool the resources of a large number of investors to provide access to a range of investments. These pooled funds are known as **Collective Investment Schemes (CISs)**, funds, or collective investment vehicles.

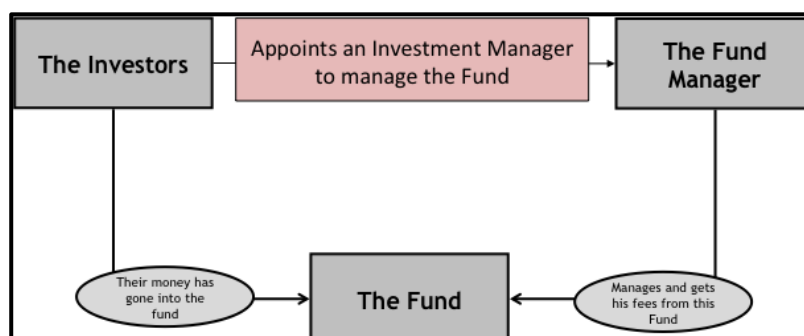
The term ‘collective investment scheme’ is an internationally recognized one, but investment funds are also known by other names in different countries, such as mutual funds, unit trusts or investment companies with variable capital. An investor is likely to come across a range of different types of investment fund as many are now established in one country and then marketed internationally.

Funds that are established in Europe, and are marketed internationally, are often labelled as UCITS funds, meaning that they comply with EU rules and the UCITS branding is seen as a measure of quality that makes them acceptable for sale in many countries in the Middle East and Asia.

The main centre for establishing funds that are to be marketed internationally is Luxembourg, where investment funds are often structured as open ended investment companies known as a SICAV (Société d’Investissement à Capital Variable). Other popular centers for the establishment of investment funds that are marketed globally include the UK, Ireland and Jersey where the legal structure is likely to be either an open-ended investment company (OEIC) or a unit trust.

The international nature of the investment funds business can be seen by looking at the funds authorized for sale in Bahrain, which include SICAVs, OEICs and unit trusts from a range of internationally recognized fund management houses.

A Mutual Fund is a professionally managed type of collective investment scheme that pools money from many investors and invests it in stocks, bonds, short-term money market instruments and other securities. Mutual funds have a fund manager who invests the money on behalf of the investors by buying / selling stocks, bonds etc.

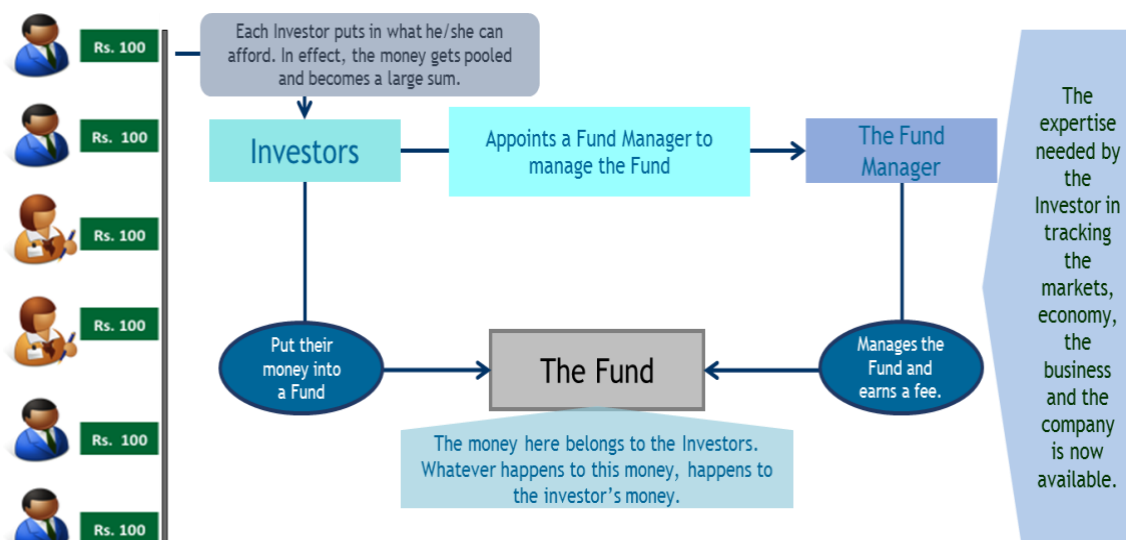


2.4.2 Rationale behind Collective Investment

Collective investment schemes pool the resources of a large number of investors, with the aim of pursuing a common investment objective. This pooling of funds brings a number of benefits, including:

- Economies of scale;
- Diversification;
- Access to professional investment management;
- Access to geographical markets, asset classes or investment strategies which might otherwise be inaccessible to the individual investor;
- In some cases, benefit of regulatory oversight; and
- In some cases, tax deferral.

2.4.3 Structure of a Mutual Fund



2.4.4 Mutual Fund Structure - constituents

- Sponsor:** Sponsor is basically a promoter of the fund. For example ABC Bank is the sponsor of the mutual fund ABC Mutual Funds. The fund sponsor raises the money from the public, who become shareholders. The pooled money is invested in the securities. Sponsor appoints the trustees.
- Trustees:** two third of the trustees are independent professional who own the fund and supervise the activities of the AMC. IT has the authority to sack the employees for non-adherence to the rules of the regulator. It safeguards the interest of the investor. Trustees are the people authorized to act on behalf of the Trust
- Asset Management Company:** Trustees appoint the Asset Management Company (AMC), to manage investor's money. The AMC in return charges a fee for the services provided and this fee is borne by the investors as it is deducted from the money collected from them. It is the AMC, which in the name of the Trust, floats new schemes and manages these schemes by buying and selling securities. Whenever the fund intends to launch a new scheme, the AMC has to submit a Draft Offer Document to SEBI.

This draft offer document, after getting SEBI approval becomes the offer document of the scheme. The Offer Document (OD) is a legal document and investors rely upon the information provided in the OD for investing in the mutual fund scheme.

The role of the AMC is to manage investor's money on a day to day basis. Thus it is imperative that people with the highest integrity are involved with this activity. The AMC cannot deal with a single broker beyond a certain limit of transactions. The AMC cannot act as a Trustee for some other Mutual Fund. The responsibility of preparing the OD lies with the AMC. Appointments of intermediaries like independent financial advisors (IFAs), national and regional distributors, banks, etc. is also done by the AMC. Finally, it is the AMC which is responsible for the acts of its employees and service providers. As can be seen, it is the AMC that does all the operations. All activities by the AMC are done under the name of the Trust, i.e. the mutual fund. The AMC charges a fee for providing its services.

2.4.5 Fund Management -Passive and Active Investment Management

There are a wide range of funds with many different investment objectives and investment styles. Each of these funds has an investment portfolio managed by a fund manager according to a clearly stated set of objectives.

An example of an objective is to invest in the shares of UK companies with above average potential for capital growth and to outperform the FTSE All-Share index. Other funds' objectives could be to maximize income or to achieve steady growth in capital and income. In each case, it will also be clear what the fund manager will invest in, i.e., shares and/or bonds and/or property and/or cash or money instruments and if derivatives will be used to hedge currency or other market risks. It is also important to understand the investment style they adopt. Investment styles refer to the fund manager's approach to choosing investments and meeting the fund's objectives. In this section we will look at the difference between active and passive management.

A. Passive Management:

Passive management is seen in those collective investment funds that are described as index tracker funds. Index tracking, or indexation, involves constructing a portfolio in such a way that it will track, or mimic, the performance of a recognized equity index.

The advantages of employing indexation are that:

- Relatively few active portfolio managers consistently outperform benchmark equity indices.
- Once set up, passive portfolios are generally less expensive to run than active portfolios, given a lower ratio of staff to funds managed and lower portfolio turnover.

The disadvantages of adopting indexation, however, include the following:

- Performance is affected by the need to manage cashflows, rebalance the portfolio to replicate changes in index constituent weightings and adjust the portfolio for stocks coming into, and falling out of, the index.
- Also most indices assume that dividends from constituent equities are reinvested on the ex-dividend (xd) date, whereas a passive fund can only invest dividends when received, usually six weeks after the share has been declared ex-dividend.
- Indexed portfolios may not meet all of an investor's objectives.
- Indexed portfolios follow the index down in bear markets.

- B. Active Management:** In contrast to passive management, active management seeks to outperform a predetermined benchmark over a specified time period. It does so by employing fundamental and technical analysis to assist in the forecasting of future events, which may be economic or specific to a company, so as to determine the portfolio's holdings and the timing of purchases and sales of securities.

Two commonly used terms in this context are 'top down' and 'bottom up'. 'Top down' means the manager focuses on economic and industry trends rather than the prospects of particular companies. 'Bottom up' means that the analysis of a company's net assets, future profitability and cash-flow and other company specific indicators is a priority.

Included in the 'bottom up' approach is a range of investment styles, including:

- Growth investing, which is picking the shares of companies with opportunities to grow in the long term;
- Value investing, which is picking shares of companies that are undervalued relative to their present profits or cash flows;
- Momentum investing, which is picking the shares whose value is rising on the basis that this rise will continue;
- Contrarian investing, the flip side of momentum investing which involves picking shares that are out of favour and may have 'hidden' value.

2.4.6 Types of Mutual Funds

A. Open Ended Vs Closed Ended

Open ended Fund: In open ended MFs, the fund house continuously buys and sells units from investors. New units are created and issued if there is demand, and old units are eliminated if there is redemption pressure. There is no fixed date on which the units would be permanently redeemed or terminated. If you want to invest in an open ended fund, you buy units from the fund house. Similarly, when you redeem your units, the fund house directly pays you the value of the units.

Close Ended Fund: Similar to a company, a closed-ended fund issues a fixed number of shares in an initial public offering, which trade on an exchange. Share prices are determined not by the total net asset value (NAV), but by investor demand. Unlike standard mutual funds, you cannot simply mail a check and buy closed fund shares at the calculated net asset value price. Shares are purchased in the open market similar to stocks. Information regarding prices and net asset values are listed on stock exchanges, however, liquidity is very poor.

Each fund has a predetermined investment objective that tailors the fund's assets, regions of investments and investment strategies. At the fundamental level, there are three varieties of mutual funds:

- Equity Funds
- Debt Funds
- Money Market Funds

B. Exchange Traded Fund

An exchange-traded fund (ETF) is an investment fund, usually designed to track a particular index. This is typically a stock market index, such as the FTSE 100. The investor buys shares in the ETF which are quoted on the stock exchange, like investment trusts. However, unlike investment trusts, ETFs are 'open-ended funds'. This means that, like OEICs, the fund gets bigger as more people invest and gets smaller as people withdraw their money. ETF shares may trade at a premium or discount to the underlying investments, but the difference is minimal and the ETF share price essentially reflects the value of the investments in the fund.

C. Hedge Funds

Hedge funds are reputed to be high risk. However, in many cases, this perception stands at odds with reality. In their original incarnation, hedge funds sought to eliminate or reduce market risk. That said, there are now many different styles of hedge fund - some risk-averse, and some employing highly risky strategies. It is, therefore, not wise to generalize about them.

The most obvious market risk is the risk that is faced by an investor in shares - as the broad market moves down, the investor's shares also fall in value. Traditional 'absolute return' hedge funds attempt to profit regardless of the general movements of the market by carefully selecting a combination of asset classes, including derivatives, and by holding both long and short positions (a 'short' position may involve the selling of shares which the fund does not at that time own in the hope of buying them back more cheaply if the market falls. Alternatively, it may involve the use of derivatives). However, innovation has resulted in a wide range of complex hedge fund strategies, some of which place a greater emphasis on producing highly-gearred returns than controlling market risk.

Many hedge funds have high initial investment levels meaning, that access is effectively restricted to wealthy investors and institutions. However, investors can also gain access to hedge funds through funds of hedge funds.

The common aspects of hedge funds are the following:

- **Structure** - Most hedge funds are established as unauthorized and, therefore, unregulated collective investment schemes, meaning that they cannot be generally marketed to private individuals because they are considered too risky for the less financially sophisticated investor.
- **High investment entry levels** - Most hedge funds require minimum investments in excess of £50,000; some exceed £1 million.
- **Investment flexibility** - Because of the lack of regulation, hedge funds are able to invest in whatever assets they wish (subject to compliance with the restrictions in their constitutional documents and prospectus). In addition to being able to take long and short positions in securities like shares and bonds, some take positions in commodities and currencies. Their investment style is generally aimed at producing '**absolute**' returns - positive returns regardless of the general direction of market movements.
- **Gearing** - Many hedge funds can borrow funds and use derivatives to potentially enhance returns.
- **Liquidity** - To maximize the hedge fund manager's investment freedom, hedge funds usually impose an initial 'lock-in' period of between one and three months before investors can sell their investments on.
- **Cost** - Hedge funds typically levy performance-related fees which the investor pays if certain performance levels are achieved, otherwise paying a fee comparable to that charged by other growth funds. Performance fees can be substantial, with 20% or more of the '**net new highs**' (also called the 'high water mark') being common.

2.5 Key Learnings:

At the end of this chapter one should be conversant with the following fundamental concepts:

- Trade-able financial asset Equity - Features and Benefits
 - Stocks offer investors the greatest potential for growth
 - Inherent risk of market fluctuation
- Equity dimensions
 - Face Value
 - Dividend
 - EPS & PE Ratio
 - Fundamental & Technical analysis
 - Book Value & Replacement Value
- Equity Life-Cycle and required fields and data
- Trade-able financial asset Debt - features and Benefits
 - Bonds are used by companies, municipalities, states and U.S. and foreign governments to finance a variety of projects and activities
 - Short term, Medium term and Long term debt instruments and their issuers
- FIS dimensions
 - Face value
 - Issue price
 - Coupon
 - Maturity date
- Debt Life-cycle and required fields and data
- Trade-able financial asset Money Market Instruments (MMIs) - Features and benefits
 - They are securities with maturities of up to twelve months
 - In addition to the cash instruments that go to make up the market, the money markets also consist of a wide range of over-the counter off-balance sheet derivative instruments.
 - Cash instruments traded include - Treasury bills, Commercial papers, Repos, Negotiable bank CDs, Euro-Dollar CDs and Bankers' Acceptance.
- Trade-able financial asset - Funds - Features and benefits
 - Collective investment schemes pool the resources of a large number of investors, with the aim of pursuing a common investment objective

- Structure and constituents
 - Sponsor
 - AMC
 - Fund Manager
 - Trustee
- Fund management - Active and Passive
- Types of Funds
 - Close-ended & Open-ended
 - Equity Funds
 - Debt Funds
 - Money market funds (Cash Funds)
 - Exchange Traded Funds (ETFs)
 - Hedge Funds

2.6 Test Your Understanding

1. Which of the following statements is true?
 - a. High P/E ratio stocks are expensive
 - b. Low P/E stocks are stocks that have no future
 - c. PEG ratio should be used to evaluate whether a stock is expensive
 - d. Nothing can be stated with certainty
2. Holding shares in a company means _____.
 - a. Being full liability towards the company
 - b. Having an ownership stake in that company
 - c. Having full ownership
 - d. All of the given options
3. Shares are _____ than Bonds.
 - a. Less Risky
 - b. Equally Risky
 - c. More Risky
 - d. None of the given options
4. A Fund Manager manages his fund by mimicking a benchmark index. He is a _____.
 - a. Hedge Fund Manager
 - b. Pension Fund Manager
 - c. Insurance Fund Manager
 - d. Passive Fund Manager
5. Closed-ended collective investment schemes - Mutual Funds are _____.
 - a. of Limited Lifespan
 - b. only Equity Funds
 - c. Perpetual
 - d. not for Retail Investors

Chapter overview: WM Services

This chapter gives an overview of the wealth management services. We will look into the Custodial services offered by WM. We will also get to know about the types of custodians and their role. We will learn about Estate Planning and the role of Trusts. At the end we will be learning about Tax Planning.

3 Wealth Management Services

3.1 Custodians

Custodians hold a range of assets on behalf of their customers. These include equities, government bonds, corporate bonds, other debt instruments, mutual fund investments, warrants and derivatives.

Institutional investors, money managers and broker/dealers are among those who rely on custodians and other market participants for the efficient handling of their worldwide securities portfolios.

The market is dominated by a small number of key players - comprising major banks and specialist providers.

Custodians effect settlement of trades (that is, completion of a transaction, wherein the seller transfers securities or financial instruments to the buyer and the buyer transfers money to the seller) and provide safekeeping of the assets on behalf of clients. The services also include:

- collection of income arising from the portfolios (dividends and interest payable)
- application of entitlements to reduced rates of withholding tax at source and reclaiming withheld taxes after-the-fact
- notification and dealing with corporate actions (such as bonus issues, rights issues and takeovers)

3.1.1 Central Securities Depositories

An entity that holds and administrates securities and enables securities transactions to be processed by book entry. Securities can be held in a physical (but immobilised) or dematerialised form (i.e. so that they exist only as electronic records). In addition to the safekeeping and administration of securities, a CSD may incorporate clearing and settlement functions.

3.1.2 Global Custodians

The global custody product was christened by a Chase Manhattan manager in late-1974. The underlying services delivered by Chase were not new: several banks had provided settlement and safekeeping services on an international basis for many years. However, these activities were typically provided free-of-charge - and the functions therefore starved of resources - as part of investment management or other activities. So it is generally accepted that global custody as a product in its own right was born in 1974.

At the outset, the key driver was a change to United States pension's law. The 1974 Employee Retirement Income Security Act ("ERISA") came to the Statute books, forcing US pension plan sponsors to segregate investment management and custody of the underlying assets. Such segregation is now established as a legal or regulatory requirement, or simply good business practice, around the world.

Chase had developed the product for a single US-based institutional investor to support investment in 15 countries of investment around the world. Other banks (from the 'money centre' of New York City and elsewhere) soon developed comparable product offerings.

With global custody as a stand-alone product, a chasm soon emerged between those providers who were committed to invest in staff, systems and product development - and those who soon fell by the wayside.

Those firms who have invested well have produced a comfortable stream of fee income - from custody fees levied, foreign exchange margin income and net interest income. In times of

trouble, this line of business has been a key contributor of liquidity to the banks and non-bank financial institutions who comprise the leading custodians of the world.

Service providers - both large and small - act for clients in many countries worldwide, handling assets across approximately 100 countries of investment. The range of services is ever more sophisticated. Measured by the value of assets held under custody, it is a multi-trillion dollar industry.

3.2 Standard actions at the Custodian

3.2.1 Capturing External Messages

Custodians receive corporate action information from several different sources: vendors, depositories, sub-custodians, exchanges and issuers. Most info is received in an electronic announcement format through a nightly feed or SWIFT MT564 and MT568 message types. The information may be automatically or manually fed into a custodian's corporate actions system depending upon how the information is received and the level of automation maintained by a given custodian. Key data elements include dates and rates, which are cross checked between various sources to ensure accuracy of the information.

For global issues, the custodians often rely on local sub-custodians and vendors. The deadlines on these issues may differ between the depository, sub-custodians, and global custodian each placing a buffer period to ensure adequate time to accurately process client elections. Asset managers may also receive multiple deadlines from different custodians, which they then have to track.

3.2.2 Creation of Corporate Action Event

Positions are captured from the custody platform taking into account trade date and entitlement where appropriate. The custodian then uses the critical data elements in each announcement type to determine how eligibility should be structured for the announcement and adds any processing requirements.

3.2.3 Build and Distribute Notification

Once all the information is processed in the corporate actions system and is checked against the notification details that were received from one of the external parties, the custodian builds a notification document. Custodians maintain databases of client and investment manager static data such as contact information that are housed and updated within the corporate actions system. Depending on the client's choice of distribution for particular items, the custodian would, upon approval of the notification, send the notification to the clients either via electronic means or via fax.

The above process will be repeated if any amendments or changes occur to the offers, and subsequently are transmitted to clients up to and including the appropriate entitlement date. The custodian strives for timely distribution of the corporate action information so that clients and investment managers are able to make an informed decision.

3.2.4 Receiving and Processing Response

As the entitlement date approaches for those actions that require a response, the custodian would be canvassing investment managers who have not provided responses by custodian's stated cut-off date. The cut-off date can vary in the U.S. market from 24 to 48 hours prior to the market expiration, and from 48 to 96 hours in the global market. As responses are received they are validated against the parties listed on the custodian's investment manager or client file to ensure that the responding party is authorized to instruct on a corporate action. The custodian also checks that all relevant information that was required for that particular corporate action is included in the response. Investment managers have the option of responding via several communication channels. Custodians accept responses via Internet response modules, via FAX, or via SWIFT. Automated responses may update a custodian's corporate action systems in straight through manner. Depending upon the client and the custodian, further confirmation may be provided to investment managers confirming receipt of responses.

Other down-stream processes include a full reconciliation of client responses to custodian, depository, and/or sub-custodian records in order to account for all client positions.

An encumbrance is then placed on the assets that are surrendered to the depository or sub-custodian to ensure that no trading activity would affect the account's participation in the corporate action.

3.2.5 Best Efforts Practices and Default Actions

There may also be instances when a custodian does not receive a response/instruction from the asset manager by the custodian's stated deadline. Some custodians have zero tolerance policy, where they will not take any action without getting instruction from the client. Most custodians, however, do apply a default instruction depending on event type. For example, custodians will have a default on client instructions to always exchange 144As, on an optional stock cash dividend it could be to take cash. The default action is usually based on a standard operating model across all clients. It may also be defined in the client contract.

The custodians are also faced with receiving multiple instructions on corporate actions at the absolute deadline. Most instructions are sent via fax thereby requiring the custodian to manually process each action. This often leaves the custodian with minimal time to perform the necessary steps to timely and accurately instruct local market agents prior to the final market cut-off times.

Custodians have escalation policies, and do send out reminders to the asset managers to send in the instructions. The best efforts recommendation may vary based on how an asset manager submits their instructions to a custodian (i.e. Fax, email, standardized automated format). This could be an incentive to asset managers to automate and standardize communications of their corporate actions systems.

The industry should be moving toward deadlines that are closer to the end market deadline, but until the necessary automation is in place this will be difficult to achieve. DTCC's re-engineering project, once completed, will be helpful in this regard. The best efforts process, or having closer deadlines which give the asset manager more time to decide how to respond, may become a competitive advantage between custodians.

3.2.6 Process Instruction

As the instructions are processed over to the depository, the custodian also sends instructions to all the locations where the asset may be held ensuring that all reconcilements for all outstanding trading activity can be corroborated. This includes brokers owing outstanding trades, or failed trades, loan positions with lending parties etc. In these instances the custodian will deliver instructions to the broker to act on the position via a “liability letter”. The liability letter will instruct the broker to return (for loans) or deliver (for trades) the shares due. Otherwise, they will be held responsible to ensure that the client’s instruction is executed and the entitlement is received in accordance with the instructions provided. After the submission of the instructions the custodian expects a confirmation that instructions were in fact received. Sub-custodian sends confirm via a SWIFT MT567 response, the depository via PTOP ticket or similar facility through DTCC, and issuer gives a window ticket if certificates were physically presented to issuer.

3.2.7 Collect and Process Entitlement

The open entitlements are tracked for mandatory and voluntary payment dates as open items in the custodian’s corporate actions system to indicate which items are coming due on any particular date to ensure payment is being allocated. Sub-custodians and depositories also notify custodian on payment receipts. Once a particular settlement comes in, a reverse balancing is done to ensure that all clients that received instructions have actually received the correct amount announced in the custodian’s corporate action event. The custodian also takes into account any changes that have occurred during the process and/or pro-rata, and balances the expected amount based on an adjusted rate. Prior to posting the amount to the account, the custodian notifies the client that the final rates have been announced and provides changes from the original announcement. As is necessary the custodian will claim counterparties for entitlements due on shares on loan or in custody elsewhere due to pending or failing trades. Custodians confirm payment receipt via a SWIFT MT566 message. This message is used to confirm to the investment manager that securities and/or cash have been credited/debited to their account as the result of a corporate action events.

3.3 Estate Planning

3.3.1 Introduction to Estate planning

Take appropriate steps to ensure that accumulated wealth passes to their intended beneficiaries and in as tax efficient method as possible.
Steps that can be taken vary but some key stages

3.3.2 Estate Planning Process

Establish assets and liabilities including any funds only payable on death
Consider need for power of attorney to protect their interests when incapable of managing their affairs. Identify who they wish to inherit their estate and any specific gifts they wish to make. Extent of any liability to inheritance taxes and action that should be taken to mitigate

3.3.3 Execution of a Will

Where possible essential to ensure assets pass in accordance with their wishes
Specialist advice needed especially if own property overseas
Inheritance laws will usually determine who receives what if no will
Where it is not possible to make a will, give consideration to an offshore trust

3.3.4 Inheritance Tax

Liability can be significant and major concern for older and wealthier clients
Consider how to mitigate by use of exemptions, gifts and properly drawn will
Remaining liability can be insured against using either term or life insurance
Policy is usually written in trust so that proceeds are payable to beneficiaries and do not form part of estate

3.4 Trusts

3.4.1 Parties to a trust

- Settlor - the person who creates the trust by executing a trust deed
- Trustee - the individual charged with looking after the trust property on behalf of the beneficiaries
- Beneficiary - the individuals named in the trust deed who are to benefit from the trust

3.4.2 Types of trusts

Bare trust; interest in possession trust; discretionary trust

3.4.3 Uses of Trusts

Estate planning; asset and business preservation; asset and family protection; tax planning and charitable giving

3.4.4 Offshore Trusts

Offshore asset protection trusts used by wealthy as part of their overall tax planning strategy. Established in offshore financial centres and use discretionary trust structure known as offshore asset protection trust

3.4.5 Uses of Offshore trust

- Privacy and protection
- Wealth preservation
- Tax planning - inheritance tax; income tax; capital gains tax
- Legal certainty, flexibility and efficiency

3.4.6 Trusts & Foundations

Wealthy persons often feel the need to contribute to charitable causes. These causes typically cover:

- Education for the poor
- Housing for the homeless
- Food for those in poverty
- Other social objectives

It is also possible that a person wishing to do good has no money of his or her own. Being highly motivated to do good such persons often collect money from various sources to pursue these social objectives.

Such philanthropists may also set up Foundations, named for the social cause it espouses or in memory of a loved one.

A Foundation pursues a broad range of initiatives for the cause in which financial enablement is one of several actions taken.

The words “Endowment”, “Fund”, “Benefit” or “Charity” are often included in the names of such entities.

Here are some prominent examples:

- The Ford Foundation: this was established by Henry Ford the automobile tycoon to support leaders and organizations working in the area of social change.
- The J. Paul Getty Trust was founded by an oil tycoon of the same name and is dedicated to art.
- The Church Commission of England is set up to preserve Churches in England.
- The Children’s Health Fund (CHF) was founded by singer/songwriter Paul Simon (of Simon & Garfunkel fame) and pediatrician Irwin Redlener to provide health care to homeless and medically under-served children.

In addition, wealthy persons also need to plan on how their wealth shall pass on to the next generation. This requirement, often called succession planning, is specific to:

- Tax considerations
- How the wealth is to be used by the receiver
- Ensuring specific amounts reach specific persons

Trusts and Foundations achieve these results efficiently.

A Trust is an arrangement where one party entrusts a second party to hold assets or property and use it for the benefit of a third party, as specified by the first party.

Naming the Parties in a Trust:

- Settlor or Grantor: The first party, who thought up of the idea behind the Trust
- Trustee: the second party, on whom the Settlor relies to work as per the goal
- Beneficiary: the third party for whom the Trust was set up.

The Trust itself is a separate legal entity. Trustees are associated with the Trust. Setting up of the Trust is often done by one of the following agencies which help out the Settlor with its plan:

- A legal firm
- A Bank, especially its Wealth Management division
- Specialist Wealth Management firms
- Specialist Trust practitioners

Each of these agencies often provide Trusteeship services. The Trustee would typically be an officer of that agency. Whichever person works in the Trust department serves as a Trustee of the Trust. In such cases the Trustee is an organization rather than an individual.

If Trusteeship services are provided on a professional basis or is another entity, then that other entity has its own legal form.

Therefore, in examining a Trustee, if that Trustee is a firm, then the persons behind that firm become important. That firm has a Board, shareholders and a governance structure which are important to understand.

3.4.7 Knowing the Settlor

The very nature of Trust services is to separate the owner of funds from the funds.

In a tax context, a parent separates itself from money to make sure the child gets the benefit of the money with minimal tax consequences. Those engaging in charity are giving money away. In many other situations, the recipient of benefits from the Trust does not know or deal with the Settlor. This separation, which is inherent to the nature of Trusts is a matter of caution for bankers.

Is the separation sought for genuine reasons? Or is the separation itself the real goal and not some other charitable, social or tax cause?

Trusts, almost uniquely, resemble the 'Layering' step in a classical Money Laundering operation where separation of original source from final destination is the goal. It becomes critically

important, therefore to establish the credentials of the Settlor. It can also happen that while the Settlor is legitimate, it is the goal which is not. We must therefore turn to the Beneficiary.

3.4.8 Knowing the Beneficiary

The genuineness of the Trust is also established by ascertaining the credentials of the beneficiary. For instance, in a family trust setup for succession and tax planning, the beneficiary would be a relative of the Settlor. Even if not all beneficiaries are relatives, there will be a limited number of named, specific persons who are the beneficiaries of the Trust.

Beneficiaries could also be organizations. Based on the entity-type, a thorough due diligence on the beneficiary is required to establish identity and genuineness. Sometimes a trust might be created by an individual for his/her own benefit. In this case both the grantor and the beneficiary will be the same.

3.4.9 Anonymous Donors and Beneficiaries

As we discussed earlier, a person with a good heart may not have the money to pursue social initiatives. The person may set up a large network to contact people for donations in small amounts. Similarly, the grants, contributions, charity made may also be to a large number of people. Multiple, anonymous donors pose a problem in ascertaining genuineness because no one, single verifiable name is the Settlor. It also poses a money laundering risk.

Similarly, by distributing amounts to a large number of anonymous recipients the real intentions of a group can also be hidden. Anonymity requires extra caution.

3.4.10 Foundations

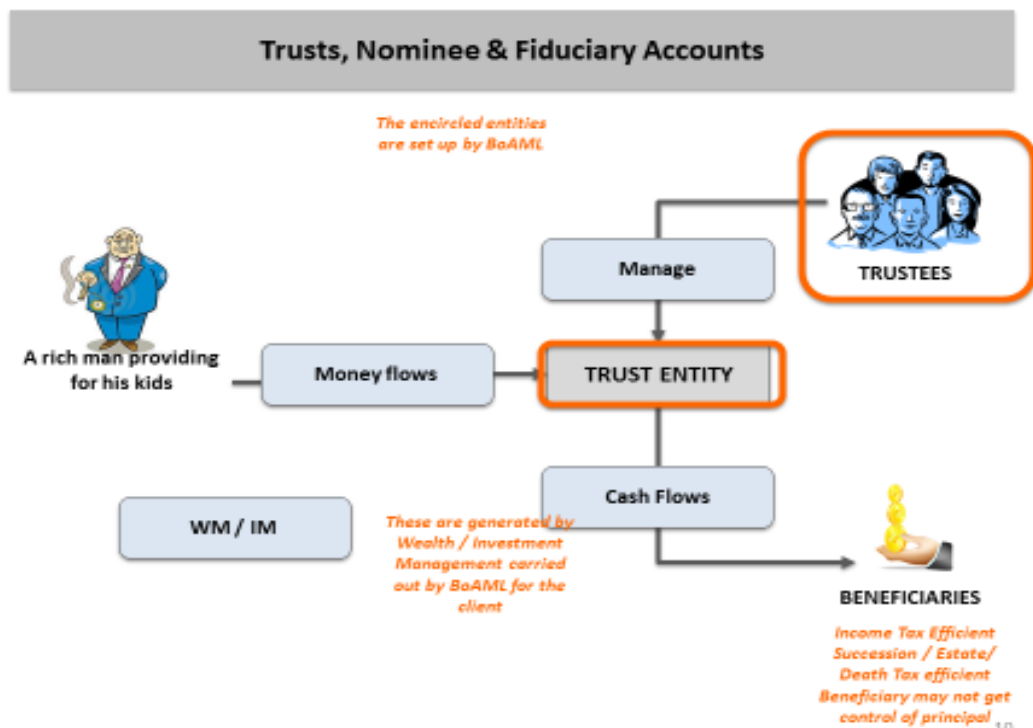
While in essence similar to Trusts, Foundations name persons who will oversee the grant process by which particular projects or charities or individuals are funded. Such a Board or Committee associated with the Foundation also provides an insight into other persons associated with the Foundation or the manner in which the Foundation is administered.

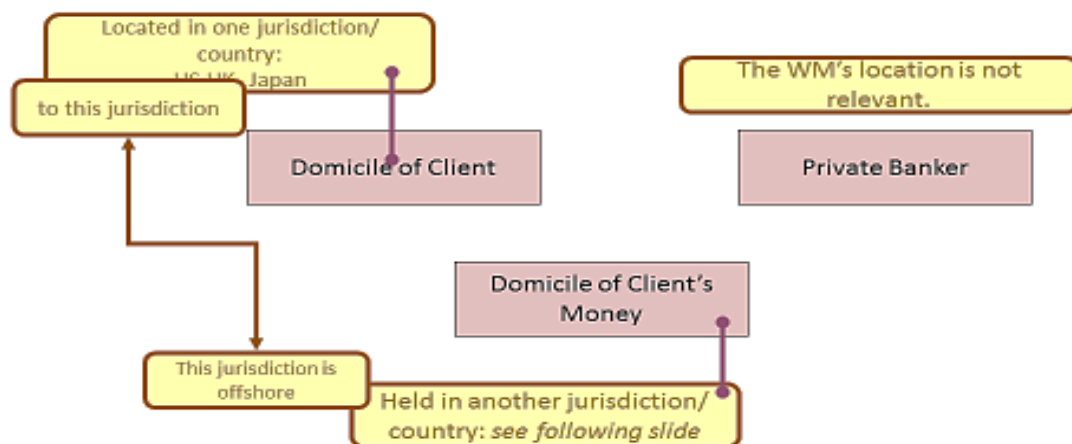
3.5 Tax Planning

- **Role of the adviser:-**
 - Ensure investment recommendations are tax efficient
 - Tax evasion versus tax avoidance
- **Types of tax:-**
 - Income tax
 - Capital gains tax
 - Withholding tax
- **Domicile and residence:-**
 - Residence of an individual will determine how tax authorities treat their income and gains for tax purposes
 - Domicile - individuals who are resident in a country but not domiciled there may receive special tax treatment in respect of income and gains arising outside of that country

3.5.1 Tax Planning Considerations

- **General**
 - Need to determine where the client pays tax and the extent of any liabilities and allowances that are available.
 - Need to establish the client's residence and domicile.
- **Investments**
 - Need to recognise the effect of tax on investments as it may influence choice.
 - The effect of changing investments needs to be assessed as if the sale of one investment generates a large tax bill then the new investment needs to outperform by some distance.
 - If overseas investments are held, what double taxation agreements are in place and, if none, what is the effect on investment returns.
- **Income**
 - What is the client's income tax position? If he has a high income, it may be better to invest for capital growth.
 - Assuming the client pays income tax, are there investments which are tax exempt, bear favoured rates of tax or on which tax can be deferred?
- **Gains**
 - What is the tax position on capital gains?
 - Are there investments which are exempt from tax on gains, receive favoured treatment and is it relevant how long the asset is held?





The offshore jurisdiction is linked to a mainland whereby there are tax advantages from holding the assets offshore.

These offshore locations are typically located geographically near by.

The mainland and the offshore centre have various legal arrangements between them; the mainland is favoring a particular offshore location.

Many of these offshore locations are known as "tax havens" due to the easy tax regime.

The offshore location has minimum legal requirements for forming an entity, minimal fees and ongoing costs.

3.6 Key Learnings:

At the end of this chapter one should be conversant with the following fundamental concepts:

- Wealth Management Services include
 - Custodial services
 - Estate Planning
 - Trusts
 - Tax Planning
- Custodians - Custodians hold a range of assets on behalf of their customers. These include equities, government bonds, corporate bonds, other debt instruments, mutual fund investments, warrants and derivatives.
- Entities include -
 - Depositories
 - Global Custodians
- Standard actions at the Custodian level during corporate actions includes
 - Capturing External Messages
 - Creation of Corporate Action Event
 - Build and Distribute Notification
 - Receiving and Processing Response
 - Best Efforts Practices and Default Actions
 - Process Instruction
 - Collect and Process Entitlement
- Estate Planning - Take appropriate steps to ensure that accumulated wealth passes to their intended beneficiaries and in as tax efficient method as possible.
- Trusts - Types of Trusts, parties to Trust & uses of Trust.
- Trusts and Foundation - Wealthy persons often feel the need to contribute to charitable causes. Such philanthropists may also set up Foundations
- Tax Planning -
 - Role of advisor
 - Types of tax
 - Domicile and Residence
 - Tax planning considerations
 - Jurisdictions

3.7 Test your Understanding

1. A centralized location in which security certificates are placed and stored for later transfer is known as _____.
 - a. Central Depository
 - b. Custodian
 - c. Exchange
 - d. Mutual Fund

2. A centralized location in which security certificates are placed and stored for later transfer is known as _____.
 - a. Central Depository
 - b. Custodian
 - c. Exchange
 - d. Mutual Fund

3. Which of the following services are offered by Global Custodians?
 - a. Safekeeping of a variety of securities in a range of jurisdictions
 - b. Making arrangements for the receipt and delivery of securities and cash
 - c. Collecting and repatriating dividends and interest
 - d. Notifying clients of corporate actions and executing their instructions
 - e. All of the Above

4. Which of the following services are provided by the Custodian Banks?
 - a. Settlement Services
 - b. Asset Services
 - c. A and B
 - d. None of the options given

5. Registration of Assets ensures _____.
 - a. Securities are registered upon settlement
 - b. Securities are registered once the order is confirmed
 - c. Securities are registered upon delivered
 - d. Securities are registered upon intimation

Chapter Overview: Regulations in WM

This chapter will help the participants get a sound understanding of the Regulations pertaining to the Wealth Management. We will look into the FINRA structure and operation. We will get to know about the special nature of documentation in WM in fair detail. The chapter also covers the points on terms of businesses and agreements. We will have affair knowledge about various Account types. We will also deal with the importance of KYC and Due Diligence and the need for professional ethics. The chapter also deals with some important laws and legislations like FATCA.

4 Regulations in Wealth Management

Generally speaking, products which are market oriented in nature provide investors protection through the laws applicable to market participants.

Similarly banking products are covered by banking regulation. Wealth Management customers use products from both areas. This can cause overlaps - but also gaps. While the overlaps is not an issue for customers, the gaps are an issue.

The better way then to understand regulation for Wealth Management is from the Consumer Protection angle. If one wants to understand inherent risk in the products used by customers, look at the chart below:

	Exchange Traded Products	OTC / Off Market traded products	Products from Fund houses
<i>Customer Perspective of Risk</i>	Equities	Most others	Funds
Price Risk	High	Low in Money Market instruments; moderate to high in others	In line with the profile of the Instruments/ investments held by Fund
Execution Risk	Low: exchanges are robust platforms	There could be problems which will then add to investment costs of the customer	Low: Fund houses have well integrated operations
Price Transparency	High	Low	High
Consumer Protection inherently available	High	Low	High
Regulation	Adequate	Inadequate	Adequate

The Financial Industry Regulatory Authority (FINRA) takes a different approach. It is not based on the product and the market related rules and regulations. If the customer is dealing with FINRA registered members then that affords a measure of protection, standards in conduct and ethics that customers can rely on.

4.1 FINRA Operates in the Self-Regulatory Organization Zone

Members must 'behave' their own selves.

Building confidence among investing public comes from behaving.

Confidence = business. More business.

Previously such activities were handled by NASD & under the NYSE/NASDAQ rulebook. Every exchange imposes such rules on their brokers. FINRA goes beyond that old structure; it replaces that.

The Securities and Exchange Commission is on top of FINRA.

It gets involved in the markets space only where:

- Preserving the integrity, efficiency and fairness of the securities market
- Overseeing SROs
- Penalizing wrongdoers

4.1.1 FINRA Structure

FiNRA Manual /Rule Book: The rules apply to all members. Certain rules apply only if you are member of both FINRA and that exchange

Market Monitoring: Monitors markets and firm activities. Helps members comply with FINRA rules and every other Regulation.

Compliance: Education & Training: This is aimed at equipping brokers with they need to know in order to be compliant.

Enforcement: While FINRA says it has authority, this in effect comes from:

- a. being able to report anyone who is violative*
- b. Expulsion*

Arbitration & Mediation: In place to address disputes between and among: investors, brokers, individual registered representatives.

For Investors: Investor Education, Investor alerts and market data. FINRA induces confidence, positioning itself as intended for investor protection.

Important Note to reiterate: Securities traded in public markets offer greater security. Those traded in private markets offer less (OTC). FINRA covers ALL activities of members in whichever market they might operate. The SEC does not cover a similar range.

As a Result:

- There is a Code of Conduct which Firms have to adhere to
- There are requirements for Account Opening including approvals
- Rules related to Margin Accounts
- Rules for Orders and Transactions in Client Accounts
- Rules for confirmation and reporting requirements
- Standards for reporting performance

4.2 Special Nature of Documentation in Wealth Management

4.2.1 Seamlessness implies:

The ability to move from one asset class to another without complicated transaction documentation

Ability to access an unanticipated service without too many problems

Seamlessness requires anticipating legal requirements for documents. For e.g. if a customer comes up with a loan requirement later on that would not be the time to ask for documentation. It can be taken and held beforehand.

There is usually a technology solution that enhances seamlessness

Seamlessness involves being in a position to execute transactions and meet client needs instantly - even if the client is not accessible at the point in time.

For this, Wealth Managers pre-execute a variety of documents on the basis of anticipated needs. Obviously, this entail a high level of trust and this becomes a core aspect of the relationship between the wealth manager and his client.

4.2.2 Here are reasons for composite, complex documentation:

- The opening of multiple accounts including with back-end service providers like Property Managers and Custodians
- The power to represent and act on behalf of the client to multiple agencies including offshore banks and custodians
- To give range of powers in choosing investment portfolios
- General liens to structure lending

4.2.3 Client Account Set-Up in Internal Systems Involves

- Setting up the client master
- Automatically pick and assemble the relevant set of contracts and forms based on the explicit or implicit requirements of the client
- Pre-fill and print contracts, agreements and forms (including bar-codes)

While Standard Operating Procedure is to pre-fill forms to minimize errors/ increase efficiency in WM, certain parts need to be client input/ handwritten for legal reasons.

4.2.4 Business Rules that support Seamlessness

Wealth Management tries to make offerings of products and services most convenient to clients. In doing so certain implicit “Business Rules” arise.

Let’s look at a couple of straightforward examples.

An order to “Buy”

Includes an instruction to pay
Includes an instruction to receive securities
Includes a request for a margin trade/ place in lien

An order to “Sell”

Includes an instruction to deliver securities
Includes an instruction to receive money
Includes a request for a margin trade/ place in lien/ stock borrowing

These business rules are:

Back-ended by a power of attorney to instruct bankers
Back-ended by a Power Of Attorney to instruct custodians
Back-ended by a typical broker transaction agreement
Back-ended by a stock borrowing request/ related commitments

Each of these is an example of documentation.

4.2.5 Terms of Business & Agreements

A. Terms of Business:-

- Purpose:- communicate clearly and fairly information needed by client
- Content:- services to be provided, charges and basis on which they will act
- Provided before any investment business conducted

B. Client Agreements:-

- Purpose:- legal agreement documenting terms
- Content:- services to be provided, charges and basis on which they will act
- Execution:- client's signature denotes acceptance of terms of the agreement
- Uses:- for ongoing relationships or complex services
- Examples:- internet stockbroking; discretionary investment management; futures and options trading

C. Disclose Status

- Rationale:-
 - Disclose range of products on which advice will be given
- Scope of advice:-
 - Whole of market
 - Limited to several product providers
 - Limited to a single product provider
- Remuneration:-
 - Relevance is also on how firm or adviser is remunerated
 - Commission only
 - If firm or adviser holds itself out to be independent then must offer fee option

D. Other Disclosures

- Charges and Commissions:-
 - The total price to be paid including all related fees, commissions, charges and expenses and any taxes payable via the firm
 - Where these cannot be indicated at the time, the basis on which they will be calculated so that the client can verify them
 - The commissions charged should be itemised separately
 - Where any costs or charges are payable in a foreign currency, what the currency is and the conversion rates and costs
 - Where other costs and taxes not imposed by the firm could be payable, how they will be paid or levied
- Cancellation Rights:-
 - The existence of the right to cancel or withdraw
 - Its duration
 - The conditions for exercising it including any amount the customer may have to pay
 - What happens if the customer does not exercise the right
 - Any other practical details the customer may need
 - Where the customer exercises their right to cancel, the effect is that he withdraws from the contract which is then terminated

4.2.6 The Absence of “Omnibus” Documentation

Sometimes an organization (in WM unlikely) prefers not to take omnibus documentation because in such instances clients can “disown” the document in courts:

- Coercion
- The printed word over the written word: is interpreted in favor of the client

Sometimes a client will be advised by his legal counsel against signing certain pages of the document, asking his client to sign only if the service/product is intended to be used. In specific situations, a client request may be such that existing documentation does not cover the situation visualized.

In all such cases the documentation needs become transactional.

4.2.7 Transacting on Client Instructions with Pending Documentation

If that relates to KYC/AML/OFAC requirements, it is a strict NO.

If the txn relates to *transfers out* to other “known accounts” (his own; cash or securities accounts) with us, it represents a low risk.

If the txn relates to *transfers out* to other “known accounts “ (his own; cash or securities accounts) *with other institutions*, it represents a moderate risk.

If the txn relates to *transfers out* to third party accounts (with us or elsewhere), it represents a higher risk.

If the txn is associated with structured derivatives/ derivative-led strategies which have a significant price/ market risk: appropriate sign offs will be essential to cover the bank/firm in event of loss.

4.2.8 Exception Based Txns / Fax/ Phone/ Voice based instructions

Best Practice:

A document in confirmation of transaction needs to be sent to ‘address on record’ immediately. It should state that the document will be deemed accepted unless rejected.

In WM, this document will end up at the desk of the Relationship Manager who may or may not complete the legal serving of confirmation.

Alternative Best Practice:

To include in the next periodic transaction reports, the confirmations as an attachment / marked out. A prudent Relationship Manager will accept the need to document these with the client; an immature one will still pull them out and secret them in his own dossier.

4.2.9 Customer Account Opening and Authorization Requirements

- Account Types: Cash; Margin; Day Trading; Prime Brokerage: these categorizations relate to what the client seeks to do.
- Account Registration Types: Relates to legal entity. In WM, different structures are used; the client’s holding is not necessarily/ always Individual
- Account Authorizations: On how the account is to be operated
- Customer Screening: KYC, AML; but also other checks for insiders and broker staff
- Disclosures: Required in respect of special accounts; e.g.: margin accounts

4.3 Account Types

- **Cash Account:** Accounts in which customers pay for what they buy; deliver what they sell.
- **Margin Account:** The customer receives funding from the broker. Where funding is involved the US Fed's Regulation T must be met fully.
- **Option Account:** Operationally, may not look different from other accounts but there are specific aspects to be noted in FINRA regulations
- **Day Trading Account:** MUST be categorized as such. There are rules to determine such accounts; specific patterns are described.
- **Prime Brokerage Account:** Is not an account type associated with Wealth Management. However, we cover it briefly just to be aware of it.
- **DVP/RVP:** Accounts in which each trade is settled one at a time (Trade-for-Trade) and which have a NIL closing balances as a result
- **Fee Based Accounts:** Accounts the nature of which is characterized by the nature of client-broker relationship. Client decides - broker executes
- **Advisory / Discretionary Accounts:** Account characterized by the nature of client-broker relationship. Broker decides/ helps decide - broker executes

The classification of accounts into different types implies that the broker-dealer (FINRA Member) knows a lot more about the customer. Not knowing enough in order to classify the account correctly is in itself a violation of FINRA Regulations.

4.3.1 Cash Accounts

A customer Calls to buy some shares/ securities or To sell some shares/ securities

He HAS to have the money to pay for everything he wants to buy. He HAS to have the SECURITIES to deliver everything he sells.

As a matter of fact, the Exchange is heavily reliant on the broker to make sure that Market Discipline is maintained. Adequate Liquidity in the system and payment failures are avoided only by enforcing such practices for Cash Accounts and this is the primary level of security for the operation of the exchange.

But, Cash Accounts that deal in non-exchange traded products have the same effect anyway. The only distinction is that there is no related Exchange, worrying about Market Discipline / Funding and Failure. This is, at once, the strength of the Exchange system and the disadvantage inherent in the OTC method.

NO Margin Trading, NO Day Trading in a Cash Account.

4.3.2 Margin Accounts

A customer Calls to buy some shares/ securities or To sell some shares/ securities

He might not have the money to pay for everything he wants to buy. He might not have the particular security he is looking to sell.

But he does have some_stock/security which is valuable.

The Broker might lend the balance of the cash within permitted regulatory limits for such lending. The Broker might organize securities/stock - lending for all or part of the sell order. As additional security to cover potential losses from the trade, the broker will take collateral from the customer. Margin trading is used for both buying (going LONG) and for selling (going SHORT). Each is discussed separately. The account in which such trades are done has to be designated as a Margin Account. Such transactions cannot be done in a Cash Account.

Margin trading rules are complex and comprehensively discussed later.

4.3.3 Option Accounts

The customer wishes to:

1. Buy Options (either calls or puts)
2. Write Options

The use of Options in Wealth Management can have the impact of:

1. Reducing risk when the customer buys options.
2. Increasing risk when the customer writes options

Regardless of this, Options are considered as advanced strategies which may not be easy to understand for the individual investor. Therefore, many conditions have to be satisfied in allowing customers to deal in options.

- Options Disclosure Document to be provided to the customer who intends to operate an Options account.
- Due Diligence of Accounts: assess customer's suitability and approve/ disapprove the account
- Customer to reaffirm / verify the background information on the basis of which the client has been approved for Options trading.
- Customer to sign agreement that he/she understands the FINRA rules applicable to options trading within 15 days of approval.

The Options Account Disclosure Document is a 186 page document. In November 2012 an addendum has been issued. It describes:

- Different kinds of Options
- Chapter X of this document describes the risks: general risks for writers and holders.
- Chapter X also describes special risks related to specific options (equity, index, interest rates etc.)
- The Nov 2012 supplement discusses certain technical aspects of the impact of corporate actions

This document, available as a booklet, must be supplied previously to the customer. Then certain assessments need to be carried out in relation to the client.

A. Option Accounts - Information to be gathered and assessed

The following information for EACH person (every account holder in joint accounts)

- a. Investment objectives (e.g., safety of principal, income, growth, trading profits, speculation)
- b. Employment status (name of employer, self-employed or retired)
- c. Estimated annual income from all sources
- d. Estimated net worth (exclusive of family residence)
- e. Estimated liquid net worth (cash, securities, others)
- f. Marital status; number of dependents
- g. Age; and
- h. Investment experience and knowledge (e.g., number of years, size, frequency and type of transactions) for options, stocks and bonds, commodities, and other financial instruments

This information is related to an assessment of knowledge and awareness of issues and risks associated with Options. The information is used to answer the question: “*Can this customer understand and use options?*”

B. Option Accounts - Customer Record to be maintained

Source or sources of background and financial information (including estimates) concerning the customer;

- Discretionary authorization agreement on file, name, relationship to customer and experience of person holding trading authority;
- Date disclosure document(s) furnished to customer;
- Nature and types of transactions for which account is approved (e.g., buying covered writing, uncovered writing, spreading, discretionary transactions);
- Name of registered representative;
- Name of Registered Options Principal or Limited Principal—General Securities Sales Supervisor approving account; date of approval; and
- Dates of verification of currency of account information. a standard account approval form is to be used to ensure the receipt of all the required information.
- Refusal of a customer to provide any of the information called for in subparagraph (i) shall be so noted on the customer's records at the time the account is opened.
- Information provided shall be considered together with the other information available in determining whether and to what extent to approve the account for options trading.
- A record of the information obtained pursuant to this subparagraph and of the approval or disapproval of each such account shall be maintained by the member as part of its permanent records.

C. Option Accounts - Approval

Nature and types of transactions for which account is approved to be SPECIFIED

- buying
- covered writing
- uncovered writing
- spreading
- discretionary transactions)

4.3.4 Day Trading

A Day Trader looks to buy earlier in the day and sell later in the day, before close of market, hopefully at a *higher price*. A Day Trader also looks to sell earlier in the day and buyback later in the day, before close of market, hopefully at a *lower price*.

Since the trader has sold what was bought within the Trade Cycle time, the position is square. If the trader made a profit or a loss, that amount will be received (paid) by on Settlement date. The same is true where the trader has bought what was sold within the Trade Cycle time.

A. Day Trading Risks

Since the intention is to compulsorily square the position within the day, there is every chance of the customer making a loss. This implies that if a call goes wrong, a loss is inevitable. In the event that the day trade is a short-sales, then there is a need to borrow securities. The pressure to borrow securities which are not available in the market can cause a problem in the whole market / system.

B. Day Trading Patterns Defined

A Day Trade account is a sub-type of a margin account

- Consider a Five Business Day period
- During this period, four or more day trades are conducted
- The day trades are more than six percent of the customer's total trading activity for that same five-day period.
- Under the rules, a pattern day trader must maintain minimum equity of \$25,000 on any day that the customer day trades.
- The required minimum equity must be in the account prior to any day-trading activities.
- If the account falls below the \$25,000 requirement, the pattern day trader will not be permitted to day trade until the account is restored to the \$25,000 minimum equity level.

“Equity” = Value of Portfolio (minus) Loan taken from broker, if any.

C. Day Trading Buying Power / In Detail

Day Trading Buying Power: not more than 4 times the Equity maintained by the Customer in the Account for the purpose. Any margin maintenance required for other trading activities should not be included in this calculation.

Customer makes a Deposit	\$ 25,000
Day Trading Buying Power: <i>Maximum</i>	\$ 100,000
This amount is adjusted by any Maintenance Margin that the customer has to maintain for any other trade. (<i>Margin accounts are as a topic, dealt with separately.</i>)	
Customer makes a Deposit	\$ 25,000
Margin required to be maintained in respect of some other trade	\$ 5,000
Equity available for Day Trading	\$ 20,000
Day Trading Buying Power: <i>Maximum</i>	\$ 80,000

D. Day Trading Buying Power / How are Trades Calculated

In Day Trading to recap:

A BUY - is followed by A SELL

A SELL - is followed by a BUY

A customer buys for \$ 50,000 in a Day Trade. Later in the day he sells the \$ 50,000 worth stock. The total trade he did in the day for day trading is calculated at \$ 50,000; one side of the trade ONLY. NOT both sides of the trade.

A customer buys for \$ 50,000 in a Day Trade. He does not sell Later in the day.
How much did he trade?

He traded \$ 50,000 only. It is NOT a day trade as he failed to square. On T+3 this customer will payout Cash. On that day, the equity in the account will reduce. The next day his trading limit will also reduce proportionately (by 4 times 50,000 is that is the limit enjoyed).

E. Day Trading Buying Power / Work out on your own

1. A customer has the following balances. Determine the Equity in the account available for Day Trading. What is the maximum trading limit a broker may set for Day Trading?

Equity Shares held	\$ 50,000
Cash held in the account	\$ 75,000
Margins for other transactions	\$ 35,000
Amount owed to the broker under <u>Reg T</u> borrowings	\$ 15,000

Solution

The total value of assets in the client account is \$ 125,000/-.

The amount he owes his broker is \$ 15,000/-. Therefore the equity in the account is \$ 115,000. For calculating the Day Trading Buying Power, the margin required to be maintained for other trades needs to be further deducted. So, the margin available for Day Trading is \$ 75,000/-. The Day Trading that the customer can engage in cannot exceed 4 times this amount; i.e. \$ 320,000

2. A customer has the following balances. Determine the Equity in the account available for Day Trading. A broker wants to be conservative. How many times the Equity do you suggest is allowed for Day Trading? Please give the dollar value of your suggested number.

Equity Shares held	\$ 100,000
Cash held in the account	\$ 100,000
Margins for other transactions	\$ 50,000
Amount owed to the broker under <u>Reg T</u> borrowings	\$ 25,000

Solution

The total value of assets in the client account is \$ 200,000/-.

The amount he owes his broker is \$ 25,000/-. Therefore the equity in the account is \$ 175,000. For calculating the Day Trading Buying Power, the margin required to be maintained for other trades needs to be further deducted. So, the margin available for Day Trading is \$ 125,000/-. If we want to be conservative, instead of 4 times this, we may recommend 3 times this. So the trading limit can be set at \$ 375,000/-. The max allowed would be \$ 500,000/-.

F. Day Trading Buying Power: managing the limit

- If a pattern day trader exceeds the day-trading buying power limitation, the firm will issue a day-trading margin call to the pattern day trader.
- The pattern day trader will then have, at most, five business days to deposit funds to meet this day-trading margin call.
- Until the margin call is met, the day-trading account will be restricted to day-trading buying power of only two times maintenance margin excess based on the customer's daily total trading commitment.
- If the day-trading margin call is not met by the fifth business day, the account will be further restricted to trading only on a cash available basis for 90 days or until the call is met.

G. Day Trading Buying Power: Restrictions for not topping up

On May 2nd [Monday], a customer that has a trading limit of \$ 80,000/-. This is the maximum allowed in law. On that day the customer trades up to \$ 100,000/-. What is the margin call the broker should make?

\$ 20,000

By when (which date) must the customer top up the margin call account?

By the 5th working day. By the end of business on May 9th, the following Monday.

For the next 5 days, (i.e. till end of Business on 5th of May), what is the permitted trading limit for the customer.

Up to the 9th the customer will be allowed to trade only up to \$ 40,000/-.

As of end of 9th May, the customer has not topped up the margin account. What next?

From 10th, the customer will be allowed to trade only up to \$ 20,000/- i.e. only ONE times the margin held; in other words on a "Cash Available Basis." Do remember the customer is still engaging only in Day Trading. Cash basis should not be confused with a Cash account.

H. Day Trading Equity: Restrictions

No Withdrawal of Equity: for 2 days

Any funds used to meet the day-trading minimum equity requirement or to meet any day-trading margin calls MUST remain in the pattern day trader's account for two business days following the close of business on any day when the deposit is required.

No Cross-Guarantees

The rules also prohibit the use of cross-guarantees to meet any of the day-trading margin requirements.

It is determined on May 2nd 2014, that the Day Trading Equity required is \$ 125,000/-. Subsequently the level of day trading comes down. When can the customer withdraw any amount from this account?

Withdrawal can be made bringing the Day Trading Equity below \$ 125,000 any time after May 6th. i.e. on May 7th.

I. Day Trading Equity: Is the account coded forever?

In general, once a customer account has been coded as a pattern day trader, the firm will continue to regard the customer as a pattern day trader even if it does not day trade for a five-day period. This is because the firm will have a "reasonable belief" that the customer is a pattern day trader based on prior trading activities. However, customers may and do change their trading strategy. In such cases the account can be reclassified / recoded based on revised approach of the customer.

J. Day Trading in a Cash Account

This is prohibited.

Under the “Free Riding Prohibition” (In the US Fed’s market lending rule, Regulation T) moreover,

- IF a customer sells a security in a Cash Account
- Before paying for it in that Cash account

The broker must freeze the account for 90 days.

4.3.5 Fee vs. Advisory Accounts

A. Discretionary Portfolios

A Discretionary Portfolio is one in which the Investment Adviser need not revert to the client for a sign-off on each investment decision. The client, when placing the funds signs an investment mandate. This investment mandate can be as generic (as is with Mutual Funds) and extremely specific as you would expect with Private Client Groups.

The legal documentation is worded to ensure that the Investment Adviser is not responsible for losses except in cases of negligence and gross violation of fiduciary trust; or violation of the specifics on the investment mandate.

Investment Adviser Performance is a factor of comparison to benchmarks; the choice of benchmark has to be appropriate to the investment strategy. (Publicly traded funds - i.e. mutual funds and similar vehicles - are discretionary in nature.)

Underperformance of a discretionary fund represents a Reputation Risk: legal disclaimers notwithstanding, clients tend to draw from underperformers and reallocate to outperformers.

B. Non-Discretionary Portfolios

A Non - Discretionary Portfolio is one in which an Investment Advisor merely makes investment suggestions. It is the client’s prerogative to accept the recommendation; or make other investments of his own choice.

The client, when placing the funds signs an investment mandate. This investment mandate is non-discretionary in nature.

Firms tend to track the performance of their recommendations and of model portfolios that reflect the firm’s recommendations.

Paradoxically, if the firm is able to show outperformance on the strength of its recommendations, the client tends to place funds in Discretionary Funds.

C. Fees, Risks and Rewards

Discretionary Fees tend to be higher than Non-discretionary fees.

Investment Risks in both cases remain with the client.

Undoubtedly, in discretionary funds the client looks to expertise and will hold the Investment Adviser responsible for underperformance.

However, the same is also true of Non-discretionary funds where the client has either:

- followed every recommendation made, or
- adopted a model portfolio as recommended by the manager

Fees are standard; the Investment Adviser does not participate in either upsides or downsides.

D. High Risk Investment Mandates

A client may widen the mandate given to the Fund Manager. This could include permission to use advanced derivative-driven strategies. These strategies could be deployed standalone; or at portfolio level.

Such mandates approach the structure of a Hedge Fund mandate (Alternate Investment Management). Such mandates may/ can include a fee structure which offers participation in the upside.

The base fee is a percentage of assets held. The performance fee can be between 20% (industry standard) and 40% (star managers). Performance fees are paid only for outperformance.

If the markets soar and then tank, further fees are payable if the 'high water mark' is later crossed again; else not. Downside risk is capped with legal documentation.

Fund Managers never take losses. (Hedge Fund Managers typically invested alongside in the LLP). Performance failure is a reputation risk and limits ability to attract money.

4.3.6 Numbered Accounts

Many jurisdictions in the USA permit confidential, numbered accounts for which the name of the investor is shielded by the financial institution in which the account resides.

The investor must acknowledge in writing that he owns the account and provide all the information listed above to his broker-dealer, but the broker-dealer can then ensure that all confirmations and statements are printed with an alias instead of the account owner's true name.

Swiss bank accounts are the most famous example of this practice, but there are plenty of other countries that allow for secrecy in banking.

A lot of people do not know that the NYSE permits coded accounts too.

However, the fact that the account itself has greater confidentiality should not be confused for the ability to evade the Anti Money Laundering rules

4.4 KYC & AML

The 9/11 terrorist attacks traumatized the world and alerted the most powerful nations of the world to the dangers posed by international terrorism. In that incident the conspirators had used the banking system to access funds. Donors made money available at the counters of specific banks around the world. In the absence of the current standards, the hijackers were able to collect cash across the counters at various banks.

Money is essential to carrying out such nefarious plans. At the time, the access to money through the banking system was ridiculously simple. In the investigations that followed while some of the trail was reconstructed there were no faces, names or addresses to go after. Donors remained anonymous and perhaps are still active.

Anti Money Laundering and Combating the Financing of Terrorism combined with Know Your Customer requirements make what the 9/11 conspirators did tough to replicate. It can be argued that they would still find a way to execute such attacks. But it should be made as tough as it can be made; and certainly no leading bank of the world would want to be complicit through acts of omission.

4.4.1 Customer Due Diligence

Background

Know Your Customer (KYC) is the colloquial term for what regulators of the world called Customer Due Diligence.

Knowing one's customer as any banker - indeed any businessman- will tell you is as old as banking itself. How else to deal on behalf of, lend to and speak for your client, which is what bankers do for a living?

However, terrorism and other supposedly lesser crimes like drug smuggling, gun running and trafficking in humans have brought the focus on how money flows and who transacts with the bank. This is especially true of payments and payments systems but is not restricted to any one area of banking, financial services, capital markets or insurance.

These concerns now embrace non-financial organizations too as the world gets serious about combating national and international crime and strengthening security in general. Banks and financial organizations have made substantial investments in global financial and payment infrastructure. These enable money to be moved effortlessly across continents. A few transfers later it would be hard to detect who the sender was and who the recipient was. A number of banks which might have served as a transit point could well be clueless about the nature of the transaction.

This swift and sophisticated infrastructure is meant to be used for 'good'; not 'evil'. Whether good or evil, all work in the modern world requires money. In the effort to combat the forces cited above the regulators of the world have worked hard over the last several years to prevent such entities / persons from misusing the financial systems of the world.

It is always the case that criminals try stay a step ahead of the law enforcers. If the money from criminal activities could be brought into the banking system and shown to be legitimate, then the world's financial infrastructure could be put to misuse and detection could be avoided. This process of penetrating the financial system and changing the color of ill-gotten wealth into legitimate wealth is Money Laundering.

So, there are two issues here:

- Who is trying to access the financial system?
- What is the transaction which they are conducting?
-

The KYC or Customer Due Diligence process focuses on banks operating as gate-keepers to the world's financial system.

The other aspect - transaction monitoring - is an ongoing activity to see if any malafide persons have crept in; or any normal person has somehow been persuaded to carry out some malafide transactions.

4.4.2 Money Laundering: A quick overview

The Joint Money Laundering Steering Group of the UK provides a nuanced definition of Money Laundering.

A. Offence of money laundering

Money laundering takes many forms, including:

- Trying to turn money raised through criminal activity into ‘clean’ money (that is, classic money laundering);
- Handling the benefit of acquisitive crimes such as theft, fraud and tax evasion;
- Handling stolen goods;
- Being directly involved with any criminal or terrorist property, or entering into arrangements to facilitate the laundering of criminal or terrorist property; and
- Criminals investing the proceeds of their crimes in the whole range of financial products.

The techniques used by money launderers constantly evolve to match the source and amount of funds to be laundered, and to stay ahead of law enforcement agencies.

There are three broad groups of offences related to money laundering that firms need to avoid committing. These are:

- Knowingly assisting (in a number of specified ways) in concealing, or entering into arrangements for the acquisition, use, and/or possession of, criminal property;
- Failing to report knowledge, suspicion, or where there are reasonable grounds for knowing or suspecting, that another person is engaged in money laundering; and
- Tipping off, or prejudicing an investigation.

It is also a separate offence under the ML Regulations not to establish adequate and appropriate policies and procedures in place to forestall and prevent money laundering (regardless of whether or not money laundering actually takes place).

B. KYC has 3 main steps

- Client Identification Procedure
- Client Acceptance Policy
- Customer Due Diligence

C. Principle FINRA Rules related to KYC / AML

- FINRA 2090 : Know Your Customer: this is anyway also required in AML and as per the Patriot Act.
- FINRA 4511: Record-keeping: though not specifically with reference to AML, this supports AML: records to be kept for 6 years.
- FINRA 4512: Customer Account Information: Who operates the account? Though not specifically with reference to AML, this supports AML: records to be kept for 6 years.

D. Know Your Customer - FINRA Rule 2090; Effective July 2012

Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.
Essential Facts.

For purposes of this Rule, facts "essential" to "knowing the customer" are those required to:

- effectively service the customer's account,
- act in accordance with any special handling instructions for the account,
- understand the authority of each person acting on behalf of the customer, and
- comply with applicable laws, regulations, and rules.

FATF Recommendations, specifications of the US Patriot Act are important to know in this context. Also the OFAC lists have to be tracked. Suspicious Activity reports have to be duly filed.

E. Customer Account Information- FINRA Rule 4512; Effective Dec 2011

Firms are obligated to maintain information on who operates accounts and under what authority. Maintain the name of the associated person, if any, responsible for the account, rather than requiring firms to maintain the signature of the registered representative introducing the account.

Where a member firm designates multiple individuals as being responsible for an account, the firm is required to maintain each of their names and a record indicating the scope of their responsibilities with respect to the account. For purposes of the rule, it is the member firm's obligation to determine whether a particular individual is responsible for the account based on the scope of the individual's activities with respect to that account.

Maintain the signature of a partner, officer or manager of the firm with respect to an account, but it clarifies that the purpose of this signature is to denote that the account has been accepted in accordance with the firm's policies and procedures for acceptance of accounts. The signature also serves to validate the identity of the named associated person, if any. The rule does not require a partner, officer or manager to provide any particular representations.

Further, this signature requirement may be satisfied through the use of electronic means. In this regard, FINRA will consider a valid electronic signature to be any electronic mark that clearly identifies the signatory and is otherwise in compliance with the Electronic Signatures in Global and National Commerce Act (E-Sign Act), the guidance issued by the SEC relating to the E-Sign Act¹⁰ and the guidance provided by FINRA through its interpretive letters, which address electronic approval processes generally.

With respect to a discretionary account maintained by a member firm, the new rule requires firms to obtain the manual dated signature of each named, natural person authorized to exercise discretion in the account. For retention purposes, firms may choose to maintain and preserve the signature record on electronic storage media consistent with SEA Rule 17a-4(f). The new rule no longer requires firms to record the date discretion was granted, or to record the age or approximate age of the customer in connection with exempted securities.

The new rule also clarifies that:

- The requirements of the rule do not apply to investment discretion granted by a customer as to the price at which or the time to execute an order given by the customer for the purchase or sale of a definite dollar amount or quantity of a specified security; and
- Nothing in the rule shall be construed as allowing member firms to maintain discretionary accounts or exercise discretion in such accounts except to the extent permitted under the federal securities laws.
- For an account that was opened pursuant to a prior FINRA rule, FINRA Rule 4512 requires member firms to update the information for such an account in compliance with the new rule whenever they update the account information in the course of their routine and customary business, or as required by other applicable laws or rules.

FINRA believes that to promote greater consistency and uniformity of account record information, it is necessary that firms update the account information in such a manner.

Firms to preserve:

- any customer account information that subsequently is updated for at least six years after that update; and
- the last update to any customer account information, or the original account information if there are no updates, for at least six years after the account is closed.

It reminds firms that they may be subject to additional recordkeeping requirements under the SEA.16. It also reminds firms of their obligation to comply with the requirements of FINRA Rule 2070 (Transactions Involving FINRA Employees).

4.4.3 Private Banking (PB), Corruption and AML

Observation of the Financial Action Task Force:

Wealth Management / Private Banking often involves a number of Politically Exposed Persons. PEPs who have stolen the assets of the respective nations prefer private banking because of the confidential nature of the business.

PB also offers offshore banking, trust services and other devices which assist in promoting secrecy. This secrecy, while it has legitimate uses, can in the case of criminals become a method for hiding their ill gotten wealth.

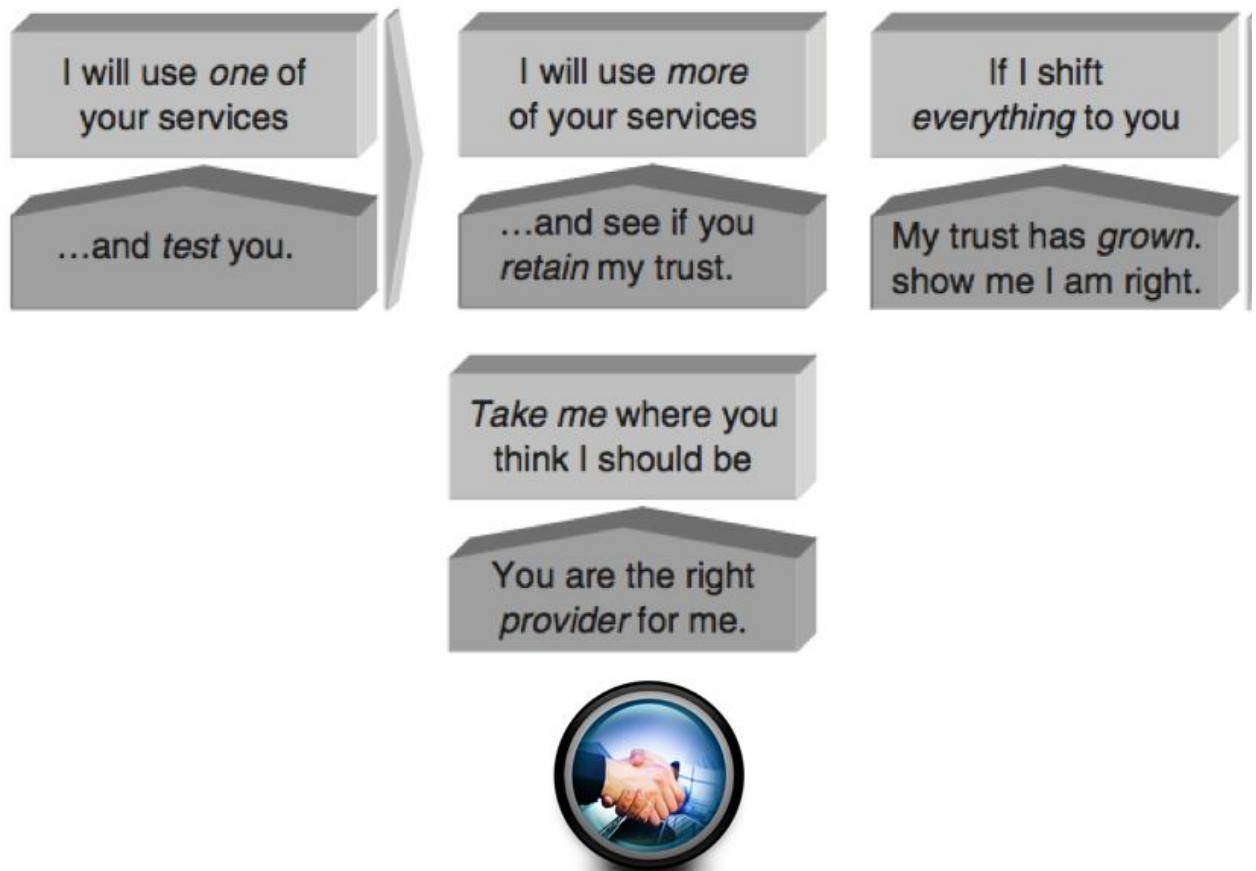
In this context, WM / PB presents a high risk area when it comes to Money Laundering risks. The Financial Conduct Authority (FCA) has today fined Barclays Bank (Barclays) £72,069,400 for failing to minimise the risk that it may be used to facilitate financial crime. The failings relate to a £1.88 billion pound transaction (Transaction) that Barclays arranged and executed in 2011 and 2012 for a number of ultra-high net worth clients. The clients involved were politically exposed persons (PEPs) and should therefore have been subject to enhanced levels of due diligence and monitoring by Barclays.

While the FCA makes no finding that the Transaction, in fact, involved financial crime, the circumstances of the Transaction gave rise to a number of features which, together with the PEP status of the individuals, indicated a higher level of risk. This required Barclays to adhere to a higher level of due skill, care and diligence but Barclays failed to do this. In fact, Barclays applied a lower level of due diligence than its policies required for other business relationships of a lower risk profile. Barclays did not follow its standard procedures, preferring instead to take on the clients as quickly as possible and thereby generated £52.3 million in revenue. The Transaction involved investments in notes backed by underlying warrants and third party bonds. It was the largest of its kind that Barclays had executed for individuals.

Barclays went to unacceptable lengths to accommodate the clients. Specifically, Barclays did not obtain information that it was required to obtain from the clients to comply with financial crime requirements. Barclays did not do so because it did not wish to inconvenience the clients. Barclays agreed to keep details of the Transaction strictly confidential, even within the firm, and agreed to indemnify the clients up to £37.7 million in the event that it failed to comply with these confidentiality restrictions. Few people knew of the existence and location of the firm's due diligence records which were kept in hard copy and not on Barclays' systems. This had a detrimental impact on how the Business Relationship was monitored by Barclays and also meant that Barclays could not respond promptly to the FCA's request for this information.

4.5 The Need for Professional Ethics

Our business is based on trust.



Our Industry and Trust: are crucially important to the wider economy.

Banks channelize savings in an economy to industry: this makes banks an **IMPORTANT** element in economic development and growth. In doing so, banks ask consumers to **TRUST** them.

Any breach of this **TRUST** is damaging to the economy; especially if consumers lose faith in banking. All those who have money in deposits are the bank's customers. Bank offers Safety & Trust is a key factor.

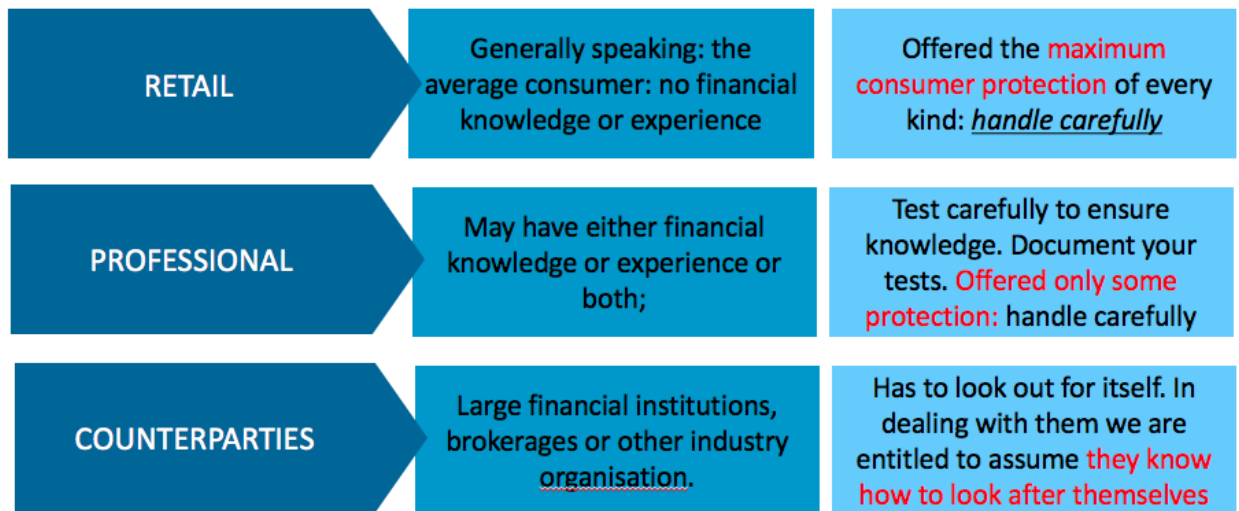
All those who need money are also the bank's customers. Bank assesses risks in lending to ensure that the promise of safety (to depositors) is not breached. Those who have money also have other investible surpluses which they do not want to place with banks in Deposits. But if anything goes wrong, investors beware! Those who need money also have other needs for long term debt and equity not traditionally available from the bank. Bank assesses risks in investing and makes recommendations.

Customers see "**TRUST**" in a situation where none actually exists and the rule is "Buyer Beware"! Financial Services are Vital to Economic Growth. Customers will be starved for investment options. Correspondingly, industry/ borrowers will be starved of sources of capital and loans.

4.5.1 Codes of Conduct for Firms

- A. “Treating Customers Fairly” is a key cornerstone of UK FSA expectations of Firms. It can be considered as “best in class” and is in harmony with the EU rules and views
- B. FSA has defined six ‘consumer outcomes’ to explain to firms what it believes TCF should do for its consumers. These are:
- Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
 - Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
 - Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
 - Where consumers receive advice, the advice is suitable and takes account of their circumstances.
 - Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect.
 - Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.
- C. Key Persons (Approved Persons) MUST:
- Act with integrity
 - Act with due skill, care and diligence
 - Observe proper standards of market conduct
 - Deal with regulators in an open and cooperative way.
 - Take reasonable steps to ensure that the business of the firm is organised so that it can be effectively controlled.
 - Exercise due skill, care and diligence in managing the business of the firm.
 - Take reasonable care to ensure the firm complies with the relevant requirements and standards of the regulatory regime.
- D. Training & Competence
- It is the responsibility of the firm to ensure that staff members are appropriately qualified for their role.
 - There is an obligation on firms to ensure that their employees continue to be competent.
 - It is the firm’s responsibility to have a sound programme in place to ensure that its employees remain up-to-date with developments in the market place.
- E. The CFA Institute has this to say about “Suitability”:
- Assess client investment experience, risk and return objectives and financial constraints
 - Determine if investment is suitable and consistent to client mandate and interests
 - Judge suitability in the overall context of client situation
 - When managing per mandate of fund - actions should be consistent with mandate or fund

F. Client have to be classified as follows:



G. Disclose

The purpose of the Duty to Disclose is to allow client to make an informed decision.

What is material depends upon product or investment.

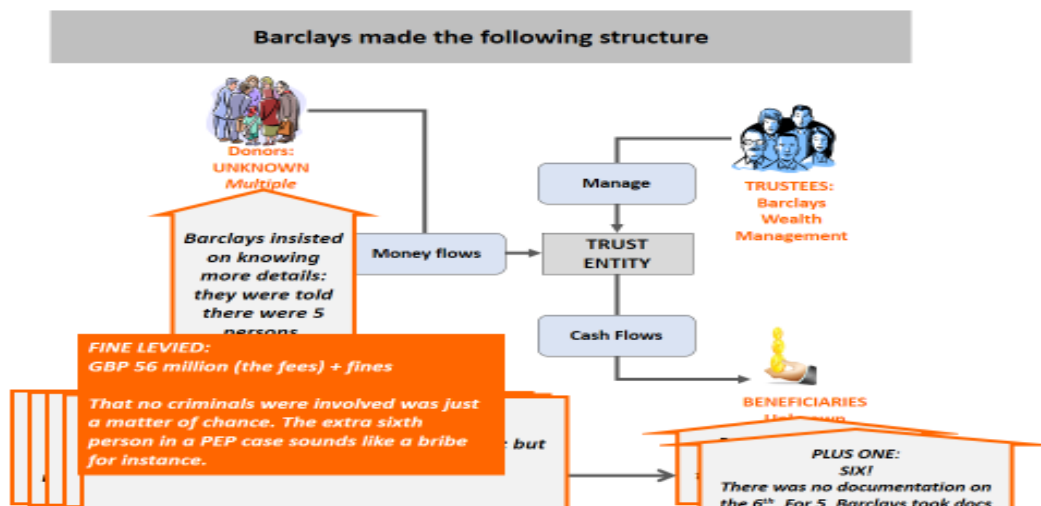
The requirement to disclose includes such things as: charges; cancellation rights; encashment penalties; risk warnings and any special non-standard terms

Examples:-

- Financial planning reports and reason why letters
- Simplified prospectus for a mutual fund
- Key features document

Best Practice requires that the rationale behind investment and other recommendations is included in letters or reports to clients so that in addition to having essential information about the product or investment, that the client can see how the adviser has assessed why the particular solution is suitable and appropriate for them

Key features documents are designed to provide all of the key information about a product in a standardised, easy to understand format.



4.6 Foreign Account Tax Compliance Act

4.6.1 General Background

FATCA, enacted as part of the Hiring Incentives to Restore Employment Act on March 18, 2010, added Sections 1471 through 1474 to the Internal Revenue Code (the "Code"). FATCA is an effort to combat tax avoidance by U.S. taxpayers through the use of offshore accounts and offshore intermediaries. To accomplish this objective, FATCA amends the Code by imposing new U.S. information reporting and withholding requirements on "foreign financial institutions" ("FFIs") that maintain "United States Accounts." An FFI includes any foreign entity that

- accepts deposits in the ordinary course of a banking or similar business;
- holds financial assets for the accounts of others as a substantial portion of its business; or
- is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.

This broad definition encompasses most foreign investment vehicles, including foreign hedge funds, private equity funds, venture capital funds, CLOs, and CDOs. FATCA also imposes increased disclosure obligations on certain "non-financial foreign entities" ("NFFEs") (defined as foreign entities that are not FFIs) that present a high risk of tax avoidance. Generally, NFFEs must certify they have no significant U.S. owners or disclose those owners to avoid withholding. However, NFFEs are subject to less onerous information reporting and withholding requirements than FFIs.

Generally, FATCA requires FFIs (but not NFFEs) to enter into an agreement (an "FFI Agreement") with the IRS to comply with verification, due diligence, and information reporting procedures with respect to "United States Accounts," which are defined as financial accounts held by U.S. taxpayers and foreign entities with substantial (i.e., greater than 10%) U.S. owners. FFIs that comply with these requirements will be considered "participating FFIs" ("PFFIs").

FFIs that do not sign an FFI Agreement and PFFIs and NFFEs that fail to comply with their reporting obligations under the FATCA rules will be subject to a 30% withholding tax on withholdable payments made to them. Withholdable payments include any payment of interest, dividends, rents, and other fixed or determinable annual or periodical gains, profits, and income ("FDAP income"), if from sources within the U.S. Withholdable payments also include gross proceeds from the sale or disposition of any property of a type that can produce interest or dividends from U.S. sources.

FATCA also requires PFFIs to withhold on "passthru payments" (which, as discussed below, include both "withholdable payments" and certain non-U.S. source payments, referred to as "foreign passthru payments") made to "recalcitrant account holders" (i.e., account holders that will not provide the required information to determine if such accounts are United States Accounts) and to other FFIs that do not sign an FFI Agreement with the IRS (such FFIs are referred to as "non-PFFIs").

The IRS previously released three notices, Notice 2010-60, Notice 2011-34, and Notice 2011-53, containing preliminary guidance on the implementation of FATCA. The proposed regulations build on much of the guidance contained in these Notices, with several important changes.

4.6.2 Highlights of the Proposed Regulations

A. Expansion of Grandfathering Period for Certain Obligations

As originally enacted, FATCA grandfathered certain obligations outstanding on March 10, 2012 from its withholding requirements. To help facilitate the implementation of FATCA, the proposed regulations extend the grandfathering by excluding from the definition of "withholdable payment" or "passthru payment" any payment under, or gross proceeds from the disposition of, any obligation outstanding on January 1, 2013.

An obligation for this purpose is any legal agreement that produces or could produce a withholdable payment or passthru payment. Obligations do not include, however, instruments treated as equity for U.S. tax purposes or instruments that lack a stated expiration or term (i.e., demand deposits). Obligations also do not include agreements to hold financial assets for others' accounts. Further, a material modification of a grandfathered obligation will result in the obligation being treated as though newly issued on the date of the modification.

The proposed regulations set forth the following as examples of agreements that can constitute "obligations":

- Debt instruments, as defined under the Code (for example, a bond, guaranteed investment certificate, or term deposit);
- Binding agreements to extend credit for a fixed term (such as a line of credit or a revolving credit facility), if the material terms under which credit will be provided are fixed;
- Life insurance contracts that are payable upon either death or attaining a specific age;
- Term certain annuity contracts; and
- Derivatives transactions entered into between counterparties under an ISDA Master Agreement and evidenced by a confirmation.

B. Transitional Rules for Affiliates with Legal Prohibitions on Compliance

Notice 2011-34 stated that the Treasury and IRS intend to require that each FFI that is a member of an expanded affiliated group must be a PFFI or deemed-compliant FFI (discussed further below) in order for any FFI in the expanded affiliated group to be treated as a PFFI. Treasury and IRS recognized, however, that some foreign jurisdictions have laws in place that prohibit an FFI's compliance with certain FATCA requirements. In response to this, the proposed regulations provide a transition period for the full implementation of this requirement. Until January 1, 2016, a non-PFFI affiliate in a jurisdiction that prohibits reporting or withholding under FATCA will not prevent other FFIs in the same affiliated group from becoming PFFIs.

For the affiliated PFFIs to qualify, the non-PFFI affiliate must agree to perform due diligence to identify its United States Accounts, maintain certain records, and meet certain other requirements. Similar rules also apply to branches of FFIs that are subject to prohibitions preventing FATCA compliance.

C. Easing of Due Diligence Procedures for Identifying United States Accounts

PFFIs must perform due diligence to identify and report United States Accounts, recalcitrant account holders, and NFFE accounts. Notices 2010-60 and 2011-34 provided preliminary guidance regarding the required diligence procedures. In response to comments received, however, the proposed regulations outline several changes meant to ease the administrative burden on PFFIs by focusing primarily on electronic reviews of preexisting accounts.

The regulations delineate the due diligence necessary for individual and entity accounts, for both existing accounts and accounts opened after the effective date of an FFI Agreement. The following summarizes the PFFIs' diligence requirements.

D. For pre-existing individual accounts:

Accounts with balances or values of \$50,000 or less are generally not treated as United States Accounts for FATCA reporting purposes and are thus exempt from due diligence review.

Certain cash value insurance contracts with a value or balance of \$250,000 or less are exempt from due diligence review.

Accounts with a balance or value exceeding \$50,000 but not \$1,000,000 are subject to review of electronically searchable data for indicia of U.S. status. U.S. indicia include: Identification of an account holder as a U.S. person;

- A U.S. place of birth;
- A U.S. address;
- A U.S. telephone number;

Standing instructions to transfer funds to an account maintained in the U.S.

- A power of attorney or signatory authority granted to a person with a U.S. address; or
- A U.S. "in care of" or "hold mail" address, if the only address identified for the account.
- Accounts with a balance exceeding \$1,000,000 are subject to review of electronic and non-electronic files for U.S. indicia, including an inquiry of the actual knowledge of any relationship manager associated with the account. A manual review is limited to current files and is required only to the extent that the electronically searched files do not contain sufficient information.
- Accounts with balances of \$250,000 or less are exempt from due diligence procedures (until the balance exceeds \$1,000,000). For remaining accounts, PFFIs can generally rely on anti-money laundering/know your customer ("AML/KYC") records and other existing account information to determine whether the entity is an FFI, is a U.S. person, is excepted from documenting its substantial U.S. owners (for example, because it is engaged in a nonfinancial trade or business), or is a passive investment entity. For passive investment entities that have accounts in excess of \$1,000,000, the PFFI must obtain information regarding all substantial U.S. owners or a certification that the entity does not have any substantial U.S. owners.
- PFFIs must review the information provided at opening, including identification and any documentation under AML/KYC rules. If U.S. indicia are found, the FFI must obtain additional documentation or treat the account as held by a recalcitrant account holder. Accordingly, FFIs will generally not need to make significant changes to the information collected during the account opening process in order to identify United States Accounts, except to the extent that U.S. indicia are identified. Accounts of other FFIs (other than owner-documented FFIs for which the PFFI has agreed to perform reporting) and entities engaged in an active nonfinancial trade or business are exempt from documentation of substantial U.S. owners. For all other entities, PFFIs must determine whether the entity has any substantial U.S. owners upon opening a new account. This is generally done by obtaining a certification from the account holder.

E. The Definition of Financial Account

Under the Code, a "financial account" for FATCA purposes is any depository account, any custodial account, and any equity or debt interests in an FFI, other than interests regularly traded on established securities markets. The proposed regulations refine this definition to focus on traditional bank, brokerage, and money market accounts, and interests in investment vehicles, but include cash-value insurance contracts and annuity contracts issued by FFIs. The regulations exclude most debt and equity securities issued by banks and brokerage firms, as well as life insurance contracts that do not have a cash value, accounts held by exempt beneficial owners, and certain tax-favored retirement or pension fund savings accounts.

F. Passthru Payments

FATCA requires PFFIs to withhold on passthru payments made to non-PFFIs and recalcitrant account holders. Under the proposed regulations, passthru payments include both withholdable payments and "foreign passthru payments" (passthru payments that are attributable to withholdable payments but are not themselves withholdable payments). The definition of "foreign passthru payment" is currently reserved for in the proposed FATCA regulations.

As discussed above, withholdable payments include any FDAP income and gross proceeds from the sale or disposition of any property of a type that can produce interest or dividends from U.S. sources. PFFIs must begin to withhold on these payments on January 1, 2014.

The proposed regulations reserve the definition of foreign passthru payments. Notice 2011-53 provided that PFFIs would not be obligated to withhold on foreign passthru payments made before January 1, 2015. In response to numerous comments regarding the cost and administrative complexity of identifying foreign passthru payments, the proposed regulations provide that withholding will not be required with respect to foreign passthru payments before January 1, 2017. The proposed regulations do require, however, that PFFIs must report to the IRS annually the aggregate amount of certain payments made to each non-PFFI. This is meant to reduce the incentives for non-PFFIs to use PFFIs as "blockers" to avoid the application of FATCA.

G. Deemed-compliant FFIs

The Treasury and IRS have the authority to authorize certain FFIs as "deemed-compliant" FFIs, and earlier notices have identified certain types of FFIs that would qualify. Such deemed-compliant FFIs may avoid FATCA withholding without having to enter into an FFI Agreement. The proposed regulations implement the exemptions provided in the earlier notices and expand the category of deemed-compliant FFIs. The proposed regulations also expand the category of retirement plans treated as posing a low risk of tax evasion.

The proposed regulations provide that deemed-compliant FFIs can be either "registered" or "certified." Registered deemed-compliant FFIs must register with the IRS and certify at least every three years that certain procedural requirements will be followed. Certified deemed-compliant FFIs are not required to register with the IRS but must use a Form W-8 to certify to a withholding agent that they meet certain requirements. Under the proposed regulations, FFIs that will be eligible to become registered deemed-compliant FFIs include:

- Local FFIs;
- Non-reporting members of PFFI groups;
- Qualified collective investment vehicles (an investment vehicle regulated as such by its country of incorporation or organization; all direct holders must be PFFIs, deemed-compliant FFIs, or exempt beneficial owners);
- Restricted investment funds (an investment fund incorporated or organized in a Financial Action Task Force compliant jurisdiction, regulated as such by its country of incorporation or organization, that (i) sells interests through compliant distributors only; (ii) has agreements prohibiting sales of interests to U.S. persons, non-PFFIs, or passive NFFEs with any substantial U.S. owners; and (iii) complies with account identification and redemption rules); and

- FFIs that comply with an agreement between the U.S. and the jurisdiction in which the FFI is located (see "Intergovernmental Framework" below).

Because the types of entities that can qualify as "qualified collective investment vehicles" or "restricted investment funds" is so limited, compliance with FATCA is effectively mandated for foreign investment funds located outside the U.S. that are managed from within the U.S. and that trade in U.S. securities and commodities. Furthermore, many foreign limited companies that serve as feeder funds or investment managers will also be required to become FATCA compliant. Although the cost of compliance will be high, failure to enter into an FFI Agreement could make investing in the U.S. capital markets cost-prohibitive.

FFIs that will be eligible to become certified deemed-compliant FFIs under the proposed regulations include:

- Non-registering local banks;
- Retirement plans;
- Non-profit organizations;
- FFIs with only low-value accounts (no account in excess of \$50,000; affiliated group does not have assets in excess of \$50,000,000); and Owner-documented FFIs (but only certified deemed-compliant with respect to a specific withholding agent; that agent must be a PFFI or a U.S. institution).

H. Refunds

A beneficial owner may claim a refund for an over withheld amount, to the extent withholding on a payment under FATCA exceeds the owner's underlying U.S. tax liability. Non-PFFIs, however, may not seek a refund for payments beneficially owned by them, except if otherwise required under an income tax treaty. Under the proposed regulations, an NFFE claiming a refund (other than as required by treaty) must provide information regarding its substantial U.S. owners or a certification that it does not have any substantial U.S. owners.

4.6.3 Expanded Categories of Non-Financial Foreign Entities Exempt from FATCA

The proposed regulations expand the types of NFFEs that are exempt from withholding tax and information reporting under FATCA, including certain publicly traded companies and their affiliates, NFFEs predominantly engaged in active businesses, and nonfinancial holding companies.

A. Intergovernmental Framework

On February 8, 2012, the Treasury, France, Germany, Italy, Spain, and the United Kingdom issued a joint statement outlining an intergovernmental framework as an alternative to FATCA. Under this framework, the U.S. and a country with which the U.S. signs an agreement (the "FATCA Partner") will create automatic exchanges of information.

In this alternative, the U.S. and the FATCA Partner would enter into an agreement under which the FATCA Partner would require FFIs within that country to perform due diligence to collect and report information directly to that country's tax authority.

This information would then be automatically transferred to the U.S. In return, the U.S. would agree to reciprocal collection and reporting of information to FATCA Partners. For certain FFIs located in a FATCA Partner, the U.S. would allow the FFIs to avoid entering into FFI Agreements with the IRS. These FFIs would also not be required to terminate recalcitrant account holder accounts or impose passthru payment withholding on recalcitrant account holders or FFIs organized in any FATCA Partner jurisdiction. The U.S. government plans to include more countries in this framework in the future.

B. Additional IRS guidance

The IRS held a public hearing on May 15, 2012. Many of the witnesses at the hearing requested that the IRS give FFIs more time to implement FATCA. Other issues witnesses raised included conforming account identification and documentation requirements to existing AML/KYC rules and intergovernmental agreements. Final regulations are expected to be published in the summer of 2012, and the Treasury has announced that it plans to release a draft model FFI Agreement by mid-2012. The Treasury also plans to modify the existing Qualified Intermediary, Withholding Partnership, and Withholding Trust agreements to better coordinate with FATCA.

4.7 FATCA Timeline

March 18, 2010

- IRS issues Notice 2010-60, 2010-37 I.R.B. 329, which provided preliminary FATCA guidance.
- IRS issues Notice 2011-53, 2011-32 I.R.B. 124, which provided a timeline for the implementation of FATCA.
 - Obligations outstanding as of this date, and gross proceeds from the sale of such obligations, are not subject to FATCA.
 - IRS begins accepting FFI Applications through its electronic submissions process.
- FFI Applications submitted before this date will be effective on July 1, 2013, and will avoid withholding beginning January 1, 2014. FFI Applications submitted after this date will be effective as of the date entered into with the IRS.
 - Withholding on U.S.-source FDAP payments (including pass-thru payments that are with-holdable payments) begins.
 - Reporting of name, address, TIN, account number, and account balance with respect to United States Accounts begins (for calendar year 2013). Reports are due by September 30, 2014, with respect to calendar year 2013. Reports thereafter are due by March 31 of each succeeding year.
- Reporting expanded to include income associated with United States Accounts (for calendar year 2015).
 - Withholding on foreign pass-thru payments begins (no earlier than this date).
 - Full reporting, including information on the gross proceeds from broker transactions, begins (for calendar year 2016).

4.8 Key Learnings

At the end of this chapter one should be conversant with the following fundamental concepts:

- Regulations- products which are market oriented in nature provide investors protection through the laws applicable to market participants
- FINRA It gets involved in the markets space only where
 - Preserving the integrity, efficiency and fairness of the securities market
 - Overseeing SROs
 - Penalizing wrongdoers
- FINRA structure
- Special Nature of Documentation in Wealth Management
- Terms of Businesses and agreements
- Customer account opening requirements
- Account types
 - Cash Accounts
 - Margin Account
 - Option Account
 - Day trading account
 - DVP/RVP
 - Fee based accounts
 - Advisory / Discretionary accounts
- KYC & AML
 - Anti Money Laundering and Combating the Financing of Terrorism combined with Know Your Customer requirements make what conspirators do, tough to replicate
 - Customer Due Diligence - The KYC or Customer Due Diligence process focuses on banks operating as gate-keepers to the world's financial system.
 - Principal FINRA rules relating to KYC-AML
 - Private Banking, Corruption & AML - WM / PB presents a high risk area when it comes to Money Laundering risks.
 - Codes of conduct for firms
 - Client Classification
- FATCA is an effort to combat tax avoidance by U.S. taxpayers through the use of offshore accounts and offshore intermediaries.
 - Highlights of proposed regulations
 - Passthru payments
 - Expanded Categories of Non-Financial Foreign Entities Exempt from FATCA
 - FATCA timeline.

Chapter Overview: Securities Borrowing & Lending

This chapter will help the participants get a sound understanding Securities borrowing & lending, the legal framework involved and the participants in the process. We will get an overview of the regulations and the legal framework involved in securities borrowing and lending. We will also get to know in fair detail about the lenders and intermediaries. At the end of the chapter, we learn of the different organization characteristics and portfolios.

5 Securities Borrowing & Lending

5.1 Introduction

Securities lending is a long-established practice that plays an important role in today's capital markets by providing liquidity that reduces the cost of trading and promotes price discovery in rising as well as falling markets. The resultant increase in efficiency benefits the market as a whole - from the securities dealers and end investors through to the corporate issuers that depend on efficient, liquid markets to raise additional capital.

5.2 The Legal Framework

5.2.1 Definitions

In some ways, the term “securities lending” is misleading and factually incorrect. From a legal perspective in many jurisdictions, the transaction commonly referred to as “securities lending” is, in fact...

“a transfer of title of securities linked to the subsequent reacquisition of equivalent securities by means of an agreement.”

Such transactions are collateralized and the “rental fee” charged, along with all other aspects of the transaction, are dealt with under the terms agreed between the parties. It is entirely possible and very commonplace that securities are borrowed and then sold or on-lent.

There are some consequences arising from this clarification:

Absolute title over both the securities on loan and the collateral received passes between the parties.

- The economic benefits associated with ownership - e.g. dividends, coupons etc. - are “manufactured” back to the lender, meaning that the borrower is entitled to these benefits as owner of the securities but is under a contractual obligation to make equivalent payments to the lender.
- A lender of equities surrenders its rights of ownership, e.g. voting. Should the lender wish to vote on securities on loan, it has the contractual right to recall equivalent securities from the borrower.
- Appropriate documentation of lending ensures that securities lending transactions do not incur taxes that would negate any financial benefit.

5.3 Different types of securities loan transaction

As a by-product of being “appropriately documented”, and as a result of prudent risk management, securities loans in today's markets are made against collateral in order to protect the lender against the possible default of the borrower. This collateral can be cash, or other securities or other assets

A. Transactions collateralised with other securities or assets

At the expiry of the transaction, the flows in this chart are reversed; although daily marking to market will result in collateral flows in either direction.

- Non-cash collateral would typically be drawn from the following collateral types:
- Government Bonds: OECD debt, or restricted to G7, G20, etc
- Corporate Bonds: Typically a minimum credit rating
- Convertible Bonds: Usually matched to the securities being lent
- Equities: Of specified Indices
- Letters of Credit: From banks of a specified credit quality
- Certificates of Deposit: Drawn on institutions of a specified credit quality
- Warrants: Atypical, but usually matched

- Other money market instruments
- The eligible collateral will be agreed between the parties, as will other key factors including:
 - Notional limits: The absolute value of any asset to be accepted as collateral
 - Initial margin: The margin required at the outset of a transaction
 - Maintenance margin: The minimum margin level to be maintained throughout the transaction

B. Concentration limits:

The maximum percentage of any issue to be acceptable, e.g. less than 5% of daily traded volume. The maximum percentage of collateral pool that can be taken against the same issuer, i.e. the cumulative effect where collateral in the form of letters of credit, CD, equity, bond and convertible may be issued by the same firm. In a large number of securities lending transactions, collateral is held by a Tri Party Agent. This specialist agent (typically a large custodian bank or International Central Securities Depository) will receive only eligible collateral from the borrower and hold it in a segregated account to the order of the lender. The Tri Party Agent will mark this collateral to market, with information distributed to both lender and borrower. Typically the borrower pays a fee to the Tri Party agent.

There is debate within the industry as to whether lenders that are flexible in the range of noncash collateral they are willing to receive are rewarded with correspondingly higher fees. Some argue that they are, others claim that the fees remain largely static but that borrowers are more prepared to deal with a flexible lender and therefore balances and overall revenue rise.

- The agreement on a fee is reached between the parties and would typically take into account the following factors:
 - Demand and supply: The less of a security available, other things being equal, the higher the fee a lender can obtain
 - Collateral flexibility: See above - the cost to a borrower of giving different types of collateral varies significantly, so that they might be more willing to pay a higher fee if the lender is more flexible

Dividend issues: The size of the manufactured dividend required to compensate the lender for the post-tax dividend payment that it would have received had it not lent the security. Different lenders have varying tax liabilities on income from securities; the lower the manufactured dividend required by the lender, the higher the fee it can negotiate.

The term of a transaction: Securities lending transactions can be open to recalls or fixed for a specified term; there is much debate about whether there should be a premium paid or a discount for certainty. If a lender can guarantee a recall-free loan then a premium will be forthcoming. One of the attractions of repo and swaps is the transactional certainty on offer from a counterpart.

Certainty: There are trading and arbitrage opportunities, the profitability of which revolves around the making of specific decisions. If a lender can guarantee a certain course of action, this may mean it can negotiate a higher fee. Fees vary from security to security and over time.

C. Transactions collateralized with cash

Cash collateral is, and has been for many years, an integral part of the securities lending business, particularly in the United States. The lines between two distinct activities - Securities lending and Cash reinvestment - have become blurred; and to many US investment institutions securities lending is virtually synonymous with cash reinvestment. This is much less the case outside the United States but consolidation of the custody business and the important role of US custodian banks in the market means that this practice is becoming more prevalent internationally.

At the expiry of the transaction, the flows in this chart are reversed.

The importance of this point lies in the very different risk profiles of these increasingly intertwined activities. Crucially, cash reinvestment is not usually covered by an indemnity - insurance from the lending agent that provides some protection in the event of a counterpart default. It can be argued that this creates a conflict of interest for the cash manager - they earn fees but do not share the direct financial risk of this activity. They do, however, run considerable reputational and commercial risk if they do not manage this potential conflict. Cash reinvestment was traditionally dominated by unitized funds that pooled the collateral for ease of management and to achieve the various economies of scale available in money market investment. However, segregated accounts with client specific risk profiles are now becoming much more common.

Note that the securities lending loan term (i.e. time to maturity) will determine the benchmark rate that is to be paid on the cash. Most loans can be recalled at any time, so the cash will generally have an overnight rate benchmark. It is common for the interest to be physically settled monthly. Below we provide an example of relative importance of cash and non-cash to different fiscal locations and as you can see the US domiciled lenders are overwhelmingly taking cash as collateral whilst other jurisdictions have a predilection for non-cash collateral. The relative scale and importance of the US lending community brings the overall percentage of collateral taken as cash up to 59.5%. These statistics owe a great deal to historic tax legislation and inertia but have served the non US lenders well in during the credit crunch when some money market funds lost money.

The revenue generated from cash-collateralised securities lending transactions is derived in a different manner from that in a non-cash transaction. It is made from the difference or “spread” between interest rates that are paid and received by the lender. Reinvestment guidelines are typically documented in the appendix of the underlying securities lending agreement. Unfortunately it is still typical for these guidelines to be bespoke and lack any specific risk language. This situation is changing in light of client and provider experiences related to the liquidity crisis prompted by the Credit Crunch. The adoption of a more risk management orientated approach is to be welcomed and encouraged. Some typical guidelines might be as follows:

Conservative

- Overnight G7 Government Bond repo fund
- Maximum effective duration of 1 day, or any term agreements are a small proportion
- Floating-rate notes and derivatives are not permissible
- Restricted to overnight repo agreements

Quite Conservative

- AAA rated Government Bond repo fund
- Maximum average maturity of 90 days
- Maximum remaining maturity of any instrument is 13 months

Quite Flexible

- Maximum effective duration of 90 days
- Maximum remaining effective maturity of 2 - 3 years
- Floating-rate notes and eligible derivatives are permissible
- Credit quality: Short-term ratings: A1/P1, long-term ratings: A-/A3 or better

Flexible

- Maximum effective duration of 90 days
- Maximum remaining effective maturity of 5 years
- Floating-rate notes and eligible derivatives are permissible
- Credit quality: Short-term ratings: A1/P1, long-term ratings: A-/A3 or better

Some securities lending agents offer bespoke reinvestment guidelines whilst others offer reinvestment pools.

D. Other transaction types

Securities lending is part of a larger set of interlinked securities financing markets. These transactions are often used as alternative ways of achieving similar economic outcomes, although the legal form and accounting and tax treatments can differ. The other transactions include:

- Sale and repurchase agreements (“Repos”)
- Swaps
- Buy/sell backs

E. Conclusion

The scale and significance of the securities lending industry should now be apparent to the reader. It is important to note that this is not purely a business that drives short selling - there are many reasons to borrow securities and securities lending is an important tool in a variety of capital market functions. In the next chapter we will focus in more depth on the structure of the market and the different routes that supply can follow through it.

5.3.1 Lenders and intermediaries

The securities lending market involves various specialist intermediaries which take principal and/or agency roles. These intermediaries separate the underlying owners of securities - typically large pension or other funds, and insurance companies - from the eventual borrowers of securities, whose usual motivations are described earlier.

A. Intermediaries

1. Agent intermediaries

Securities lending is increasingly becoming a volume business and the economies of scale offered by agents that pool together the securities of different clients enable smaller owners of assets to participate in the market. The costs associated with running an efficient securities lending operation are beyond many smaller funds for which this is a peripheral activity. Asset managers and custodian banks have added securities lending to the other services they offer to owners of securities portfolios, while third-party lenders specialise in providing securities lending services. Owners and agents “split” revenues from securities lending at commercial rates. The split will be determined by many factors including the service level and provision by the agent of any risk mitigation, such as an indemnity. Securities lending is often part of a much bigger relationship and therefore the split negotiation can become part of a bundled approach to the pricing of a wide range of services.

(a) Asset managers

It can be argued that securities lending is an asset management activity - a point that is easily understood considering the reinvestment of cash collateral. Particularly in Europe, where custodian banks were perhaps slower to take up the opportunity to lend than in the United States, many asset managers run significant securities lending operations.

What was once a low-profile, back-office activity is now a front-office growth area for many asset managers. The relationship that the asset managers have with their underlying clients puts them in a strong position to participate.

(b) Custodian banks

The history of securities lending is inextricably linked with the custodian banks. Once they recognised the potential to act as agent intermediaries and began marketing the service to their customers, they were able to mobilise large pools of securities that were available for lending. This in turn spurred the growth of the market. Most large custodians have added securities lending to their core custody businesses. Their advantages include: the existing banking relationship with their customers; their investment in technology and global coverage of markets, arising from their custody businesses; the ability to pool assets from many smaller underlying funds, insulating borrowers from the administrative inconvenience of dealing with many small funds and providing borrowers with protection from recalls; and experience in developing as well as developed markets.

Being banks, they also have the capability to provide indemnities and manage cash collateral efficiently - two critical factors for many underlying clients. Custody is so competitive a business that for many providers it is a loss-making activity. However, it enables the custodians to provide a range of additional services to their client base. These include foreign exchange, trade execution, securities lending and fund accounting.

(c) Third-party agents

Advances in technology and operational efficiency have made it possible to separate the administration of securities lending from the provision of basic custody services, and a number of specialist third-party agency lenders have established themselves as an alternative to custodian banks. Their market share is currently growing from a relatively small base. Their focus on securities lending and their ability to deploy new technology without reference to legacy systems can give them flexibility.

2. Principal intermediaries

There are three broad categories of principal intermediary:

- Broker Dealers
- Specialist intermediaries
- Prime brokers

In contrast to the agent intermediaries, they can assume principal risk, offer credit intermediation, and take positions in the securities that they borrow. Distinctions between the three categories are blurred. Many firms would be in all three. In recent years securities lending markets have been liberalised to a significant extent so that there is little general restriction on who can borrow and who can lend securities. Lending can, in principle, take place directly between beneficial owners and the eventual borrowers. But typically a number of layers of intermediary are involved. What value do the intermediaries add?

A beneficial owner may well be an insurance company or a pension scheme while the ultimate borrower could be a hedge fund. Institutions will often be reluctant to take on credit exposures to borrowers that are not well recognised, regulated or who do not have a good credit rating. This would exclude most hedge funds. In these circumstances, the principal intermediary (often acting as prime broker) performs a credit intermediation service in taking a principal position between the lending institution and the hedge fund.

A further role of the intermediaries is to take on liquidity risk. Typically they will borrow from institutions on an open basis - giving them the option to recall the underlying securities if they want to sell them or for other reasons - whilst lending to clients on a term basis, giving them certainty that they will be able to cover their short positions.

In many cases, as well as serving the needs of their own proprietary traders, principal intermediaries provide a service to the market in matching the supply of beneficial owners that have large stable portfolios with those that have a high borrowing requirement. They also distribute securities to a wider range of borrowers than underlying lenders, which may not have the resources to deal with a large number of counterparts. These activities leave principal intermediaries exposed to liquidity risk if lenders recall securities that have been on lent to borrowers on a term basis. One way to mitigate this risk is to use in-house inventory where available. For example, proprietary trading positions can be a stable source of lending supply if the long position is associated with a long-term derivatives transaction.

Efficient inventory management is seen as critical and many securities lending desks act as central clearers of inventory within their organisations, only borrowing externally when netting of in-house positions is complete. This can require a significant technological investment. Other ways of mitigating ‘recall risk’ include arrangements to borrow securities from affiliated investment management firms, where regulations permit, and bidding for exclusive (and certain) access to securities from other lenders.

On the demand side, intermediaries have historically been dependent upon hedge funds or proprietary traders that make trading decisions. But a growing number of securities lending businesses within investment banks have either developed “trading” capabilities within their lending or financing departments, or entered into joint ventures with other departments or even in some cases their hedge fund customers. The rationale behind this trend is that the financing component of certain trading strategies is so significant that without the loan there is no trade.

(a) Broker dealers

Broker dealers borrow securities for a wide range of reasons:

- Market making
- To support proprietary trading
- On behalf of clients

Many broker dealers combine their securities lending activities with their prime brokerage operation (the business of servicing the broad requirements of hedge funds and other alternative investment managers). This can bring significant efficiency and cost benefits. Typically within broker dealers the fixed income and equity divisions duplicate their lending and financing activities.

(b) Specialist intermediaries

Historically, regulatory controls on participation in stock lending markets meant that globally there were many intermediaries. Some specialised in intermediating between stock lenders and market makers in particular, e.g. UK Stock Exchange Money Brokers (“SEMB”). With the deregulation of stock lending markets, these niches have almost all disappeared. Some of the specialists are now part of larger financial organisations. Others have moved to parent companies that have allowed them to expand the range of their activities into proprietary trading.

(c) Prime brokers

Prime brokers serve the needs of hedge funds and other ‘alternative’ investment managers. The business was once viewed simply as the provision of six distinct services, although many others such as capital introduction, risk management, fund accounting and start up assistance have now been added:

- Services provided by prime brokers
- Profitable activities Part of the cost of being in business
- Securities lending Clearance
- Leverage of financing provision Custody
- Trade execution Reporting

Securities lending is one of the central components of a successful prime brokerage operation, with its scale depending on the strategies of the hedge funds for which the prime broker acts. Two strategies that are heavily reliant on securities borrowing are long/short equity and convertible bond arbitrage.

The cost associated with the establishment of a full service prime broker is steep and recognised providers have a significant advantage. Some of the newer entrants have been using total return swaps, contracts for difference and other derivative transaction types to offer what has become known as “synthetic prime brokerage”. Again securities lending remains a key component of the service as the prime broker will still need to borrow securities in order to hedge the derivatives positions it has entered into with the hedge funds, for example, to cover short positions. But it is internalised within the prime broker and less obvious to the client.

Beneficial owners : Those beneficial owners with securities portfolios of sufficient size to make securities lending worthwhile include:

- Pension funds
- Insurance and assurance companies
- Mutual funds/unit trusts
- Endowments

When considering whether and how to lend securities, beneficial owners need first to consider the characteristics of their organisations and portfolio.

A. Organisation characteristics

- Management motivation
Some owners lend securities solely to offset custody and administrative costs. Others are seeking more significant revenue.
- Technology investment
Lenders vary in their willingness to invest in technological infrastructure to support securities lending.
- Credit risk appetite

The securities lending market consists of organisations with a wide range of credit quality and collateral capabilities. A cautious approach to counterpart selection (AAA only) and restrictive collateral guidelines (G7 Bonds) will limit lending volumes.

B. Portfolio characteristics

- Size
Other things being equal, borrowers prefer large portfolios.
- Holdings size
Loan transactions generally exceed \$250,000. Lesser holdings are of limited appeal to direct borrowers.
Holdings of under \$250,000 are probably best deployed through an agency programme, where they can be pooled with other inventories.
- Investment strategy
Active investment strategies increase the likelihood of recalls, making them less attractive than passive portfolios.
- Diversification

Borrowers want portfolios where they need liquidity. A global portfolio offers the greatest chance of generating a fit. That said, there are markets that are particularly in demand from time to time and there are certain borrowers that have a geographic or asset class focus.

- Tax jurisdiction and position
Borrowers are responsible for “making good” any benefits of share ownership (excluding voting rights) as if the securities had not been lent. They must “manufacture” (i.e. pay) the economic value of dividends to the lender. An institution’s tax position compared to that of other possible lenders is therefore an important consideration. If the cost of manufacturing dividends or coupons to a lender is low then its assets will be in greater demand.
- Inventory attractiveness
“Hot” securities are those in high demand whilst general collateral or general collateral securities are those that are commonly available. Needless to say, the “hotter” the portfolio, the higher the returns from lending it. Having examined the organisation and portfolio characteristics of the beneficial owner, we must now consider the various possible routes to market.

The possible routes to the securities lending market:

- (a) Using an asset manager as agent - A beneficial owner may find that the asset manager they have chosen, already operates a securities lending programme. This route poses few barriers to getting started quickly.
- (b) Using a custodian as agent - This is the least demanding option for a beneficial owner, especially a new one. They will already have made a major decision in selecting an appropriate custodian. This route also poses few barriers to getting started quickly.
- (c) Appointing a third-party specialist as agent asset manager(s) or custodian(s), and instead appoint a third-party specialist. This route may mean getting to know and understand a new provider prior to getting started. The opportunity cost of any delay needs to be factored into the decision.
- (d) Auctioning a portfolio to borrowers - Borrowers bid for a lender’s portfolio by offering guaranteed returns in exchange for gaining exclusive access. There are several different permutations of this auctioning route:
 - Do-it-yourself auctions
 - Assisted auctions
 - Agent assistance
 - Consultancy assistance
 - Specialist “auctioneer” assistance

This is not a new phenomenon but one that has gained a higher profile in recent years. A key issue for the beneficial owner considering this option is the level of operational support that the auctioned portfolio will require and who will provide it.

- (e) Selecting one principal borrower

Many borrowers effectively act as wholesale intermediaries and have developed global franchises using their expertise and capital to generate spreads between two principals that remain unknown to one another. These principal intermediaries are sometimes separately incorporated organisations, but, more frequently, are parts of larger banks, broker-dealers or investment banking groups. Acting as principal allows these intermediaries to deal with organisations that the typical beneficial owner may choose to avoid for credit reasons e.g. hedge funds.

(f) Lending directly to proprietary principals

Sometimes after a period of activity in the lending market using one of the above options, a beneficial owner that is large enough in its own right, may wish to explore the possibility of establishing a business “in house”, lending directly to a selection of principal borrowers that are the end users of their securities. The proprietary borrowers include broker-dealers, market makers and hedge funds. Some have global borrowing needs while others are more regionally focused.

(g) Choosing some combination of the above

Just as there is no single or correct lending method, so the options outlined above are not mutually exclusive. Deciding not to lend one portfolio does not preclude lending to another; similarly, lending in one country does not necessitate lending in all. Choosing a wholesale intermediary that happens to be a custodian in the United States and Canada does not mean that a lender cannot lend Asian assets through a third-party specialist and European assets directly to a panel of proprietary borrowers.

5.4 Key Learnings

At the end of this chapter one should be conversant with the following fundamental concepts:

- SBL - plays an important role in today's capital markets by providing liquidity that reduces the cost of trading and promotes price discovery in rising as well as falling markets.
- Legal Framework - a transfer of title of securities linked to the subsequent reacquisition of equivalent securities by means of an agreement.
- Different types of Securities loan transaction - securities loans in today's markets are made against collateral in order to protect the lender against the possible default of the borrower. This collateral can be cash, or other securities or other assets
- Lenders & Intermediaries
 - Agent Intermediaries
 - Principal intermediaries
- Characteristics & Portfolio
 - Organization Characteristics
 - Portfolio Characteristics
- The possible routes to Securities lending

5.5 Test your Knowledge

1. Repos and SBL are in essence
 - a. Very similar if the collateral is some other security
 - b. Very similar if the collateral is cash
 - c. Different
 - d. Same in flows but the structure is different
2. Extent of lending to one counterparty level is typically restricted to:
 - a. The borrowing counterparty
 - b. The issuer of the collateral accepted
 - c. Either of these
 - d. Both of these
3. When a custodian lends securities as agent of more than one customer, segregation refers to:
 - a. Keeping securities separate in a physical sense
 - b. Knowing which securities are the subject of lending in a legal sense
 - c. Keeping securities in a legal sense
 - d. Knowing which securities are the subject of borrowing in a legal sense
4. Which of the following asset does not qualify as collateral for the purpose of Securities Lending?
 - a. Cash
 - b. Securities
 - c. Assets in kind
 - d. Letter of Credit
5. In context of Securities Lending- a Custodian is most likely a _____ of the Security.
 - a. Beneficial Owner
 - b. Agent Lender
 - c. Borrower
 - d. End User
6. Who among the following are not the lenders of Securities (on the supply side of the Securities Lending)?
 - a. Investment Funds
 - b. Pension Funds
 - c. Prime Brokers
 - d. Insurance Companies
7. Who among the following are typically the end-users of the borrowed stocks?
 - a. Hedge Funds
 - b. Mutual Funds
 - c. Proprietary Traders
 - d. All of the given options

Chapter Overview: Portfolio Performance and Management

This chapter will help the participants get an overview of portfolio management and performance. We will get know of how valuation is done on investment portfolios and how fund performances are analyzed. This chapter also covers Risk & Return and risk free portfolios. We will learn what index means and about building index. We will also know about the indexes of the world. We will learn how to measure risk while reporting. At the end we will know about client classification.

6 Portfolio Performance & Management

6.1 The Valuation of Investment Portfolios

This is an important area, especially from a customer standpoint because it is necessary to find out what the investments made some time ago are worth.

It is also an area where there is a need to follow a standard because valuing investments wrongly can deliver a misleading picture of either outperformance or underperformance, neither of which is desirable.

The valuation statement also indicates the quantum for which a portfolio may be liquidated / sold off and money realized.

Valuation is easy if an easy measure is available. That ease of measurement is the availability of a reliable quote for the investment.

Publicly available quotes: where this is available it is easy to value the investment. For instance, Google is actively traded on NASDAQ and we have the closing price from yesterday at end of day to value it this morning.

- Shares which are listed and quoted every day (highly liquid)
- Bonds listed and/ or quoted every day (Govt. Blue chip Corporate)
- Money Market Instruments
- Funds that publish Net Asset Values (NAV) every day

Public quotes are NOT available: it is difficult to value the investment. For instance, an investment in a structured note which is privately invested and held, and never traded ever is hard to price and get the value of. This can also happen with shares that are traded only once in a while. Privately invested funds do not publish NAVs.

Valuing Portfolios in their entirety:

Portfolios comprise all types of investments. Each component to be valued on its principles and valuation to be achieved for the portfolio as a whole.

6.1.1 Basic Valuation Approach

- Equity: Valued at quoted rates in the market
- Bonds: At the rate quoted on the markets PLUS the interest accrued on the bond (Dirty Price)
- Money Market Investments: Interest accrual. Usually these instruments are not quoted widely off the accrued values except in unusual market conditions
- Funds: Valued at NAV
- Portfolio Investments: At valuation provided by the Portfolio Manager which have to be consistent with the above principles.

This simplified approach ignores the principles by which investments which are not liquid are dealt with.

6.1.2 Net Asset Value

The simple formula is

$$\text{Net Asset Value} = \frac{\text{Net Asset}}{\text{Shares/ Units in the Fund}}$$

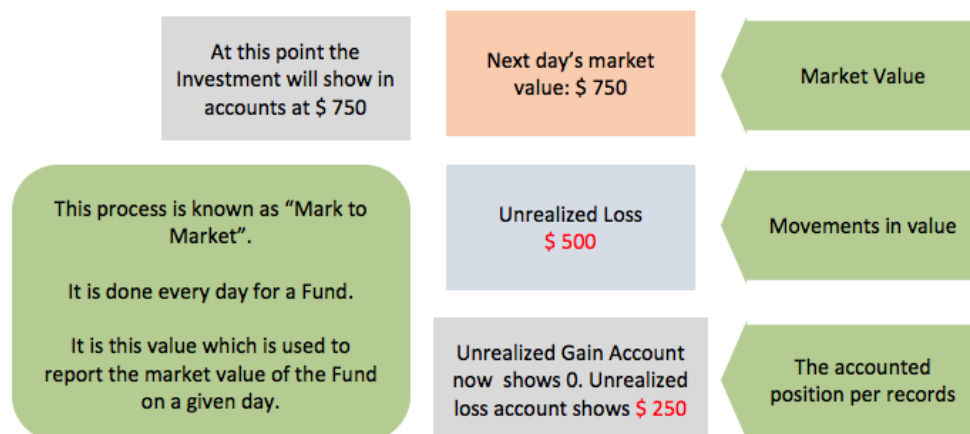
The Net Asset Value reflects the worth of the investment. It is a key measure in assessing a Fund Manager's performance. If an existing investor wants to withdraw his money, this is the value he will want to receive. If an investor wants to invest in the fund he has to buy units/shares at this rate.

NAV reflects everything that happened till the end of the NAV date. It is available as public information from then on. Next morning, when markets open investment values may rise. This rise will get reflected in the NAV at the close of that day. Any one investing during the day will be able to buy units only at the NAV at the close of that day.

They cannot buy-in into today's market action. The benefits (or losses) of that market action belongs to those who owned the Fund that morning; and to no one else.

6.1.3 Market Cyclicity

When an instrument is NOT traded, the unrealized losses can become profits if the market cycle turns favorable. Likewise, unrealized gains can become losses. Every day's market value is compared to the value of the investment shown in the accounts as at the end of the previous day. The process is continuous so long as the investment is held as shown below:



This is an illustration of how things can be; this simple example should not be over-interpreted.

6.1.4 Analyzing Fund Performance

A fund's performance is analyzed by comparing to its appropriate benchmark.

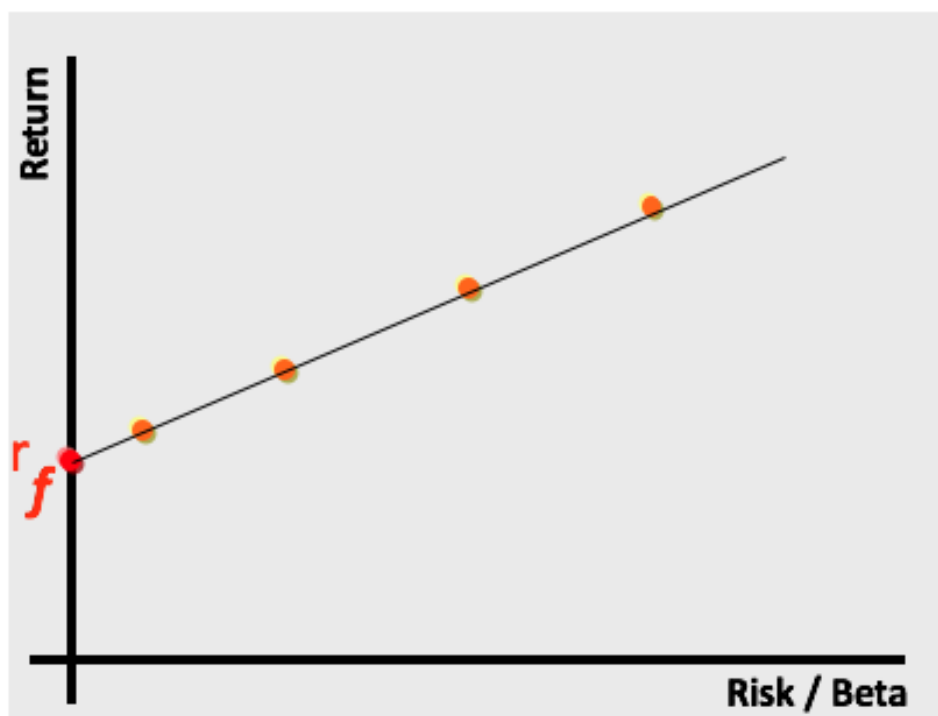
- If the fund has grown by 30% but the benchmark index is up by 40% the fund will be marked as an **underperformer**.
- If the fund has grown by 30% but the benchmark index is up by 20% only the fund will be marked as an **outperformer**.
- If the fund has shrunk by 30% but the benchmark index is down by 20% only the fund will be marked as an **underperformer**.
- If the fund has shrunk by 30% but the benchmark index is down by 40% only the fund will be marked as an **outperformer**.

As you can see in the last instance, the customer has lost 30% of his money. The Fund Manager says he is an outperformer as per this benchmarking methodology. This is not acceptable to a certain type of customer who wants returns no matter what. Lets understand that better.

6.1.5 Risk Free Return and all possible combinations of Risk and Return in an economy:

If a person seeks an investment that is risk free, in a given market that would be a loan to the government. A Treasury Bill is just such a loan. The risk free rate in an economy is represented by the return on a Treasury Bill and denoted by ' r_f '. This is the point denoted by the red dot in the accompanying graph.

We could also examine various investment opportunities available in an economy and grade them on the risk they represent. These opportunities could be ranked on the risk axis and the return to be expected from them could be plotted on the returns axis. This line is known as the Security Market Line. Risk, denoted by Beta is 'zero' for Treasury Bills.



6.1.6 Beta

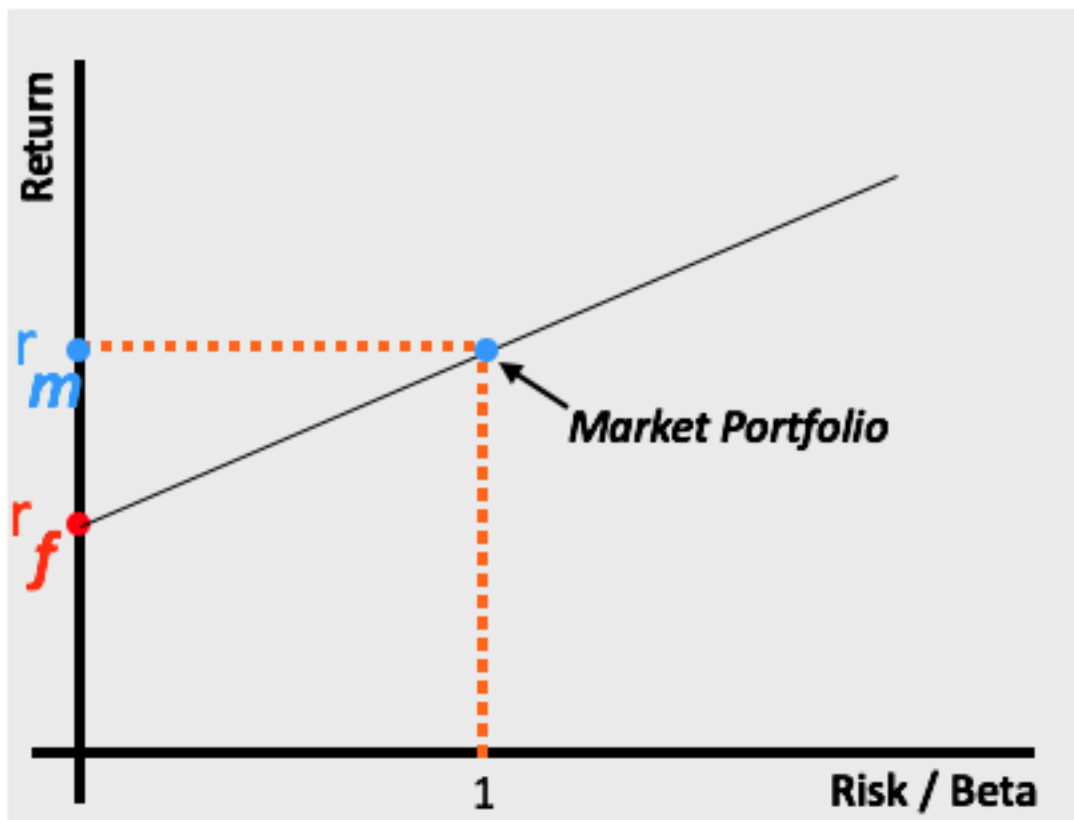
- The sensitivity of an investment's return to market movements is called beta
- In considering the contribution of a security to portfolio risk, the riskiness cannot be considered in isolation
 - The riskiness has to be considered in the context of the Market Risk
 - If for every 1 percent rise in the market, the stock rises by 2%, beta for that stock is 2
- Similarly if for every 1% rise in the market, the stock rises by 0.5% the beta for that stock is 0.5
- A portfolio that has the same beta as the market (1) is a market portfolio

It is possible to visualise an investment portfolio which comprises the full market. By this we do not mean the total market. We mean every investment opportunity in the market, in the same proportion that each of those investments are present in the market.

For instance, an index portfolio.

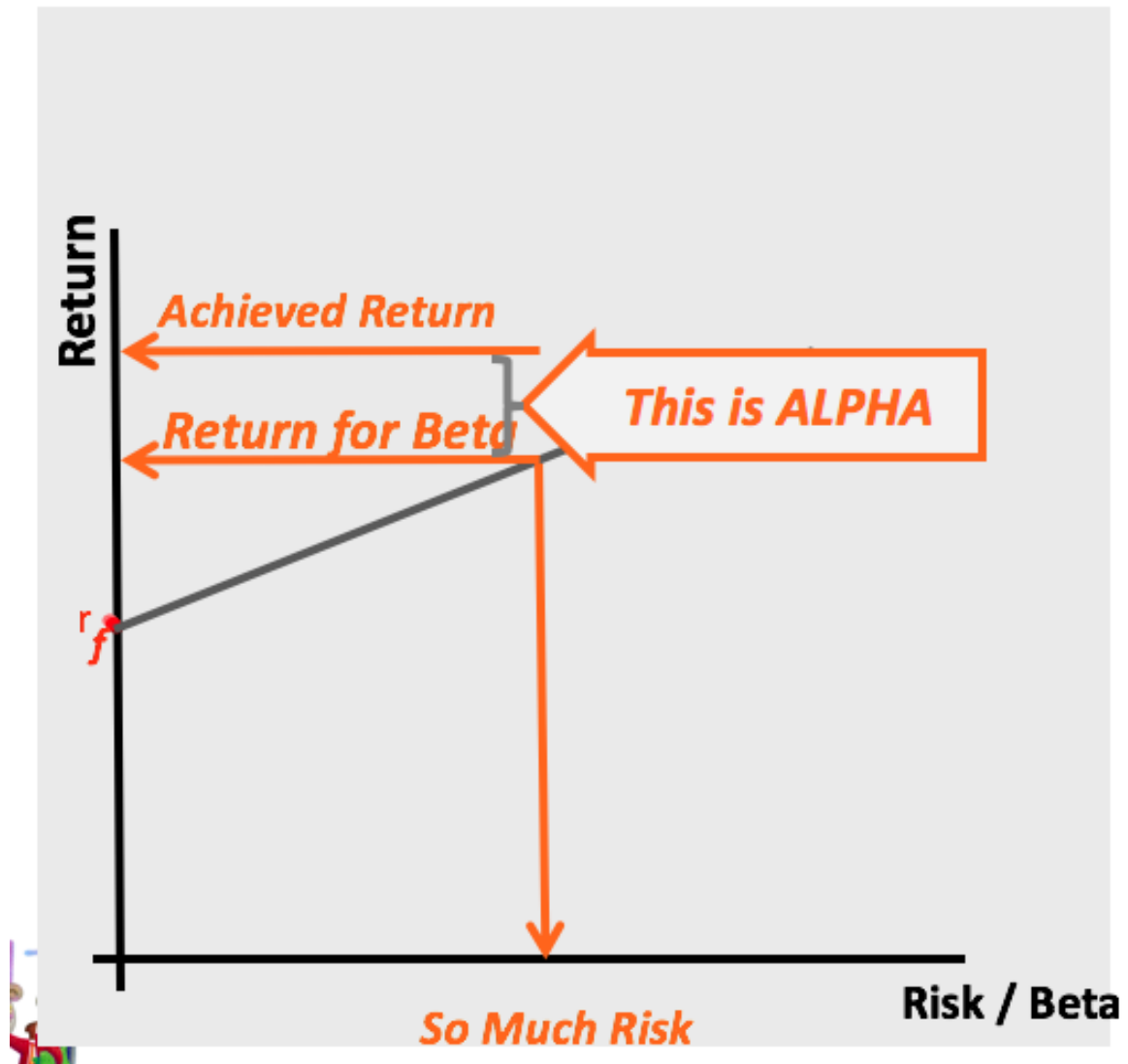
The feature of the market portfolio is that whatever happens to the market, is fully reflected in the market portfolio. In other words, the beta of this portfolio is '1'.

The difference between return on an investment and the Treasury Bill return is the risk premium for that particular investment. It is the extra return you get for taking greater risk than that represented by the T-Bill.



6.1.7 Alpha

The excess return relative to a BENCHMARK selected for a fund is ALPHA



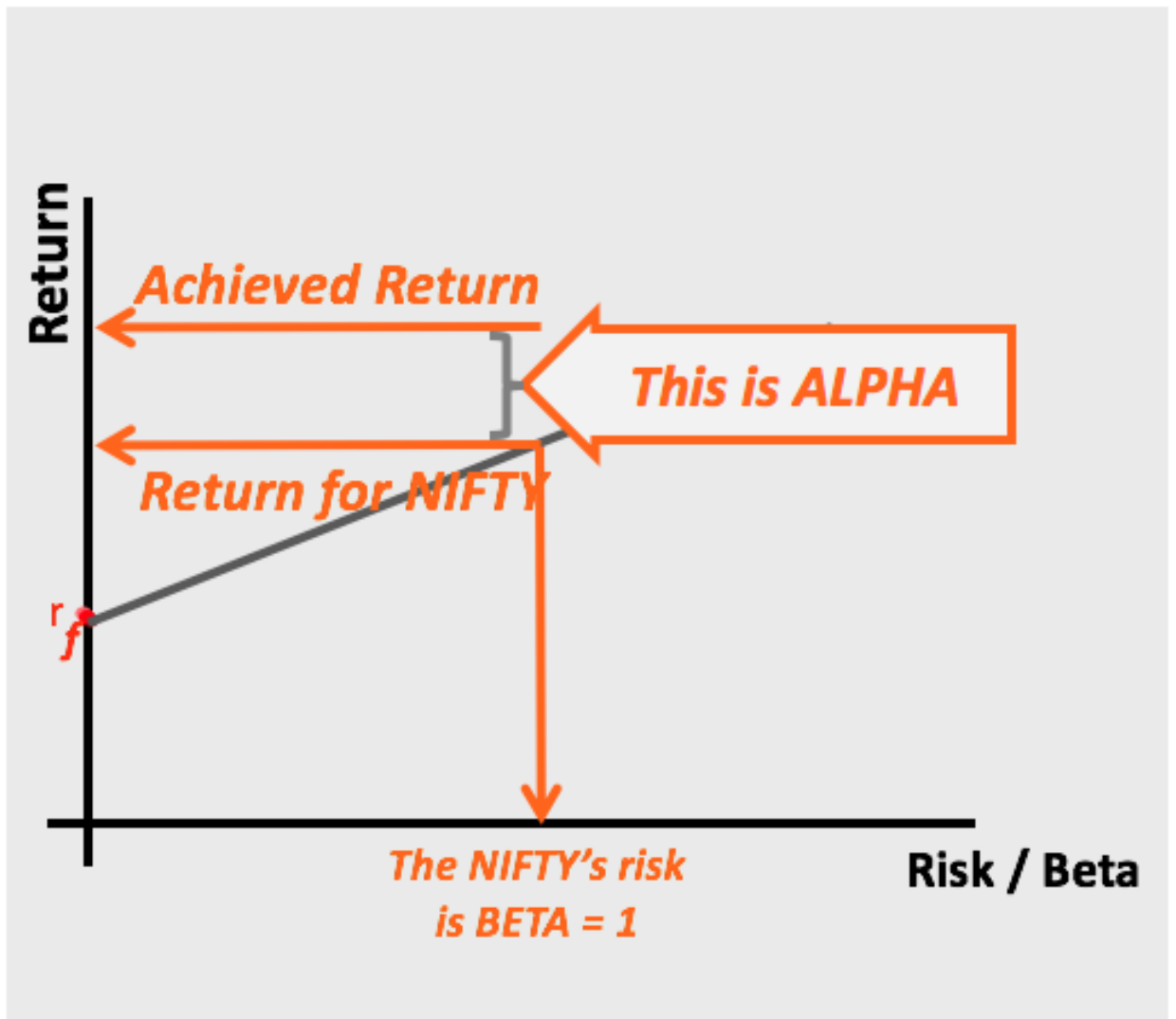
A. Alpha for a Diversified Equity Fund

For a diversified equity fund what is the INDEX we would choose?

We would choose the Broad Market Index: That could be any index from one of the markets: Dow Jones; FTSE 100; DAX; CAC; CNX Nifty 50; Sensex.

Since these are broad market indexes that represent the market as a whole, their risk level is considered beta. The return from investing in the index is the return for running Beta level of risk or the market portfolio risk.

The difference between the return generated by a Fund and the return generated by the chosen index is ALPHA.



B. The Hunt for Alpha

What is it that we are hiring a fund manager for?
To achieve what the INDEX can anyway deliver us?
For Delivering LESS THAN Beta? (definitely not!)
For Delivering Alpha?

This is the thought process behind the emergence of HEDGE FUNDS.

6.2 Indexes

If indexes are so important in benchmarking performances we need to understand them better.

An Index is a Barometer or an Indicator. A thermometer can tell you how hot (or cold!) it is outside. A different kind of thermometer can tell you if a person is unwell. A barometer can tell you if the weather is going to get dry or whether it is going to rain.

An Index of the markets (A Stock Market Index) can tell you something about what is happening in the market: and by extension in the economy.

6.2.1 Building an Index

You have to build the index, such that it tells you what you want to know. If you want to know about a person's wellness, you build a reference that tells you about body temperature. If you want to know the state of the economy and the market, you have to measure it.

If a Market Index is to indicate the state of economic health, you could measure the whole economy. That looks impossible! Nor is it needed.

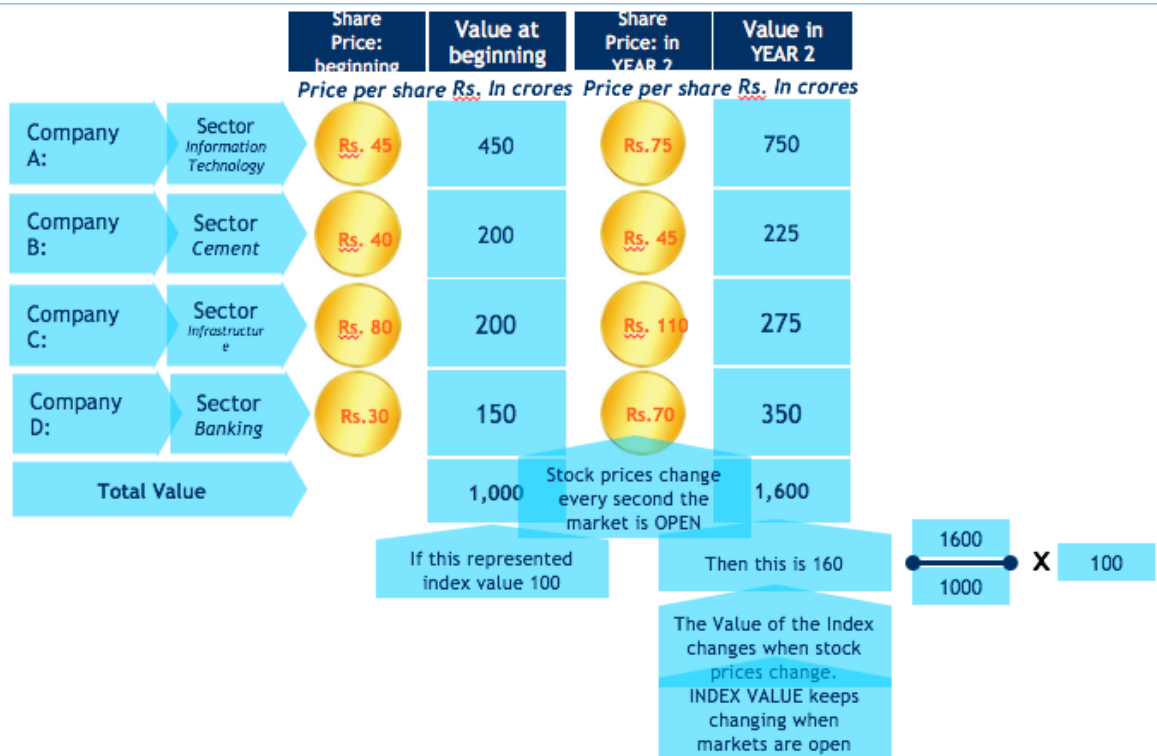
6.2.2 A Flavour of the Economy

The Index captures the essential flavor... without actually measuring the whole economy...

- List all the Important Sectors in the Economy: like mining, shipping, IT, logistics, manufacturing of different types etc.
- Find companies from each of these sectors/ businesses. They must be traded in the market. Each should be representative/best/a key company from that sector
- Build a list of such companies: one or two in each sector, capturing each sector in the economy.
- You are now ready to build the Index.

6.2.3 Index Process

- Measure the Value of Each Company in your Index List on the day you kick-start your index.
- Then total the Value of stocks in your list and equate them to an Index Value of 100.
- Then measure the change in value after some time, by referring the market price of the shares of the company on the stock exchange.
- You can keep measuring the value of the Index- in real time as the market trades



6.2.4 Mapping Indexes to Fund Themes

The chart below captures the mapping:

Fund Themes		
Theme	Invests in	Performance to be measured by comparison to
Cash Funds	Short term money market instruments	Money market index
Bond Funds	Fixed Income Securities & bonds	Bond index
Gilt Funds	Government Securities	T bill / T Bond
Equity Fund	A range of equities	Nifty/Sensex/ DJIA/FTSE 100
Index Fund	Only those stocks which comprise the index	Nifty/Sensex/ DJIA/FTSE 100
Sectoral Fund	Stocks of a sector: petroleum, banks, FMCG, Pharma etc	Industry index
Emerging Markets	Stocks of emerging markets	MSCI - EM Index
Hybrid Funds	Blend of investments in a certain proportion	Investment related indexes blended in same proportion

6.2.5 Major Equity Indexes of the World

Major Global Indexes		
Index	Consists of	Relates to the Economy of
Hang Seng 50	50 stocks	HKSE listed
NASDAQ	100 stocks	Nasdaq listed
Kospi	200 stocks	South Korea
Nikkei	500 stocks	Japan
DJIA (The Dow)	30 stocks	USA industrial economy
S&P 500	500 stocks	USA
FTSE 100	100 stocks	UK
DAX	30 stocks	Germany
MSCI EM Index	Market capitalisation of 26 economies	"Emerging Economies" including Brazil, Russia, India, China, Vietnam, Mongolia
And Nifty? And Sensex? 50 & 30.		Passive investing can also combine these indexes in different proportions.

6.2.6 MSCI Indexes

MSCI Inc. (formerly Morgan Stanley Capital International and MSCI Barra), is an American provider of equity, fixed income, hedge fund stock market indexes, and equity portfolio analysis tools. It publishes the MSCI BRIC, MSCI World and MSCI EAFE Indexes.

MSCI indexing offers a modern, seamless and fully integrated approach to measuring the full equity opportunity set, with no gaps or overlaps. The Modern Index Strategy enables the construction and monitoring of portfolios in a cohesive and complete manner, avoiding benchmark misfit and uncompensated risks. At the core is MSCI's index methodology, which provides consistent treatment across all markets and ensures best practices in investability, replicability and cost efficiency.

The chart below shows MSCI's Market Cap Indexes.

MSCI ACWI & FRONTIER MARKETS INDEX										
MSCI ACWI INDEX						MSCI EMERGING & FRONTIER MARKETS INDEX				
MSCI WORLD INDEX			MSCI EMERGING MARKETS INDEX			MSCI FRONTIER MARKETS INDEX				
DEVELOPED MARKETS			EMERGING MARKETS			FRONTIER MARKETS				
Americas	Europe & Middle East	Pacific	Americas	Europe, Middle East & Africa	Asia	Americas	Europe & CIS	Africa	Middle East	Asia
Canada United States	Austria Belgium Denmark Finland France Germany Ireland Israel Italy Netherlands Norway Portugal Spain Sweden Switzerland United Kingdom	Australia Hong Kong Japan New Zealand Singapore	Brazil Chile Colombia Mexico Peru	Czech Republic Egypt Greece Hungary Poland Qatar Russia South Africa Turkey United Arab Emirates	China India Indonesia Korea Malaysia Pakistan Philippines Taiwan Thailand	Argentina	Croatia Estonia Lithuania Kazakhstan Romania Serbia Slovenia	Kenya Mauritius Morocco Nigeria Tunisia WAEMU ²	Bahrain Jordan Kuwait Lebanon Oman	Bangladesh Sri Lanka Vietnam
MSCI STANDALONE MARKET INDEXES ¹										
				Saudi Arabia		Jamaica Panama ³ Trinidad & Tobago	Bosnia Herzegovina Bulgaria Ukraine	Botswana Ghana Zimbabwe	Palestine	

The full listing is a fascinating study and can be viewed at: <https://www.msci.com/market-cap-weighted-indexes>

6.2.7 Measuring Risk when Reporting

Sharpe Ratio

The Sharpe Ratio puts the portfolio return in the context of risk, risk free returns and variability in portfolio performance

$$\text{Sharpe Ratio} = \frac{r_p - r_f}{\sigma_p}$$

r_p This is the return on the portfolio

r_f Risk free return (T-bill return)

σ_p Standard deviation of portfolio returns

Sharpe ratios help determine whether higher return is an outcome of superior fund management or whether it is an outcome of excessive risk taking.

The same return with a lower risk profile is superior than if risk profile were higher. A higher Sharpe Ratio indicates that the portfolio performance is good in a risk adjusted context. A lower Sharpe Ratio indicates that the portfolio performance is not so good.

A portfolio with a negative Sharpe Ratio indicates that the investor is better off investing in Risk Free Securities. Sharpe Ratio thus provides a common basis for comparing the performance across different fund/ portfolio managers.

Information Ratio

- The IR compares portfolio performance in relation to a benchmark for portfolio performance
- Most portfolio performances are measured against a benchmark:
 - The IR converts it to a risk sensitive measurement by measuring tracking error and bringing it into consideration

$$\text{Information Ratio} = \frac{r_p - r_i}{SD_{p-i}}$$

r_p	This is the return on the portfolio
r_i	Return available from benchmark
SD_{p-i}	Standard deviation of portfolio returns from benchmark returns

A Fund Manager with a higher IR achieved better risk adjusted returns than a Fund Manager with a lower IR and same returns.

6.2.8 Client Classification

While on the topic of risk it should be noted that all clients have to be classified as shown below:

RETAIL	Generally speaking: the average consumer: no financial knowledge or experience	Offered the maximum consumer protection of every kind: <u>handle carefully</u>
PROFESSIONAL	May have either financial knowledge or experience or both;	Offered only some protection of every kind: handle carefully
COUNTERPARTIES	Large financial institutions, brokerages or other industry <u>organisation</u> .	Has to look out for itself. In dealing with them we are entitled to assume they know how to look after themselves

In EU this rule is captured in MiFID. In USA this rule is captured in FINRA Rule 2111.

6.3 Key Learnings

At the end of this chapter one should be conversant with the following fundamental concepts:

- Portfolio Performance - how valuation of investment portfolio is done and various approaches in the valuation.
 - Basic Valuation approach
 - Net Asset Value
 - Market Cyclicity
- Analyzing fund performance - A fund's performance is analyzed by comparing to its appropriate benchmark
- Risk free return - in a given market that would be a loan to the government
- Risk & Return in an economy
 - Beta
 - Alpha
 - Alpha for a diversified fund
- Indexes - An Index of the markets can tell something about what is happening in the market: and by extension in the economy.
- Building and index and index process
- Mapping indexes to fund themes
- Major indexes of the world
- Measuring the risk while reporting
- Client Classification

6.4 Test your understanding

1. The correct benchmark for the risk free rate in a market is the return provided by _____.
 - a. Government securities in the short term
 - b. The entire securities market
 - c. Bank fixed deposits
 - d. Mutual funds

2. Whatever happens to the market _____.
 - a. Will happen to a portfolio
 - b. Can be diversified away
 - c. Can be avoided even if we are invested
 - d. None of the above is true

3. A portfolio comprising the whole market offers returns that represent _____.
 - a. Alpha
 - b. Beta
 - c. Gamma
 - d. Theta

4. Which of the following is a valid statement?
 - a. Highly diversified portfolios offers better returns
 - b. Concentrated portfolios offers better returns
 - c. Highly diversified portfolios are more risky
 - d. Concentrated portfolios are less risky

Chapter Overview: Portfolio Performance and Management

This chapter will help the participants get an overview of the business perspective of Wealth Management. We will look at how a day's work flow proceeds right from the advisor procuring the order to generating performance reports at the end. We will know about the complete client on-boarding process in brief. We will also learn about client reporting and Channel Management. At the end we will have an overview on data management.

7 Business Perspectives

7.1 A Day in the Life Of ...

The following simplified workflow/storyline helps us focus on the key issues in Ops related tech issues in Wealth Management.

- A. The Advisor establishes contact with the customer
- B. Profile the customer's suitability; expose product portfolio
- C. When ready, Advisor will ask client to complete documentation.
 - Account opening documentation is needed for:
 - i. Bank Accounts
 - ii. Securities Accounts
 - iii. Broking Accounts
 - Investment Authorization Forms
 - i. Instructions to be made by broker on behalf of client to other service providers
 - ii. Risks, force majeure, best efforts
 - Investment Disclaimers:
 - i. Investments are subject to risks; read documents carefully...
 - KYC & AML Standards
 - i. Checks for completeness of Identity
 - ii. Screening of names against watch lists
- D. Fund the bank account
 - Make the Investment Decision
 - i. Direct Investment
 - ii. Menu of Funds (Managed Portfolios)
 - iii. Menu of Strategies (Managed Accounts)
 - Execute the Decision
 - i. Funds Transfers
 - ii. Investment Forms
 - Receive Confirmations
 - i. From the Exchange
 - ii. From the Fund House
 - Reformat all documents to our bank formats
 - Release Holding Statements in Bank format
- E. Track for performance
- F. Generate Performance reports with appropriate benchmarks

7.1.1 High Level View

Given the various requirements in relation to Wealth Management (esp. reporting) the following four record-types are crucial in fulfilling various needs:

Client Master

The client master, esp. the Client ID will be an important field to capture in various databases to ensure that the records relating to a particular client can be retrieved as needed

Securities Master

Security Identifier is important in correct identification of the security; and extracting the price and other data available from various sources.

Account Statements

These, from banks, depositories, custodians, fund-houses etc., should reference to the Client ID and will be important in reconciling holdings and reporting on performance

Transaction Data

Under a Client ID, ALL transactions need to be stored in one database so that transactions can be reconstructed as needed. This is for regulatory, reporting, valuation and other purposes. Including Cost Basis reports.

In some cases, RECORD must be available even for a few years AFTER a transaction is completed. For KYC/AML for 5 to 7 years AFTER an account is closed, too.

7.2 Client Onboarding

This sets up the Client Master.

The Client Master is the first to be set up as soon as a client is on-boarded. It contains static information about the client such as contact details. It also captures commercial terms of trade which too would be considered as static data.

Static data can change for instance when a customer shifts office or terms of trade are re-negotiated. The maintenance of client master data is important from a relationship management perspective; But also from a compliance perspective as all organizations must have up-to-date information on their clients under the current international anti-money laundering standards.

Clients need to be screened for Anti Money Laundering requirements.

There are multiple databases of Banned persons which need to be referred.

Each country has its own list and sometimes a bank may have to check for each country:

- Client based in UK - check UK list
- This client trades in US - check US list.

Such challenges can only be met by technology and this is already being deployed in a big way in banks. Tracking many of these risks in a large bank is complex. Nowadays, AML software can be put to work. Suspicious Transactions are thrown up and listed by the system for review by Risk Managers. Software can also track transactions of customers put on a watch list. OFAC Analyzer software also allows you to search OFAC designated persons/entities.

7.2.1 Master Records resulting from Client Onboarding

A. Client Master

- Client personal particulars
- (name, address etc.)
- Account details
- Operating authorizations
- Client billing plan:
 - *Advisory*
 - *Advisory + execution*
 - *Discretionary*
- Client classification
- *(associated permitted product range)*
- Client Mandate related permissions
- Nominees on the accounts
- Reporting requirements & periodicity

B. Fee Master

Client billing plans Fee table capturing:

- Advisory Fees
- Transaction Fees

If these are based on automatic operational rules related/ linked to slabs of AUM/ volume traded etc. then those rules need to be captured in the operating rules by which this Fee Master is applied to clients.

Client Master and Fee Master have to mapped to each other at onboarding.

Onboarding approved service providers - particularly Funds

Onboarding a Fund is likely to have similar features compared to an institutional onboarding. Apart from certain aspects which are common like for account master data and KYC / AML, standing settlement instructions are important.

If such empanelment is done by the IB group within the bank then these processes are handled by them. If they are empaneled by WM / PB which is often the case then the details have to be captured here.

7.2.2 Operational Processes

The decision to invest in a particular option is the outcome of an advisory process. Within the advisory process is the mandate for investing indicating

- Preferences
- Instructions
- Selections

Buy/ Sell decisions result in flows to and from specific funds of specific fund houses.

At Investment: money leaves the client account and goes to the fund house. The fund house should issue units / shares to the investor. This holding should get reflected in an updated holding statement.

At Disinvestment/ Withdrawal of Funds: units/ shares leave the account of the investor. The fund house cancels the units/ shares and releases cash. This should get reflected in an updated bank statement.

A holding statement would look as follows:

<i>Holdings</i>	<i>Units Held</i>	<i>Value at investment</i>	<i>Value at Date</i>
<i>Fund A</i>	XXXX	XXXX	XXXX
<i>Fund B</i>	XXXX	XXXX	XXXX
<i>Fund C</i>	XXXX	XXXX	XXXX
<i>Fund D</i>	XXXX	XXXX	XXXX
<i>Total Invested</i> →		XXXX	XXXX

The difference between value at investment and value on a given date is “performance” of the investment.

7.2.3 The Systems / IT Perspective in Developing the above report:

The following are key data in relation to a Fund:

- Central Index Key
 - CUSIP
- Plus
- Series ID and/ or Class ID
 - National identifier of other country (if non-USA)
 - Currency
 - Amount to invest

It is important to correctly identify:

- The Fund
- The Series (Growth, Income etc.)
- The class of share (Class A, B, C)

All three together positively identify a particular investment the client wanted to make.

A. Source of Data for Holdings & Units Held

Account Statements received from respective Fund houses have to be tagged to Client ID. This data is to be re-purposed for generating the kind of statement shown below on our bank Masthead.

B. Source of Data for Units Held & Value at the time of Investment

Transaction Data and Internal Accounts contain this information. We need to be able to verify the statement received from external sources with our own record of the transactions done and internal balances. Reconciliation between Account Statement and Transaction Data is needed. Value at Investment date is available from Transaction Data.

C. Source of Data for Value at Today's Date

Securities Master and Market Data are important to generate this. Market Data: NAV - changes every day. Using Securities Master the Market Data is to be sourced from SEC or other authoritative source. (feed from Fund house is inferior to regulatory source; SEC data conforms to XBRL standards).

This is the information which goes into arriving at Value at Date of report. Date of Report and Date of Market Data ought to match. Else, it should be mentioned separately.

7.3 Client Reporting

The following are the observed trends and possible responses in client reporting using technology.

7.3.1 Client-Centric Strategy

There is a migration from account-centric processes to client-centric processes, applications, and data, allowing an integrated service model. The trend is leading to a single 360-degree dashboard view of the relationship across accounts and products.

The realization is that we need to present what client needs in the client report rather than what we are able to get or organize easily. The challenge is to get data that services client needs from the different sources and present them in a single cogent view.

7.3.2 Institutional Client Reporting Setting the Tone

Asset management providers require sophisticated valuation, quarterly investment performance statements, and trustee, consultant, and intermediary reporting/statements that can balance personalization and scalability.

We need a Client-centric approach to reporting in situations similar to wealth management exist in Asset Management industry. The problems have been addressed/ solved elsewhere/ before. Risk and performance data must be pulled from disparate underlying systems, coupled with customization (e.g., financial commentary, etc.) and the reports must be generated efficiently through workflow/content management (e.g., fund manager, legal, and compliance sign-off, etc.)

7.3.3 Increasing Product/Services Breadth and Complexity

Today, the marketplace is made up of complex proprietary and third-party products, including overlay portfolio management, Unified Managed Accounts, alternative investments, detailed views into asset allocation and investment strategy (net/gross of fees) at the supra/sub-asset class/portfolio level, including corresponding products with detailed portfolio analytics and managed due diligence.

Sources of data are more and complex. Data have to be massaged and presented in different ways. IT needs to be able to handle more and different formats of incoming data.

7.4 Channel Management

Firms rely on the use of client segmentation—based on AUM, client behavior, and personalization—and tiered services through multiple channels, such as online, advisor, and call center, to deliver customized service offerings to clients.

Aggregated data / reports / profitability will require to be reported on the basis of channel from which the client was acquired and is managed.

Data has to be collected. But it also has to be further manipulated in order to present internally in a different manner for Management Reporting.

Data Management/Data Aggregation

The trend is toward the reliance on centralized, reconciled, trusted enterprise data, such as client information across multiple processes and applications, to allow process automation, enforce business rules, and ensure data integration.

Given the varied sources of data it is but logical that the organization would prefer to have an internal gold standard of data.

As noted before: Ability to handle more and different formats of incoming data.

7.4.1 Consolidated Financial Advisor (FA) Desktop

The industry is moving to a single, integrated FA workstation that supports end-to-end workflow across the wealth management value chain, from client profiling, investment planning, and investment management to client report/review generation.

The client facing relationship manager also has expectations and requirements from a client management perspective. The data may be the same but use case scenarios and expectations are different.

Source is the same gold standard data. Different user and presentation is needed.

7.4.2 Performance Reporting

In order to adapt to specific asset classes, firms are providing differing performance characteristics, with hedge funds and private equity firms leveraging the Internal Rate of Return (IRR) and the rest of the industry largely computing performance returns at the account level on a monthly basis using the Modified-Dietz method, with daily calculation, when necessary, to deal with significant (>10% of accounts) cash flows. Some organizations are launching initiatives to give them the capability to calculate daily returns for compliance with Hedge Fund rules. In the same time horizon, some firms are seeking the ability to deliver security-level returns.

Transaction Data and Market Data once captured, have to be processed computationally in order to be able to produce performance reports.

Organizations that have attempted to move to daily computation have been constrained not only by the volume of additional computation, but also by data scale, quality, and functional constraints imposed by their portfolio accounting and other upstream systems.

7.4.3 Increased client expectations

Clients and their interested parties are demanding higher service levels and a consistent experience across channels, and those with higher asset levels are in a position to demand more. Institutional/ultra-high-net-worth (UHNW) clients are driving sophisticated reporting needs, and the segments below them gradually adopt similar behaviors and expectations.

Newer technology platforms have brought customers new experiences borne out of other industries like entertainment.

The financial sector has to keep pace else will be viewed poorly by the customers.

This challenge can be expected from financial advisors/ relationship managers etc. as well.

While integrating more range of products from an array of sources, we also have to make them available in newer platforms.

The data formats and sources from the back end supporting systems may need to be transformed to be compatible with front end requirements.

7.4.4 Regulatory and Compliance Issues

Firms have an increasing obligation to maintain client data and reports, in compliance with the Investment Advisers Act of 1940 (Rule 204-2: seventeen separate reports, GIPS standards, Know Your Customer (KYC), and data integrity trends including the Patriot Act and SOX).

While there can be choices and debate about client requirements there can be no discussion about compliance requirements.

Transaction Data have to be maintained well beyond the transaction date, period or reporting date. Master data and transaction data often have to be maintained up to 8 years after closure of client account.

The basic sources of data for effective client reporting are:

- Account Statements
- Securities Master
- Market Data
- Client Master
- Transaction Data

These data sources need to be steam cleaned to achieve “gold standard”. A gold standard data set allows the bank to produce reports as needed.

7.4.5 How Account Statements can be dealt with

Account statements are received in two possible forms:

- Electronic formats
- Physical forms

The statements come from:

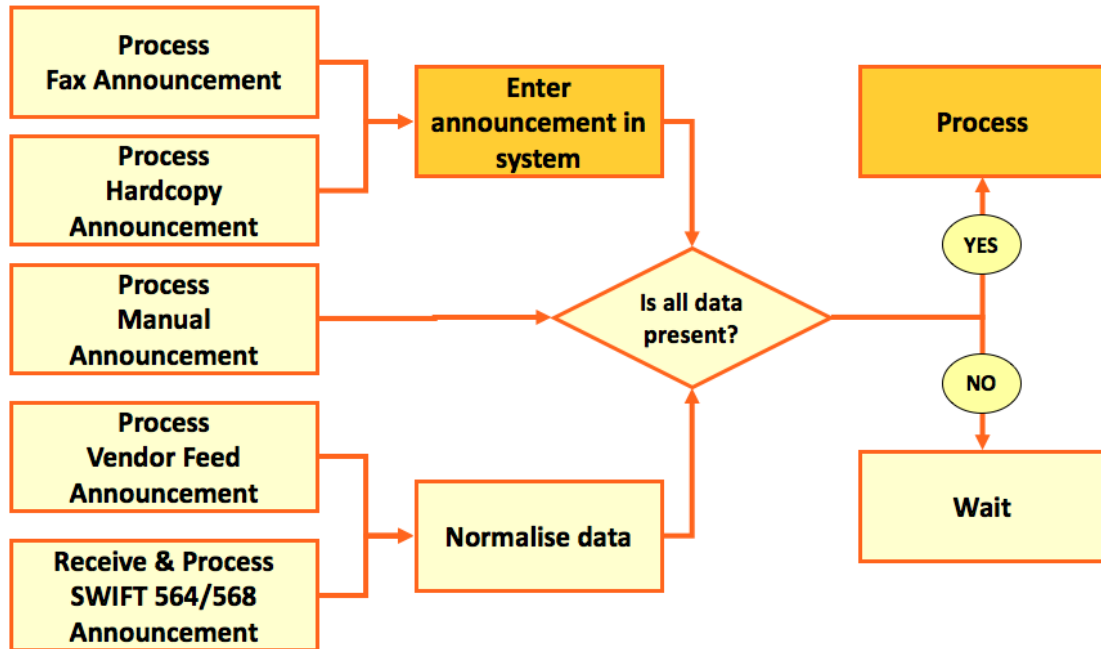
- Custodians
- Depositories
- Fund Houses
- Asset / Investment Managers
- Banks

Electronic Formats have to be harmonized to a common electronic format. The physical forms have to be converted to electronic form.

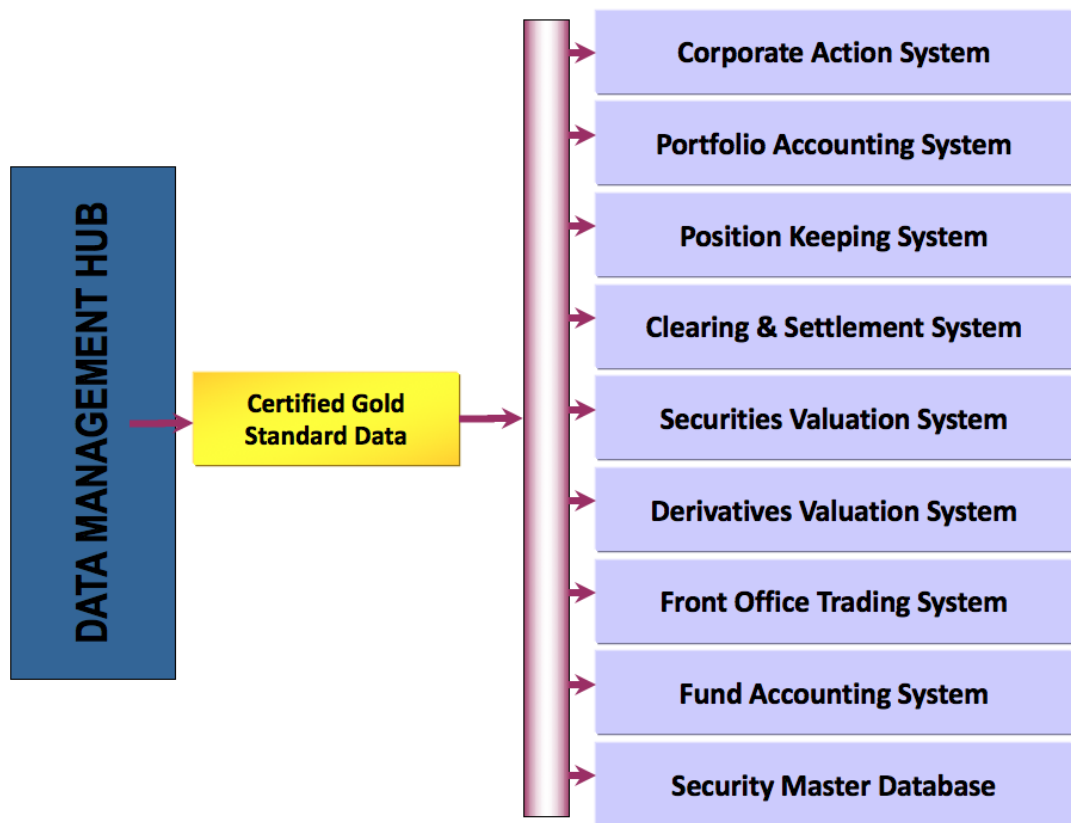
Account Statements have to be digital, consistent. The organization needs Middle-ware to manage data formats and inconsistencies.

7.4.6 Data management Hubs

This middle-ware has the following structure and workflow:



Once the Gold Data Set is achieved, it can be applied for a number of uses:



7.5 Key Learnings

At the end of this chapter one should be conversant with the following fundamental concepts:

- A simplified work flow of WM advisory.
 - The Advisor establishes contact with the customer
 - Profile the customer's suitability; expose product portfolio
 - When ready, Advisor will ask client to complete documentation.
 - Fund the bank account
 - Track for performance
 - Generate Performance reports with appropriate benchmarks
- High level view of the record types
 - Client Master
 - Securities Master
 - Account statement
 - Transaction Data
- Client on-boarding
 - Client Master
 - Fee Master
- Operational processes
 - At investment
 - At disinvestment
- The Systems / IT Perspective in Developing a report
- Client reporting - This involves the following steps
 - Client centric strategy
 - Setting the tone for Institutional Client reporting
 - Increasing product/services breadth and complexity
- Channel Management - this includes performance reporting and regulation & compliance
- How account statements can be dealt with and the data management hub.

7.6 Test your understanding

1. In context of wealth management offerings, Seamlessness implies _____.
 - a. Ability to move from one asset class to another without complicated transaction documentation
 - b. Ability to access an unanticipated service without too many problems
 - c. Both A and B
 - d. None of the given options
2. In context of Wealth Management customer documentation, the purpose of including the Terms of Business in Client Onboarding documentation is _____.
 - a. To communicate clearly and fairly information needed by the client
 - b. To communicate the services to be provided
3. A Gold standard Data set has which of the following?
 - a. Account Statement
 - b. Securities Master
 - c. Market Data
 - d. Client Master
 - e. Transaction Data
 - f. All the above
4. Asset Servicing does not include which of the following:
 - a. Flow of benefits
 - b. Buying of Securities
 - c. Notification of Events
 - d. Ensuring action by the investor
5. Actions that an Issuer takes which affect the rights of an Investor are defined as
 - a. Buy Back
 - b. Corporate Action
 - c. Asset Servicing
 - d. None of the Above
