Cyber-security: Fear This, Not That

Is the New Emerging Market a City?

The Next Stage in the Growth of ETFs

Collaboration is Driving Australia’s Pension Sector Change

J.P.Morgan
For good reason, cyber-security remains a top-of-mind concern with nearly every company these days. The public and private sectors continue to allocate their best energies around this critical topic, and the sharing of insights is often welcome. In the second part of this issue, we bring together some expert ideas in regard to preparedness for countering cyber-threats.

Also here is an interesting proposition raised by our Global Cities Initiative that asks what if the next emerging market wasn’t a country or even a region, but a city? It’s a concept worth examining on many levels as globalization changes all the rules.

The balance of our issue sheds light on various regional topics, including offshore liquidity in Hong Kong, the sweep of pension change in Australia, the evolution of U.S.-based exchange-traded funds and considerations for European securities clearance.

These are some of the subjects we’re focused on today, but we’d like to learn more about your interests. What information can we write about in future issues that might support your business needs? Our dedication is to you, the client, and for that I once again offer the breadth of our firm-wide resources. Please contact your relationship manager if you have suggestions.

And, as always, thank you for reading Thought. Please know that your questions and comments are always welcome and may be sent to thought@jpmorgan.com.

Carlos Hernandez
Chief Executive Officer
J.P. Morgan Investor Services

“Our dedication is to you, the client, and for that I once again offer the breadth of our firm-wide resources.”

Thinking OUT LOUD
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"Take a moment to understand the hazards and how your organization is dealing with them. Make sure you know who your go-to security, risk and control people are, and engage them."

Anish Bhimani  
Chief Information Risk Officer  
JPMorgan Chase & Co.

Cyber-security: Fear This, Not That

If you’re an executive in the finance industry, you’re probably used to the question: “what keeps you up at night?” For those of us who work in technology risk, a more common question is, “when do you sleep?”

As a practical matter, nobody can worry about every threat our businesses face at once. We must focus on the threats that matter most, and more specifically, the aspects of certain threats that we can control. Thinking deeply and fully about these threats is the job of your top risk, security and control officers. So if you don’t work in risk, security or control, but you still oversee offices or assets or entire organizations, what is your responsibility?

I’m a strong believer that your responsibility is to understand what to fear and to do so strategically. To put it another way, crisis communications expert Peter Sandman has stated that “Risk” is equal to “Hazard” plus “Outrage.” This is especially true in the information technology (IT) security field.

We are inundated with headlines about hackers, threats from nation-states, insider risks and frightening data breaches. The outrage is steep; but are the topics that generate this outrage necessarily a response to a true hazard? And if not, what are the real hazards? Getting past the outrage, then, and gaining a deep understanding of legitimate fears—thus the real risk your business faces—is where I believe you should put your energy.

According to a 2012 study conducted by Verizon, in 855 data breaches they examined, 71 percent occurred in businesses with fewer than 100 employees.¹

Talk to each other

Open communication is essential to understanding what to fear, and when to put action and weight behind initiatives to remediate a threat. If you don’t already have a strong and regular dialogue with the IT security experts in your organization, start today. Ask them what they see as the biggest threats you face, and the actions necessary to provide greater security and control.

There is another side to asking these questions: gaining a greater understanding of the security landscape yourself. Many in the
IT security field take for granted that their terms aren’t used in the greater business community. If you don’t know how firewalls work, ask. If you don’t understand what your risk officer means when she says “sandbox,” “SQL injection” and “white list,” ask. Don’t be afraid to ask questions if you don’t understand—the real hazard lies in not knowing what’s going on.

The internet of things
A lot of recent headlines have been devoted to fears revolving around what many call the “internet of things,” shorthand for the many objects in our environment that are now interconnected through web and wireless capabilities. These objects—everything from cars to HVAC systems to pacemakers—have been the subject of great outrage and speculation on how they could be turned against us in a cyber-attack. These threats are real, and in an age where nearly everything we touch involves technology, this speculation can lead to more than a little paranoia.

We also know that having this interconnected world provides great advantages. In today’s workplace, we can stay at home and have face-to-face conversations with our counterparts across the globe. Chat functions, mobile devices, teleconferencing and the way we control our home and work spaces have changed and made work easier and more accessible.

So, how best to balance a healthy dose of fear with a realistic view of our modern workplace? It’s perhaps best not to fear the interconnectivity itself, but rather, whether the right people have access to the right pieces.
Candid Thoughts from a Security Expert: An Interview with General Michael V. Hayden

Last November, J.P. Morgan Investor Services hosted its 5th Annual Chief Information Officer Summit in New York. The keynote speaker was General Michael V. Hayden, a retired four-star general who served for 40 years in the United States Air Force. He is also the former Director of the Central Intelligence Agency, the former Director of the National Security Agency and widely considered to be a global expert on security matters. Following his riveting presentation at the J.P. Morgan event, General Hayden offered this interview with Thought.

Focus on hygiene

Hygiene is one of those sterile words that security professionals like to use as a catch-all for remediation, updates and other activities that we should obviously be doing every day to enhance IT security.

It’s easy to get lost in the outrage generated over the last big data breach, and it’s just as easy to get lost poring over details of the many, many small tasks and initiatives that constitute IT hygiene. But it is absolutely imperative, if you want to remediate the risk of that big data breach, to keep a strong focus on hygiene.

“So if you don’t work in risk, security or control, but you still oversee offices or assets or entire organizations, what is your responsibility?”

Again, open dialogue and clear reporting from your IT risk, security and control teams are essential. Are they staffed and funded properly to deal with what is required for this basic hygiene? Do you have the proper systems of updating, patching, tracking access and assets? These are all essential questions related to hygiene that are worth your worry.

THOUGHT: What sort of measures would you say are essential prerequisites for companies to prevent cyber-threats?

HAYDEN: The first issue is simply awareness that cyber-space is a dangerous domain and if an enterprise chooses to take advantage of the incredible opportunities that it presents, it also must take care to protect itself. Cyber-defense is not a subtraction from the bottom line. Rather it is an integral and essential element in creating the top line.

THOUGHT: If you were newly in charge of cyber-security at a financial institution, what would be your first priority?

HAYDEN: My top priority would be to ensure that I had (or would soon develop) a “God’s eye” view of enterprise IT. Since cyber-security requires active response rather than static defense, I need a single place to visualize, operate and secure my IT space.

THOUGHT: Can financial companies adequately protect themselves against cyber-threats without devoting significant expense and human resources to security?

HAYDEN: There is no doubt that investment will be required,
Finally, listen

J.P. Morgan recently welcomed Richard Clarke, former National Coordinator for Security, Infrastructure Protection, and Counter-terrorism in the United States, to discuss IT security with our employees. In talking about how companies can do a better job of listening to their staff, he made a reference to Greek mythology: Cassandra, the woman gifted with the ability to see the future while, at the same time, cursed with the fact that nobody would believe her.

Mr. Clarke suggested that we need to continue to find better ways to listen to the Cassandras within our organizations. In essence, he said you should be more afraid that you’re not listening to someone trying to tell you about a problem, and less afraid that nobody is raising issues in the first place. Yes, every organization has its Chicken Littles—but every organization has its Cassandras as well. Be prepared to hear problems when they come up, and ensure that strong mechanisms exist throughout your organization to allow for thoughtful listening.

The bottom line: you don’t have to be a technologist to be a strong listener and communicator, nor a good student of technology to know security basics.

I encourage everyone, no matter their industry, to simply be a discerning consumer of information when it comes to IT security. Take a moment to understand the hazards and how your organization is dealing with them. Make sure you know who your go-to security, risk and control people are, and engage them. And in the end, adjust your outrage accordingly.

THOUGHT: At J.P. Morgan’s event, you spoke about the importance of consequence management for businesses today. What are some investments in this area that are proving to be successful?

HAYDEN: A determined attacked will get in. You have to accept that as a given. But that does not necessarily spell defeat. Successful cyber-defense allows you to operate while penetrated, to survive while under attack. That requires overall network resiliency, a high degree of self-awareness and an overall defensive scheme that wraps the most precious data and information more tightly within the network.

THOUGHT: In your opinion, should every major financial institution have a cyber-security expert on their board of directors? If so, why?

HAYDEN: Board expertise and interest in cyber-security is now recognized as an essential part of any baseline for diligence. It is also a signal inside and outside of the enterprise that the issue is taken seriously and that corporate leadership will be measured on it.

THOUGHT: What are some of the more successful measures firms are taking to mitigate risk?

HAYDEN: Current best practices invest sufficiently in patching vulnerabilities but also operate on the presumption of breach—regardless of defensive measures, some attacks will get through. And here is where resiliency separates the A from the C or D players. How quickly is the breach identified? Characterized? Isolated? Negated?

THOUGHT: How important is cyber-security insurance right now? Do you foresee growth in these kinds of insurance products going forward?

HAYDEN: Cyber-insurance is a new but fast growing industry. Insurance firms are developing measures to help firms deal with risks to IP, network functioning and even loss of personal information. And along the way they are setting standards and demanding best practices that improve overall cyber-security.

THOUGHT: How important is cyber-behavior from their national regimes that permit, enable or (in some cases) conduct aggressive cyber-behavior from their national domains.

HAYDEN: Government is truly working this issue hard with many good people. But government (and especially the U.S. government with its particular sensitivity regarding personal privacy) will be late to need, and enterprises will have to assume significant responsibilities for their own defense. Enterprises should push for more (and more rapid) information sharing by the government and for more security clearances for key personnel. They should also push government to use its diplomatic tools against regimes that permit, enable or (in some cases) conduct aggressive cyber-behavior from their national domains.

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What if the next emerging market were not a country but a city? Globalization, as seen through a more granular, sub-national perspective, has implications for how cities define their roles and their paths to economic growth. Such a lens also has relevance for how investors view and assess emerging markets.

“Cities must have a global view—along with a metropolitan, regional view—if they want to succeed in today’s global economy,” says Brian Finch, executive director of the Global Cities Initiative at JPMorgan Chase. “The same holds true for institutional investors,” said Finch. “They should increasingly think of global markets in terms of metropolitan regions, not just nation states.”

Urban areas are driving global economic growth. Today, the world’s 300 largest metro areas hold just 19 percent of the globe’s population yet contribute 48 percent of its GDP. The largest 600 cities are projected to inject $30 trillion into the world economy by 2025. Urbanization has forged megacities like Shanghai, Manila and New Delhi with populations exceeding 20 million, including their surrounding metro areas. Business and investment leaders understand that urbanization is rapidly changing the world’s demographics and, in turn, redefining the traditional notion of what constitutes growth markets.

Redefining the role of local economies

To harness the opportunities of globalization, cities and their leaders are increasingly coming to see that they must expand their traditional roles. This evolution of consciousness involves redefining what it means to be a global city. That term traditionally has been associated with financial centers like London, New York, Paris and Tokyo. Today, it’s starting to be used more widely to describe the many cities—small, medium and large—that are building on unique strengths and assets to expand their local economies through increased trade and investment with the rest of the world.

This thinking is the foundation of the Global Cities Initiative, a joint project of Brookings and JPMorgan Chase, which encourages city and metropolitan area leaders to engage internationally to grow their regions’ economies. In many ways, this shift toward global is bringing cities back to their historical role as centers of trade and commerce.
Cities in Motion

Cities in the Global Cities Initiative network are taking action to increase their global economic competitiveness. Some examples are:

- **Mexico City** and **Chicago** recently announced a Global Cities Economic Partnership to formalize and expand economic cooperation. Building on their existing Sister Cities cultural relationship, the agreement commits the two cities to work together to expand exports, foreign investment, a skilled workforce and research endeavors. The agreement, which also calls for cooperation in tourism, culture and water resources, was developed with assistance from the Global Cities Initiative.

- **Houston** employers in the energy sector report a shortage of middle-level skilled workers to fill needed positions—a challenge Houston sees as an impediment to maintaining its high rate of economic growth. A group of public and private stakeholders, led by the Greater Houston Partnership and catalyzed by the Global Cities Initiative, have convened a Regional Workforce Task Force to consider ways to strengthen the region’s workforce readiness system.

- **Atlanta** regional leaders led by Mayor Kasim Reed have recognized that to continue Atlanta’s job growth and overall success, they must help small- and medium-sized companies look outward and tap new international markets to drive sustainable job creation. As part of the Global Cities Exchange, regional leaders are developing a dedicated strategy to help more firms become new exporters and assist current exporters in finding new markets.

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**Data indicators help metro leaders**

Through new research, the Global Cities Initiative is supporting cities in a self-assessment process. “Cities and their metro areas are the new unit of global competitiveness. In order to help them understand their competitive strengths, they need to have data at a metro-based level,” says Finch.

New research is providing select metro areas with customized insights on their position in the global economy and on global engagement indicators such as exports, advanced manufacturing, aviation connectivity and the use of highly skilled immigrants in their respective metro areas. Other research is helping local leaders think about their investment in infrastructure so that companies doing international business can move their people and goods more efficiently and effectively.

**Achieving global fluency**

The concept of global fluency, introduced in the Global Cities Initiative 2013 study, “The 10 Traits of Globally Fluent Metro Areas,” provides a way to understand the arc of development that cities must travel to achieve success with global commerce. **Global fluency** is defined as the level of global understanding, competence, practice and reach that a metro area exhibits in an increasingly interconnected world economy.

The path to fluency involves three stages:

1. Gaining global awareness
2. Shifting to a global orientation
3. Becoming globally fluent

“There is a hunger for city leaders to be more deliberate in the ways that their regions engage with the rest of the world.”

City leaders are increasingly looking to each other for guidance and assistance in pursuing global engagement strategies. The Global Cities Initiative is one such learning network that is helping to support and encourage the work of metro leaders in cities around the world.

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**Brian Finch**

Executive Director, Global Cities Initiative JPMorgan Chase & Co.
This transformation, which can take decades to achieve, supports a city’s progress toward a desired economic future and an ability to influence and control its destiny, to become more competitive and to sustain an economic position. The more fluent a city, the better it can benefit from globalization while managing its challenges.

The 10 Traits study also identified strong determinants of a metro area’s ability to succeed in global markets and to better secure its desired economic future. Based on a review of 42 U.S. and international cities, the study reveals that strategies toward attaining global fluency vary based on a region’s distinguishing economic, political and geographic characteristics. The report offers a new framework for cities to assess how they are positioned in the global economy. As a first step, cities must know the strengths and weaknesses that define their global position.

A framework for awareness and action

As part of the Global Cities Initiative, Brookings and J.P. Morgan are helping cities take this first step by bringing together urban leaders to help them understand their position in the global marketplace. Forums are convening government, business, civic, university and nonprofit leaders to discuss how they might collaborate to make local economies more effective. “With fewer government resources available, it’s more important than ever that the public, private and nonprofit sectors work together to advance important economic development initiatives in our cities,” says Finch.

One finding of the 10 Traits study is that it takes intentional actions and strategies toward attaining global fluency.

More on the Global Cities Initiative:
An Interview with Chairman Richard M. Daley

Richard M. Daley served as mayor of Chicago for more than two decades and is credited with overseeing that city’s transformation into a prominent player in the global economy. Today, among his many activities, he serves as chairman for the Global Cities Initiative. Thought asked for his perspectives on the opportunities that the program offers.

THOUGHT: Why does the Global Cities Initiative find global engagement so important for the economic growth of cities?

DALEY: The Global Cities Initiative is helping cities and metropolitan regions to overcome a new 21st century reality: all over the world, cities and metros are now competing to attract residents, businesses, tourists and capital. If cities want to survive, local leaders must figure out how to tap into opportunities created by the global economy and compete in this new global marketplace. We already know that cities and metros drive national economies, so we need to ensure that our urban areas are successful—because if they are not, we jeopardize economic growth.

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Richard M. Daley
Chairman
Global Cities Initiative
smart policies to advance a city toward global fluency, and local leadership is critical to this process.

“A country is at essence a network of local and regional economies organized within national borders,” says Bruce Katz, co-director of the Brookings Metropolitan Policy Program and co-director of the Global Cities Initiative. “Local leaders can move the needle to get things done to grow the economy,” Katz said. “Part of the responsibility should be to reach out to the rest of the world as global ambassadors. It is not only the role of national leaders.”

One intended outcome of the Global Cities Initiative is the creation of a worldwide network of reformers who will champion the advancement of metro areas in the global economy through the catalyst of trade and investment. “Local leaders want to be part of a learning network,” says Finch.

As a next step, the Global Cities Initiative will help 28 metro areas in the United States over the next four years to develop regional export strategies and strengthen their foreign direct investment (FDI) plans. The development of exports and cultivation of FDI are ways for metro regions to forge international linkages and rebalance an historical reliance on domestic markets for economic growth. Work will include reaching out to small- and medium-sized businesses to help them learn about and reach new markets.

“We are seeing a lot of enthusiasm for this effort,” notes Finch. “There is a hunger for city leaders to be more deliberate in the ways that their regions engage with the rest of the world.”

**A new lens for institutional investors**

As cities and metropolitan areas increasingly become the new unit of global competition, institutional investors should take note.

Understanding the traits that enable success and how metro areas are executing within this kind of framework may provide a useful lens to assess geographic-focused investment opportunities. This kind of thinking provides an overlay to existing methods for evaluating markets. It also suggests the need for a systematic approach to evaluating cities and their metropolitan areas as distinct markets.

One point is certain: understanding which urban areas are acting on their global competitive strengths can position investors to be early movers in identifying the most promising new markets. **thought**

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**THOUGHT:** In your role as chairman, how are you engaging with metro area leaders to move this initiative forward?

**DALEY:** As chairman, I work with JPMorgan Chase and Brookings to help cities evaluate their local economy, identify their assets and seek ways through which they can better compete in the global economy. We bring together local and regional government, business and civic leaders in various cities to discuss opportunities and challenges for global growth and to connect global cities with each other, so they can work together to find mutually beneficial economic opportunities. Most recently, we announced a new initiative that will help local and regional leaders in eight U.S. cities to create export plans.

**THOUGHT:** Why should institutional investors pay attention to cities as emerging markets?

**DALEY:** Almost all over the world, cities are not only growing, they are also increasingly acknowledged as the drivers of national economies. For the first time ever, the majority of the world’s population lives in cities, and the global urban population is expected to grow significantly over the next several decades.

Cities are also centers of commerce—the places where the majority of business is transacted. In the United States, Brookings’ research as part of the Global Cities Initiative shows that metropolitan areas are responsible for a vast majority of the nation’s growth in GDP. As engines of growth and to keep pace with global competitors, many cities are ripe with opportunities for new sources of capital investment: real estate development, physical infrastructure modernization and expansion, and exports.

**THOUGHT:** What investment opportunities do you see for institutional investors as a result of cities globalizing their growth prospects?

**DALEY:** As federal government investment in cities continues to decline—especially in the U.S.—cities must look for innovative financing solutions to support the investments needed to remain competitive. They need to keep pace with investments that cities in other countries are making in their economic growth. This presents great opportunities for institutional investors who are willing to think outside the box to engage in investments like public-private partnerships, innovative bond financing and other creative initiatives. **thought**

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Secured RMB Financing through HKMA’s Cross-Border Collateral Management Service

While Renminbi (RMB) liquidity can be sourced from financial arrangements such as loans or swaps, the repo market provides a standardized and secured means to facilitate access to liquidity in the Hong Kong market. In particular, tri-party repo financing provides important administrative and operational support for the valuation, control and safekeeping of collateral. Tri-party collateral management solutions that support repurchase agreements, or repos, are common in other markets but relatively new in Hong Kong. A repo arrangement offers an alternative and secure means to access offshore RMB liquidity (sometimes also referred to as CNH). Increasing liquidity through secured financing could also be a critical and indispensable component of the successful internationalization of the RMB.

The introduction of the repo market

International financial institutions as well as multinational corporations are increasingly interested in accessing additional RMB liquidity to support their financing and investment activities. Since the secured financing market in Hong Kong is still developing, banks have accessed financing largely through the unsecured inter-bank or the swap market. In Hong Kong, as in other Asian economies, the repo market has remained relatively underdeveloped compared to the more well-established markets in the United States and Europe.

The Hong Kong Monetary Authority (HKMA) has been helping to increase access to secured financing by introducing new products such as cross-border collateral management. This tri-party repo service was launched in 2012 and created a platform to facilitate development of the repo market. Since repos are a fully secured trade arrangement and provide recourse to the associated collateral if the counterparty defaults, they offer the benefit of mitigating counterparty risk more effectively. Thus, they should attract more investors and improve liquidity in the RMB market.

O’Delle Burke
Executive Director, Collateral Management, Asia Pacific
J.P. Morgan Investor Services

“Repos are important for the development of the capital market in Hong Kong and will help to develop a more liquid secondary market.”
Market practices for repos in Hong Kong

While tri-party collateral structures are common in U.S. and Europe, local banks in the Asia Pacific regions are less familiar with tri-party repo models and the operational framework supporting them. The HKMA has helped to establish and promote tri-party collateral management in the domestic market by partnering with J.P. Morgan and other collateral agents. This provides an operational and service model that ensures that collateral supporting repo transactions is properly maintained and that collateral is valued appropriately on a continuous basis.

Similar to other markets where repos are already commonly used, the two principals in the transaction will sign the underlying global master repurchase agreement and set the commercial terms of the transaction for an agreed period. A local bank that is long on RMB cash and wants to use its funds for financing to earn more interest, for example, can lend to global banks or broker-dealers. Financing can be secured by deciding on the amount of collateral required to cover the amount of the repo for the duration of the contract, the type of collateral and how possession of the collateral will be taken in the event of a default.

The collateral agent, the third party in the transaction, ensures that operational practices for the program are managed effectively and in line with the terms agreed upon between the trading counterparties.

The benefits of repos for the participants

The repo program in Hong Kong gives international market participants another option to source liquidity for trading activities in the RMB market, based on a familiar tri-party collateral management program. In fact, one of the key benefits of the program is that international banks or broker-dealers can leverage the securities collateral already lodged with their existing tri-party collateral agent to obtain RMB liquidity. It is expected that ongoing financial markets reform, especially in the context of the new capital regime introduced by Basel III, will provide further impetus to move from unsecured financing to the use of vehicles such as repos for secured financing of transactions.

Local banks lending RMB can also benefit from using the HKMA program, as they are able to access new trading counterparties and can also utilize a new vehicle that may enable them to receive a higher return. Given these benefits, repos are important for the development of the capital market in Hong Kong and will help to develop a more liquid secondary market.

Growing the repo market

The HKMA has taken various steps to enhance the practicality of utilizing the repo program, such as extending the cutoff times for settlement to 11:30 p.m. Hong Kong time. The extended hours allow market participants located in Europe to participate in local Hong Kong trading, further expanding the pool of potential market participants in the repo market.

Further effort is still needed to help local players become familiar with the operational and systems requirements to support repo transactions. By using experienced global collateral agents, the HKMA is helping to spread repo best practices from other markets to Hong Kong.

Increased familiarity with commercial terms common in the repo market by local market participants is important for ensuring more successful trading relationships and market growth. For example, different levels of experience or risk appetite may cause a mismatch in terms of risk parameters, such as collateral haircuts. As such, using common best practices can help ensure that firms do not lose out on potential or existing trading opportunities.

A favorable alternative

Repos provide an alternative for global firms to access offshore RMB liquidity in Hong Kong, and for local banks to increase trading opportunities to lend their RMB deposits. The development of a local repo market is also an important aspect to support the internationalization of the offshore RMB market and further promote liquidity.
Collaboration is Driving Australia’s Pension Sector Change

Nearly 20 years after the introduction of compulsory superannuation—Australia’s defined contribution retirement system—the country’s increasingly mature pension structure has entered a substantial regulatory revamp that, while costly and complex to implement, will set the foundation for one of the most impressive and modern retirement systems seen anywhere.

The Stronger Super reforms present superannuation funds (or super funds) the opportunity to engage with their members via emerging technology and streamlined processes that may soon put superannuation on a usability par with online banking. This evolution is happening faster than many realize and will have radical implications for all industry participants.

The introduction of the SuperStream reforms, MySuper default accounts and the raft of new regulatory body reporting requirements from APRA, the Australian Prudential Regulatory Authority, have driven transparency, costs and efficiency to the forefront. While historically many super funds have competed on the number of products, their ability to maintain strong investment returns and an ever-growing array of ancillary member services, we are now entering a new era whereby super funds are compelled to compete for members more so than ever before. Fierce competition in the industry will be driven by new reporting and disclosure standards that allow members an unparalleled ability to compare and choose among fund offerings.

The first wave of new quarterly APRA reports was delivered in October 2013, resulting in custodians and other back office service providers rolling out a raft of new services to help funds comply with the new regime. These new services are the culmination of months of consultation across funds and industry players to build a suite of solutions designed to help with both the immediate compliance needs of funds, as well as their longer term planning challenges: how to harness the power of new data resources to drive more tailored member insights and, ultimately, how to create even more compelling solutions for members.

Amid this sweeping regulatory change, serious thinking is also being given to how Australians—both pre- and post-retirement—will interact with their Super: how they can better understand their retirement savings options, how they can more directly manage their investments and understand the costs and risks associated with those investment choices, and how these choices impact them when they retire.

Collaboration is key: the new super ecosystem

While the pressure on funds to change the way they interact with members is clear, what most don’t see is the work going on behind the scenes to rethink and reconfigure the technology framework that underpins Australia’s superannuation system.
of government-introduced measures designed to enhance the member administration back office of the superannuation industry, including setting new data and ecommerce standards for superannuation transactions, has set off a chain reaction of changes that goes deep into the operational framework of the system—and it’s this evolution that will underpin the delivery of a new wave of member engagement.

At the forefront of this change is the central role of custodians, which continues to expand and evolve. The aim is to foster a collaborative approach, consulting closely with super fund clients, fund managers, regulators and other third-party service providers to encourage a super ecosystem that will ultimately deliver streamlined, cost-effective and tailored outcomes for members.

One of the most far-reaching developments taking place in Australia is the shift from a vertically integrated environment to a more considered horizontal structure, whereby various service providers are becoming intrinsically linked in their interaction with both each other and the super fund they support. This means all parties are not only considering how new products and services will impact the end client but others in the super ecosystem as well, including member administrators (transfer agency providers), data aggregator vendors, asset consultants, regulators and other government agencies.

Ultimately, the joint goal is to achieve positive and visible member outcomes while making sure the system is as transparent and robust as possible.

Overcoming legacy issues

The transition from legacy networks and fund structures to the new world order is not a simple path. Over the past 20 years, Australia has developed a large and sophisticated superannuation market. Funds have a wide array of valuation policies and tailored product return allocation structures, such as unit pricing and crediting rates regimes, coupled with an ever-changing universe of complex and new security types, asset classes and member option products.

The Stronger Super reporting and disclosure regime is now the impetus to streamline differing data and reporting into a consistent, easily understood, accessible and transportable method through the superannuation system—ultimately allowing the provision of this data back to members in the form of easy-to-understand information about their retirement savings.

However, what sounds simple—reporting at a super fund product level—can be a major challenge for some service providers and superannuation funds, as historically many funds’ operating premise is based on a historical co-mingled asset structure, which means that a super fund’s product assets are pooled or shared for investment purposes. The super fund’s product returns are in many cases derived on the allocation of ownership of units of a whole
defined contribution regime. Across superannuation savings within the empowered to take control of their as members become more for all players in the ecosystem, will have major ramifications rapidly. This substantial element the competitive landscape changing differentiator for all players, with Technology remains a key new, innovative solutions. can work with each other to deliver Stronger Super world and how they services they can offer funds in the super ecosystem: what breadth of looking closely at their role in the technology. Service providers are in terms of both approach and things will be done going forward has meant a major rethink of how new regulatory framework is that it One of the many challenges of the New framework takes shape One of the many challenges of the new regulatory framework is that it has meant a major rethink of how things will be done going forward in terms of both approach and technology. Service providers are looking closely at their role in the super ecosystem: what breadth of services they can offer funds in the Stronger Super world and how they can work with each other to deliver new, innovative solutions. Technology remains a key differentiator for all players, with the competitive landscape changing rapidly. This substantial element will have major ramifications for all players in the ecosystem, as members become more empowered to take control of their superannuation savings within the defined contribution regime. Across industry, corporate, public sector and commercial funds alike, Australia’s Superannuation industry faces an unprecedented opportunity to get the new foundation right for what we believe will be a three-year journey to create a new era of technology-driven, member-focused solutions in Australia’s world-leading retirement savings sector. On the custodians’ side, work is underway with the Australian Custodial Services Association (ACSA), which established an ACSA Stronger Super Taskforce to coordinate the custody industry’s consultative work with APRA and ultimately achieve a similar standardization of transfer protocols among custodians, as well as between custodians and administrators. This is also the case between asset managers and custodians, with the primary aim of driving out unnecessary cost and administrative complexity. While challenging and expensive, the current regulatory overhaul has had the positive side effect of pushing natural competitors together to achieve a truly member-focused, end-to-end reporting and disclosure approach—possibly a world first for a developed defined contribution pension system. 

J.P. Morgan’s Super Efforts

As a large and experienced global player, J.P. Morgan was an early mover in mobilizing a technology response to help clients comply with various Stronger Super requirements, using a combination of locally developed platforms and leveraging our global platforms as well to manage the evolving global regulatory environment. Rather than outsourcing the development of new technology, the firm is building and delivering new solutions through a collaborative effort with both clients and the industry. This involves spending time with clients and partners to ensure the solution built is one that meets their needs and can be responsive to the changing landscape. For example, in June 2013, J.P. Morgan’s technology team invited the Australian Taxation Office’s senior solution architect for standard business reporting and some of Australia’s largest super fund member administrators (transfer agency providers) to talk about the evolving challenges faced by the super administration community, as well as the pioneering work currently underway to develop new technical standards and rules to facilitate gateway interoperability. Under the new SuperStream reforms, work is progressing to select a single gateway service provider to be used by all administrators that will create a single, streamlined protocol by which super funds can transfer member balances and individual account details to each other, all within 24 hours. J.P. Morgan also has developed a Stronger Super Toolkit, a suite of products that will be rolled out in line with the regulatory timetable. These include a due diligence service, known as the Custodial Oversight Library, which assists super funds with the provision of information in response to Superannuation Prudential Standard (SPS) 231 on Outsourcing. Another element is an Enhanced APRA Reporting Service to deal with the investment data aspects of the new APRA superannuation reporting regime which includes ‘look-through’ reporting, as well as a variety of enhanced performance measurement tools.
They are the *sine qua non* for investment managers today. In the last decade, the growth of U.S.-based exchange-traded funds (ETFs) has significantly exceeded every other asset management category. Global ETF assets stand at a record US$2.2 trillion (as of Q3 2013), with more than 70 percent, or $1.56 trillion, invested in U.S.-listed products. Furthermore, momentum does not seem to be slowing; by third quarter 2013, ETFs experienced $130 billion of inflows year-to-date.¹

In the more than 20 years since the product’s inception, ETFs have been used by most managers as a purely passive tool, designed to provide broad market exposure. Though ETFs continue to garner significant flows for this use, continuous product innovation and a steady progression toward value-added strategies have helped fuel recent expansion.

**ETF sponsors are aware that, while there has been healthy advisor usage of ETFs in the last few years, opportunity still exists to grow the market.**

Jason Ronca
ETF Product Executive
J.P. Morgan Investor Services
Today—actively managed ETFs with full disclosure

Some market observers now point to actively-managed products as the next source for new inflows into ETFs. Today, actively-managed ETFs comprise a small sliver of the overall ETF pie; to date, a mere 62 actively-managed ETFs have been launched with roughly $14.5 billion in assets and represent less than one percent of total ETF assets in the U.S. as of third quarter 2013.2

We believe that as actively managed ETFs accumulate more assets they will begin to compete with traditional mutual funds for market share. The most significant driver would be the expansion of active ETFs into new channels and new customers for investment advisors.

The case for an actively-managed product in an ETF wrapper is both simple and attractive: it proves more tax-efficient and cheaper with intraday liquidity. Until now, however, alpha-generating mutual fund shops have been hesitant to enter the space, a fact many attribute to the requirement to provide daily portfolio transparency. Undoubtedly, traditional active managers who attract assets based on their stock-picking capabilities would be averse to unveiling their proprietary research. In any event, it is true that fixed-income strategies have so far been the most successful in an actively-managed ETF wrapper. The front-running of bond trading strategies is not practical and does not expose managers or the funds to such practices.

On the table—new proposals for the SEC

There are a few proposals from asset managers currently before the SEC that, if adopted, would limit the disclosures that ETF sponsors would be required to make. Some propose that ETF sponsors be permitted to disclose their portfolios on a less than daily basis. Others look to limit disclosure to a subset of the overall investment holdings. Each proposal attempts to solve the same challenge of trying to protect portfolio management security selection while providing enough transparency so that market makers can make efficient markets.

One such proposal is Precidian Investments’ patented ActiveShares concept. This proposal utilizes a blind trust between the ETF and the authorized participant seeking to redeem shares. When the redemption is transacted, the ETF would deliver in-kind, high cost basis, tax lots of portfolio securities out of the fund to the blind trust. The blind trust would then liquidate these securities and deliver the cash to the redeeming authorized participant.3

Precidian’s process allows an ETF to maintain a discretionary veil over their portfolio holdings—an attractive option for alpha-generating managers—while realizing the tax benefits associated with in-kind redemptions. In addition to the use of blind trusts for redemptions, Precidian’s proposal only allows creations for cash similar to a mutual fund. An actual intraday net asset value would be disseminated every 15 seconds, which Precidian believes will enable market participants to hedge trading exposures and permit the efficient trading of the ETF shares closely tracking NAV within a range similar to that experienced by existing ETFs. The proposal also provides a small allotment redemption option to allow shareholders to redeem shares at NAV directly with the fund. Unlike existing ETFs that disclose the identity and amount of a fund’s securities, which form the basis for the NAV calculation each business day, ActiveShares would only disclose portfolio investments once per quarter. This would be consistent with the current disclosure requirement for ‘40 Act-registered mutual funds.

Additional SEC filings

Both T. Rowe Price and Vanguard have filed exemptive applications with the SEC to offer ETFs with partial transparency. Vanguard has proposed to release a representative sample of the fund holdings that will track the return of the ETF share class. Vanguard’s application provides statistical evidence that the tracking error between the daily return of the representative sample basket and that of the ETF shares is within the range of tracking error seen in existing index-based ETFs.4 T. Rowe Price’s filing suggests that their proposed ETF will disclose a daily hedge portfolio in which each fund will consistently invest at least 80 percent of its total assets. Additional data points detailing the difference between the
investments; sponsor record-keeping platforms were built and designed with the mutual fund structure in mind decades ago. Nevertheless, the benefits of having an ETF offering in the stable of a retirement plan are becoming quite clear. Generally speaking, ETFs are a cheaper alternative to mutual funds.

The primary hurdle preventing more widespread adoption is the fractional share conundrum. ETFs trade intraday at quoted prices in whole share increments, unlike mutual funds that trade in batch orders at the end of the day and can allocate fractional shares. TD Ameritrade feels they have a solution that has solved the fractional share challenge. When a plan participant purchases an ETF, TD Ameritrade funds the fractional share amounts by rounding up to the necessary dollar amount to purchase a whole share. When a participant sells their position, TD Ameritrade sells the position and receives the proceeds of their stake in the fractional share.

While the timing of its rollout is pending, Charles Schwab has announced the intention to launch an ETF-only 401(k) plan for providers. The plan would offer commission-free trades for a host of ETFs, allaying any potential concern over high transactional costs. If successful, other plan sponsors could follow suit as investors demand greater flexibility with retirement options.

Understanding today’s advisor market
ETF sponsors are aware that, while there has been healthy advisor usage of ETFs in the last few years, opportunity still exists to grow the market. There is definitely room for an increase in new advisors using ETFs as a core asset allocation tool, as well as for current advisors increasing their allocations to ETFs.

The overall trend in the advisor market has been toward an uptick in fee-based relationships. If that continues, late-adopting advisors should no longer have the same affinity toward mutual funds they once had in the old commission-based advisory relationship. Furthermore, a great benefit of ETFs is that advisors are able to use them as a core asset allocation tool in order to diversify client investments to build an active portfolio. They can do this either through direct investment or by utilizing ETF strategies that perform the allocations.

Sponsors are capitalizing on this opportunity in the advisor market by offering tools to educate advisors on the mechanics of ETFs and how to effectively measure the true cost of ownership. Understanding the factors beyond the management fee that drives an ETF’s cost basis—such as the bid-ask spread and liquidity associated with the product—helps advisors better compare similar funds.

“Some market observers point to the fact that ETFs are positioned to enter the wider retirement funds market.”

Building a greater awareness of ETF features and benefits will only help future widespread adoption within the advisor community.

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ETFs in 401(k) plans
Some market observers point to the fact that ETFs are positioned to enter the wider retirement funds market. Today, mutual fund assets make up more than half of the roughly $5 trillion in 401(k) market assets (as of year-end 2012). Retail investors own approximately 55 percent of all ETF assets in the U.S. Yet, defined contribution 401(k) plans comprise barely one percent of ETF assets.

Mutual funds have long maintained a stranglehold on the 401(k) market. This is due in part to technological performance of the fund’s NAV and its hedge portfolio over a rolling, one-year period would be made available to provide traders with additional tools. Creations and redemptions would generally be transacted in-kind via the delivery of the hedge portfolio.

Finally, Eaton Vance has filed an exemptive relief application with the SEC to launch its patented exchange-traded managed funds (ETMFs). As their name suggests, ETMFs would trade on an exchange like existing ETFs; however, those trade prices would be linked to the fund’s end-of-day net asset value. The final settlement value of on-exchange executions would not be known until the end of the business day, after the net asset value has been calculated. This hybrid mutual fund/exchange-traded fund approach would allow managers to maintain a discretionary veil over the portfolio investments following the mutual fund quarterly disclosure requirement.
Competition, Consolidation and Change: Key Considerations in European Securities Clearance

Michael Albanese
Global Head of Securities Clearance
J.P. Morgan Investor Services

“Clearers have an important role in providing trading members with up-to-date and transparent insight in their intraday credit and collateral requirements.”
Competition in securities trading and clearing, the introduction of new trading venues and central counterparties (CCPs), and the repositioning of some market participants continue to fundamentally reshape the securities markets. The accelerated change driven by regulation (including EMIR and MiFID) continues to affect banks, broker-dealers and clearers.

Five topics emerge as key considerations:

1. CCP clearing fees
2. Interoperability
3. The future for equity CCPs
4. Segregation and portability
5. Central clearing for OTC cash instruments

What's behind today's CCP clearance fees, and can they be sustained?

CCP clearing fees have decreased dramatically during the last few years, due primarily to regulatory-driven competition and interoperability:

- Starting in 2007, MiFID I spurred the creation of new trading venues and central counterparties in Europe. These new venues challenged the often national near-monopolies traditionally held by stock exchanges and CCPs.

- Pan-European multilateral trading facilities (MTFs) such as Chi-X, BATS Europe and Turquoise attracted the necessary liquidity for their markets by competing with the traditional exchanges on speed of trade execution and the cost of trading and clearing.
Prior to the introduction of interoperability, a trading venue could only enter into an exclusive relationship with a single CCP. Here too, newly created CCPs such as EMCF and EuroCCP changed the rules through lower price models. These models were another important contributor to attracting trading liquidity to the new MTFs. The new MTFs and CCPs were symbiotic partners, and as their combination attracted a greater market share, the traditional CCPs lowered their own clearing fees.

Competition increased when broad interoperability was introduced in Europe in 2012, driving CCP clearing fees further down as increased transparency caused these fees to become an even more direct instrument to attract business for CCPs. In fact, CCP clearing fees reached their lowest levels at the end of 2011 in anticipation of interoperability in early 2012.

Currently, the lowest CCP clearing fees in Europe are nearly comparable to those in the U.S. While that is largely viewed as a positive by market participants, there is another side to the story.

Today’s low clearing fees are putting the profitability of equity-only CCPs under considerable pressure. Many CCPs today charge for auxiliary services (e.g., account maintenance and collateral handling) and may apply cross-product subsidies such that cash equity clearing is subsidized by derivatives clearing, if available.

So the question has to be asked—is this a sustainable business model for Europe’s equity CCPs? Participants may well expect to see clearing fees fall further, but it remains to be seen whether CCPs are able to reduce fees without compromising the economics of their business model. One school of thought says that clearing fees are more likely to increase; however, this would be a difficult commercial decision for CCPs, particularly those actively competing for interoperable trade flows.

If CCPs can’t raise fees, the following options are open to them in order to maintain a healthy business:

- Lower costs
- Introduce new markets, products or services (for new sources of income)
- Find partners (mergers or take-overs)

We expect that most CCPs will look at all three options, either separately or in combination with each other.
Interoperability—will we see additional progress or adoption?

As a first step in ending exclusivity in the relationships between trading venues and CCPs, broad interoperability was implemented among a very limited number of trading venues and four European CCPs in January 2012.

Interoperability is an operational and legal arrangement between CCPs that enables clearingers to consolidate transactions executed on multiple trading venues with their CCP of choice and therefore to optimize margin requirements for their trading members and to bring further cost efficiencies. In theory, a clearer will have only one CCP relationship to maintain, one net settlement per ISIN, one consolidated margin requirement and collateral pool, and a single contribution to a default fund. Unfortunately, eighteen months after broad interoperability was first introduced, this ideal state is still largely aspirational.

For broad interoperability to succeed, more CCPs must subscribe to the operational and legal arrangements, and more trading venues must be willing to share their trade feed with multiple CCPs. Most venues have not met this goal. In fact, thus far, the major regulated stock exchanges in Europe have not participated in any significant way, as embracing interoperability may impact their turnover and liquidity. Involvement by the major stock exchanges will be essential to achieving the expected benefits of interoperability.

The best way to push interoperability ahead is for the members to put pressure on the trading venues on which they trade. The members bear today’s high costs and will ultimately benefit from consolidation. The current restricted implementation of interoperability keeps costs higher than would otherwise be necessary.

What does the future hold for cash equity CCPs?

Given lower clearing fees and limited interoperability, simple mathematics suggests that there are not enough cash equity transactions to be cleared at current pricing models to sustain the 15 cash equity CCPs currently active in Europe.

Figure 2 is based on 2012 statistics from the Federation of European Securities Exchanges (FESE). The shaded area covers the total equity clearing fee revenue for 2012 if all CCPs had charged competitive clearing fees. A low cost CCP will have an annual cost base upward of €12.5 million. This means that the total European volume can support no more than eight low-cost cash equity CCPs. Currently there are approximately 15 of those CCPs in Europe and they do not all operate on the same low-cost basis.

EMIR, or the European Market Infrastructure Regulation, is also forcing many CCPs to review (and perhaps reconsider) their business models. EMIR has introduced detailed rules and regulations for CCPs, including organizational requirements, risk mitigation measures and specified capital requirements. Under EMIR, all CCPs needed to (re-)apply to the regulatory authorities for a formal European “license to clear” by September 15, 2013. CCPs who cannot or will not want to comply with some of the new rules may exit cash clearing altogether.

Consequently, we expect to see additional CCP consolidation, whether through mergers, take-overs or other forms of cooperation. An example is the take-over of Oslo Clearing by Swiss-based SIX X-Clear and, more recently, the announced merger between EuroCCP and EMCF.

What are the options for segregation and portability?

EMIR Article 39 directly affects securities clearance through requirements for segregation and portability. To summarize, clearingers must offer their trading members the option to have their positions and their collateral administered in segregated accounts (held separate from other trading members’ positions and the clearer’s proprietary positions). This will most likely become mandatory in the first quarter of 2014. Segregation in this respect must be upheld in the books of the clearer and must also be maintained at the CCP. Segregation is intended to protect the trading member against the default of its clearer. Should a clearer default, the trading member’s positions and associated collateral can easily be identified and transferred to a new clearer (portability). Therefore, the strength of the clearer becomes a critical factor in determining the need for segregation.

Total European Clearing Fee Revenue versus Costs
(Based on 2.7 billion contracts cleared against an average fee of between €0.015 and €0.040)

Source: Federation of European Securities Exchanges (FESE)
While the aim of building more client protection into the complex system of relations among the relevant market participants is commendable, this protection comes at a cost:

- The CCPs must implement the new segregation protocols for positions and collateral. This will have significant technical, operational and legal implications. As a new service, it will most likely involve a new fee charged by the CCPs (some of which have already been published).

- Clearers will not only have to offer segregation—resulting in technology and operational changes—but will also need to demonstrate in legal terms to trading members that segregation offers the desired level of legal protection. Trading members who make use of this new service may also be charged an associated fee by their clearer.

Ultimately, market participants who are not self-clearing will have two choices:

1. Segregate their positions and collateral at the clearer and CCP level and incur the extra costs, or
2. Opt to clear with a strong, stable and secure clearer whereby the extra layer of segregation and cost will not be necessary.

**Will we see mandatory OTC securities clearing?**

The shift to central reporting through trade repositories and clearing of OTC derivatives formalized in EMIR is intended to mitigate risk by increasing transparency into outstanding rights and obligations. Many market participants have asked the obvious: why shouldn’t the same logic apply to OTC cash securities transactions?

The answer is provided in the MiFID proposals, which indicate that clearing obligations for OTC cash securities transactions (equities and bonds) are likely to be adopted in some form at some future date (see MiFID II, Level 1, Proposed Article 16.A).

In practice, however, OTC cash securities transactions can be centrally cleared today. The largest European CCPs already accept OTC transactions for clearing and settlement.

These services are not yet widely used since the CCPs require matched trade instructions in a specific format. To centrally clear an OTC transaction, for example, both the buyer and the seller have to register their side of the transaction with a so-called “matching engine provider.” The service providers will then pass on the matched trades in the correct format to the CCP for further processing. These extra steps and relationships impose additional costs, and the number of providers is limited. Additionally, should a trading member elect to centrally clear OTC cash transactions, the CCPs would require extra collateral to cover the margin requirements calculated for those positions, increasing the cost further. Nonetheless, market participants should keep in mind that, ultimately, a large part of OTC securities transactions are likely to be routed through a CCP in the coming years.

**J.P. Morgan Clearance Services**

Clearers have an important role in providing trading members with up-to-date and transparent insight in their intraday credit and collateral requirements.

As a clearer, J.P. Morgan provides coordinated agency clearance services for securities, derivatives, futures and options, and is uniquely positioned to understand and help trading members adapt to changing market conditions. The firm continues to work closely with trading members and infrastructure providers to support current and emerging business needs as the new global securities clearance model continues to take shape.

[Special thanks to Willem Mooijer and Edward Fisher for their contributions to the article.]
A recent posting on our blog offered a guest opinion from Portfolio Manager Nicholas Gartside of J.P. Morgan Asset Management.

Benjie Fraser
Global Pensions Executive

Well, well, more of the same? A quick look back over the year reveals a consistent pattern. Yet again markets, economies and returns have been dominated by the actions of policymakers and officials.

Prime Minister Abe set the tone early in the year, throwing down the gauntlet: can 3 arrows = 2 in 2 (i.e., two percent inflation in two years)? Well, the jury is still out, but it seems to be pretty clear that a plan B is not in sight and the question is what Japanese officials would have left to do once a problem emerges.

In similar fashion other policy makers have become increasingly assertive as they recognize they have to get consumers spending again. Whether it’s the British Government’s Help to Buy scheme, Governor Carney’s adoption of forward guidance or the ECB’s recent interest rate cut, the message is the same: we have more tools and we’ll deploy them until consumers get traction.

What does this mean for markets? Well, our forward-looking quantitative models now suggest GDP surprises to the upside even in peripheral Europe, and it’s difficult to see government bonds rallying much more from current levels. Equally well a large, uncontrolled sell-off is in nobody’s interest as the subsequent increase in the cost of capital could be corrosive for economic growth.

This is an environment where there’s no need to panic. The tension between a gradually improving economic backdrop and policy activism will keep market moves contained.

Scouring international bond markets, there’s also plenty of opportunity. A theme for 2014 is that the bond show will continue, but it is likely to be the year of the security selector. Quality and resilience are likely to be rewarded over vulnerability, and there are plenty of opportunities in government, corporate and emerging market bonds.
“Having both the right collateral tools and a clear understanding of the impact of regulation on collateral could create a competitive edge for institutions.”

John Rivett
Global Executive, Collateral Management Regulatory and Industry Affairs
J.P. Morgan Investor Services

Mark Trivedi
Global Product Head for Collateral Management
J.P. Morgan Investor Services

Regulatory Considerations and Collateral Implications

Since the first Group of Twenty (G20) summit in November 2008, regulations continue to evolve and be introduced across jurisdictions. Understanding these rules and their impact on efficient collateral management has become increasingly business-critical. Three key areas that impact collateral management are:

- Collateral haircuts
- Collateral segregation
- Re-use of collateral
Collateral haircuts

Historically, market participants agreed to apply a haircut to reflect the potential price fluctuations of collateral received. Haircuts range from zero on cash or government bonds to 25 percent (or more) for listed equities or highly structured bonds.

A piece of collateral can be subject to varying haircuts and relative values depending on the instrument type or the clearinghouse where it is cleared. Given these variables, market participants need strong analytical tools to review the collateral inventory and the relative value of each collateral component in order to be efficient and mitigate disputes.

Collateral segregation

Segregation of house collateral from client collateral is already an established practice. Collateral segregation aims to reduce the risk of client assets being treated as the property of the securities intermediary in the event the securities intermediary becomes insolvent.

“Market participants need strong analytical tools to review the collateral inventory and the relative value of each collateral component in order to be efficient and mitigate disputes.”

Market participants may require further segregation of posted or received collateral, which makes the safekeeping and efficient management of collateral assets operationally more challenging.

Re-use of collateral

Today the re-use of collateral is an essential tool for liquidity and financing. It maintains the flow of collateral, lowers the overall cost of trading and creates financing opportunities. In the future, there is an anticipated increase in demand for quality, highly liquid collateral. However, certain regulatory developments may restrict the re-use of collateral. These limitations may require market participants to acquire and deploy more ‘fresh’ or non-re-used collateral.

Regulators have recently focused on haircut levels.

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Affects</th>
<th>Model/Impact</th>
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<tbody>
<tr>
<td>Dodd-Frank Act and European Market Infrastructure Regulation (EMIR)</td>
<td>Cleared derivatives</td>
<td>Central counterparties (CCPs) determine the haircuts they set for the various collateral classes they accept to reflect credit, market and liquidity risks, likely creating different models across CCPs.</td>
</tr>
<tr>
<td>BCBS/IOSCO Key Principles</td>
<td>Uncleared derivatives</td>
<td>Market participants have a choice of two haircut models: either an internally developed and regulator approved model (approved by the regulator in each country where such model is used) or a standardized initial margin schedule as set by BCBS/IOSCO.</td>
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</tbody>
</table>
| Financial Stability Board (FSB) | Repo market | • Recent market consultation suggests minimum haircuts for uncleared repo transactions between a regulated and a non-regulated entity.  
• Through the introduction of numerical haircut floors on certain transactions, the FSB aims to limit leverage and reduce pro-cyclicality outside the banking system. |
| Dodd-Frank Act | Cleared derivatives | Legally Segregated Operationally Commingled (LSOC) model requires the segregation of house collateral from client collateral. |
| European Market Infrastructure Regulation (EMIR) | Cleared derivatives | Requires:  
• Segregation of house collateral from client collateral.  
• Clearing members and CCPs offer clients the opportunity to have their client collateral segregated in individual accounts, away from other clients’ collateral. In this case, the risk of shortfalls arising in other client pooled accounts should not result in shortfalls in the segregated client’s account. |
| BCBS/IOSCO Key Principles | Uncleared derivatives | • Recommends holding the collateral provided as initial margin in such a way that the collateral provider is protected if the collateral receiver enters into bankruptcy.  
• Use of third-party custodians could meet this segregation requirement. |
| Alternative Investment Fund Management Directive (AIFMD) | All collateralized transactions | • AIFMD requires a depositary to segregate house assets from client assets.  
• AIFMD requires AIF assets to be clearly identified as belonging to the AIF in the accounts of the depositary. |

Re-use of collateral

Today the re-use of collateral is an essential tool for liquidity and financing. It maintains the flow of collateral, lowers the overall cost of trading and creates financing opportunities. In the future, there is an anticipated increase in demand for quality, highly liquid collateral. However, certain regulatory developments may restrict the re-use of collateral. These limitations may require market participants to acquire and deploy more ‘fresh’ or non-re-used collateral.

FIG-01

Regulation Affects Model/Impact

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Affects</th>
<th>Model/Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dodd-Frank Act and European Market Infrastructure Regulation (EMIR)</td>
<td>Cleared derivatives</td>
<td>Central counterparties (CCPs) determine the haircuts they set for the various collateral classes they accept to reflect credit, market and liquidity risks, likely creating different models across CCPs.</td>
</tr>
<tr>
<td>BCBS/IOSCO Key Principles</td>
<td>Uncleared derivatives</td>
<td>Market participants have a choice of two haircut models: either an internally developed and regulator approved model (approved by the regulator in each country where such model is used) or a standardized initial margin schedule as set by BCBS/IOSCO.</td>
</tr>
</tbody>
</table>
| Financial Stability Board (FSB) | Repo market | • Recent market consultation suggests minimum haircuts for uncleared repo transactions between a regulated and a non-regulated entity.  
• Through the introduction of numerical haircut floors on certain transactions, the FSB aims to limit leverage and reduce pro-cyclicality outside the banking system. |
| Dodd-Frank Act | Cleared derivatives | Legally Segregated Operationally Commingled (LSOC) model requires the segregation of house collateral from client collateral. |
| European Market Infrastructure Regulation (EMIR) | Cleared derivatives | Requires:  
• Segregation of house collateral from client collateral.  
• Clearing members and CCPs offer clients the opportunity to have their client collateral segregated in individual accounts, away from other clients’ collateral. In this case, the risk of shortfalls arising in other client pooled accounts should not result in shortfalls in the segregated client’s account. |
| BCBS/IOSCO Key Principles | Uncleared derivatives | • Recommends holding the collateral provided as initial margin in such a way that the collateral provider is protected if the collateral receiver enters into bankruptcy.  
• Use of third-party custodians could meet this segregation requirement. |
| Alternative Investment Fund Management Directive (AIFMD) | All collateralized transactions | • AIFMD requires a depositary to segregate house assets from client assets.  
• AIFMD requires AIF assets to be clearly identified as belonging to the AIF in the accounts of the depositary. |
While the terms rehypothecation/re-use are often used interchangeably, they can differ in interpretation and treatment depending on the regulatory body.

<table>
<thead>
<tr>
<th>Regulation/Regulatory Body</th>
<th>Definition and Ruling/Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Stability Board (FSB) Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, August 2013</td>
<td>Defines re-use as “any use of securities delivered in one transaction in order to collateralize another transaction,” while rehypothecation is the re-use of client assets. In its policy framework, the FSB recommends that only entities subject to adequate regulation of liquidity risks should be allowed to engage in the rehypothecation of client assets.</td>
</tr>
</tbody>
</table>
| BCBS/IOSCO Key Principles for Uncleared Margining              | • While the key principles do not make a distinctive difference between rehypothecation and re-use, they allow rehypothecation of initial margin only under very strict and limited circumstances to hedge a position stemming from a trade that led to the first requirement to post initial margin.  
  • Allows variation margin received as part of derivatives trades to be re-used by the receiver on an unlimited basis, subject to any applicable local regulatory requirements. |
| European Commission Proposed Rules for Money Market Funds 2013/0306 | Draft rules prohibit the re-use of collateral received as part of a repo transaction by a money market fund.                                                                                                                                                 |
| ESMA Guidelines on UCITS                                       | Guidelines indicate that non-cash collateral received by a UCITS fund should not be sold, re-invested or pledged—effectively ruling out rehypothecation.                                                                                                          |

Regulatory developments have different implications for an institution’s ability to rehypothecate and/or re-use collateral. This increases the demand for quality, highly liquid assets and the need to have a single, clear view of counterparties, assets and obligations.

**Outlook for 2014**

The ninth G20 summit will be held in Australia in November 2014, by which time it is anticipated that:

- Mandatory clearing will have commenced in Europe following the U.S., which started in March 2013.
- BCBS will have developed internationally consistent, risk sensitive rules for capital treatment for banks engaged in shadow banking activities and will provide an update on reform implementation to mitigate banks’ interactions with shadow banking entities.
- FSB will have completed recommendations on minimum standards on methodologies for calculating haircuts on non-centrally cleared securities, developed information-sharing process within its policy framework for shadow banking, and proposed standards for global data collection regarding repo and securities lending markets.

Having both the right collateral tools and a clear understanding of the impact of regulation on collateral could create a competitive edge for institutions.

**Key Takeaways**

1. **Initial margin requires more collateral**—Industry studies estimate that the amount of incremental collateral required by new regulations for both bilateral and centrally cleared trades could range from US$500 billion to $5 trillion. This will phase in as existing trades mature and new trades are booked. Ultimately, the scope will depend on the final rules for marging uncleared derivatives, the efficiency of netting processes at the CCPs, and how and whether collateral receivers and collateral providers change their practices.

2. **Transparency and reporting**—Having the flexibility to view and report collateral assets with supporting data references (LEIs, UTIs, etc.) by entity will support market participants’ regulatory requirements across various jurisdictions.

3. **Understanding the end-user requirements**—European funds appoint depositaries who have liability for safekeeping of assets under AIFMD and UCITS. This is increasing the need for segregated collateral accounts. As a result, fund managers and agent lenders need to manage across more accounts, and collateral providers need to meet smaller requirements across a greater number of accounts. Management of eligibility schedules and concentration limits for collateral receivers across their derivative, repo and stock loan obligations, and collateral providers’ ability to efficiently optimize quality, highly liquid assets becomes increasingly business-critical.


As investors continue to explore new ways to address seismic regulatory shifts, the onus has been placed squarely on providers to deliver innovative solutions that help clients more efficiently and transparently address these changes without sacrificing growth. J.P. Morgan’s response has been to unify its wholesale franchises, both organizationally and technologically, around clients’ evolving needs.

The Corporate & Investment Bank (CIB), established in July 2012, integrated several J.P. Morgan businesses to provide a more holistic client experience—one where clients could reap the full benefits of the firm’s combined resources and vast product suite.

The online manifestation of this approach was rolled out in January 2013 with the launch of J.P. Morgan Markets: a cohesive platform that delivers financial markets solutions across the full investment lifecycle, including research, analytics, trading, post-trade capabilities and investor services.

“The creation of the CIB was about bringing different parts of the business together and organizing ourselves around the customer,” said Carlos Hernandez, chief executive officer, Investor Services. “As customers increasingly look to value for scale, we have seen more interest in different product and service bundles that weren’t previously offered. J.P. Morgan Markets is an important part of our effort to ensure clients can easily access the full breadth of our solutions.”

**Capturing the investment lifecycle**

Over the past year, many of Investor Services’ pre-existing web offerings have been integrated into J.P. Morgan Markets, including portals for custody and fund services, prime financing and collateral management. The result is streamlined client access to solutions for virtually any investment need. Additionally, by connecting each stage of the lifecycle on a single platform, clients are empowered with the transparency to clearly and conveniently track an investment from end to end—an important benefit to help support management oversight and reporting requirements.

**First-class tools for informed decision-making**

Beyond consolidating the full range of investment functionality on a single platform for the first time, J.P. Morgan thoughtfully designed the site to deliver a highly intuitive user experience. With consistent navigation and enriched features, J.P. Morgan Markets represents a significant advancement in usability that many clients have already found to economize their workflow.

Custody and fund services clients, for example, can easily configure their dashboards to view high-level snapshots of pertinent data on one screen or drill down into various product workspaces for deeper analysis.

“The new custody and fund services experience on J.P. Morgan Markets is the product of extensive client input and testing, including a successful global pilot, and the feedback we’ve received has been overwhelmingly positive,” said Brian Condon, head of product development, Custody and Fund Services. “Clients asked for an easier way to assess, manage and leverage their investment activities, and our new interface is helping them do just that.”

**Staying ahead of client needs**

While J.P. Morgan Markets does offer a comprehensive menu of solutions with a single sign-on, a high degree of personalization is built into the architecture to present views and tools most relevant to the specific user. For instance, a hedge fund client’s homepage might be focused on trading data and research, while a pension manager’s primary screen is tailored to quickly assess fund performance and governance.

At the same time, a multitude of complementary investment solutions across products and regions is a click away. The value this ease-of-use brings in today’s complex regulatory environment has become a serious consideration for clients—a trend that will only accelerate as more businesses expand electronically.
Buy-side and sell-side firms alike have invested significant human capital and technology resources to support new margin processes associated with Dodd-Frank, EMIR and other reforms. While these changes have affected operational structures, the collateral allocation decisions employed have remained largely unchanged. Approaches used in the market today generally rely on either:

- Decisions made by operational staff typically focusing on ease of allocation (e.g., delivering the largest eligible asset). This approach is used extensively by the investor community but may prove unsustainable as requirements become more complex and volumes increase.
- Algorithm-based processes leveraging a waterfall approach, enabling institutions to specify asset and/or margin obligation orderings in accordance with pre-established eligibility constraints. This functionality, offered by J.P. Morgan to its clients for more than a decade, has been leveraged by the intermediary community for tri-party transactions.

To the extent externally-sourced eligible collateral needs to be introduced in order to meet an obligation, either financing transactions or asset sales are often employed.

As the impacts of the new margin regime continue to materialize, market participants will face new pressures on their current practices that may require them to rethink their collateral allocation and financing approach. In most cases, these firms face a mismatch between assets held in their portfolios, which may fluctuate over time, and collateral eligibility that may have a long duration (i.e., multiple years). At the same time, leverage/capital/liquidity frameworks are making it more expensive for intermediaries to provide financing at the terms that directly meet the nature of these mismatches.

The easy approach to solving the mismatch would involve changes to portfolio construction; however, these changes will nearly always come at the cost of basis risk and/or yield. To more effectively meet the new collateral demands, firms may need to employ more sophisticated approaches when thinking about their collateral allocation and financing decisions upfront. These decisions may involve pledging, recalling, lending, financing or keeping a particular asset unencumbered. Each of these options will affect economics: having a means to assess the optimal decision available may allow firms to more effectively meet obligations.

J.P. Morgan has developed a multi-factor algorithm that enables firms to customize a set of factors that represent its economics and provides collateral optimization scenarios. Through a linear programming approach, the algorithm dynamically considers client-specified criteria and their impacts to transaction costs, risks realized, financing costs, liquidity requirements and lending benefits. Clients can benefit from reducing the occurrence of obviously inefficient decisions (e.g., pledging a security that is otherwise trading special in the financing markets) and less obvious decisions (e.g., balancing the need to keep larger, more liquid positions unencumbered while reducing transaction costs realized when delivering many smaller ones).

There are many impediments and requirements that may prevent firms from realizing the value of a holistic approach to their collateral portfolio and the changing nature of requirements. Sophisticated approaches, such as the multi-factor algorithm, can create a single view which may help link disparate parts of an organization involved in the collateral decision-making process to achieve better economics. Through the use of such tools in a ‘what-if’ capacity, treasurers can also better forecast their funding needs, stresses and durations to more effectively arrange strategic financing in the context of their collateral portfolio. J.P. Morgan understands the collateral demands facing buy-side and sell-side firms and is uniquely situated to meet these challenges with complete collateral portfolio solutions that provide valuable, sophisticated methodologies to improve clients’ use of collateral and related economics, including a globally consolidated view of collateral and obligations agnostic of clearer or custodian.
The UCITS IV Directive that came into effect in July 2011 included some keenly awaited measures permitting master-feeder structures. This instrumental change allowed for UCITS funds to be recognized as feeder funds, provided they invest at least 85 percent of their assets in another single UCITS (i.e., a master). This important development introduced a number of potential cost reduction and rationalization opportunities for fund promoters and investors, including:

- Economies of scale through the pooling of assets within a larger fund
- Feeders with features that cater for domestic investor preferences
- The centralization of management functions that can be achieved through the management company cross-border passporting measures also introduced under UCITS IV

Since the advent of UCITS IV, relatively few master-feeder structures have been launched, which while initially caused by a priority given to mandatory UCITS measures, we believe is more recently due to an inability to identify a clear way through the operational and logistical complexities involved in setting up cross-border structures, including:

- NAV alignment and the management of market timing risk, when the master and feeder have conflicting requirements for valuation points and dealing cut-offs
- The basis for recognition of income, deemed income and the funding of distribution payments

More recently, we have seen a pick-up of interest in master-feeders being used as a component of a comprehensive distribution strategy, and in conjunction with this, J.P. Morgan has been developing enhanced functionality to help clients address the logistical, operational and administrative challenges. An example of this addresses one of the key challenges: the difference in valuation points as outlined below with a typical UK domestic fund feeding into a Luxembourg master fund:

<table>
<thead>
<tr>
<th>Fund Structure Requirements</th>
<th>UK Feeder</th>
<th>Luxembourg Master</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market preferred valuation point</td>
<td>1200 GMT / 1300 CET</td>
<td>1500 GMT / 1600 CET</td>
</tr>
<tr>
<td>Income basis</td>
<td>UK SORP / Reportable income</td>
<td>Luxembourg GAAP</td>
</tr>
</tbody>
</table>

In this instance, a valuation of the feeder’s interest in the master at the prior day’s unadjusted close of business price could be a concern, as an investor in the feeder fund would be dealing in an NAV that didn’t reflect the same day’s market value. While some might consider aligning the valuation points, thereby putting one of the two structures out of line with domestic market practice, our solution has been to develop the ability to re-price the master fund daily at the valuation point of the feeder thereby creating a highly accurate fair valuation of the feeder fund’s main asset, allowing for dealing in the feeder at a fair price to both existing and new investors.

While challenges undoubtedly exist to achieving a successful UCITS master-feeder structure, we believe these are addressable and that cross-border fund promoters can consider master-feeders as a viable ‘tool in the box.’ We continue to consider how we can develop solutions in this field, and together with Deloitte, we are co-authoring a more detailed guide on the practical aspects of master-feeders. If you are thinking about adopting master-feeder structures for your existing or future planned funds, we welcome the opportunity to discuss our services with you further.

“With some innovative thinking around the technical challenges that have so far slowed the take-up of master-feeder funds, these vehicles can become a very useful option in a cross-border distribution strategy.”

Marcel Guibout
Product Head, EMEA Fund Accounting and Administration
J.P. Morgan Investor Services
Institutional investors in the private equity space have become more selective, preferring to spend more time with and allocating to fewer managers to minimize the costs of running a large portfolio while focusing resources on top quartile funds. Meanwhile, the appetite and capacity of multi-family offices and sovereign wealth funds to invest in alternatives has grown significantly. Traditionally conservative investor segments, such as the German pension funds market, are expressing more interest in private equity products, for which fund of funds are a natural entry point.

These diverse investor bases have very different requirements. Fund of funds managers need to be able to provide standard, commingled fund offerings, direct co-investment access and bespoke portfolio programs to cater for an investor base that has grown more sophisticated over the years.

Successful managers with a strong track record can benefit from the flight to quality. However, they need to find efficiencies to offset the higher operating costs that arise from increasingly complex operating and reporting requirements. Larger allocations from institutional investors are often accompanied by requests for separate portfolio solutions, so that they have the flexibility to act quickly in the event of crisis situations. These investors also require more favorable terms.

J.P. Morgan proactively partners with clients on new fund structures, taking advantage of our global experience as one of the largest private equity administrators in the world. Investors are also seeking greater transparency on their ultimate company and property investments held indirectly via funds of funds. Many struggle to quickly assess their exposure to companies impacted by extreme events. J.P. Morgan’s private equity fund of funds administration offering can provide full transparency to underlying companies, as well as gathering and aggregating direct property data. While tracking underlying company metrics is not a new activity, J.P. Morgan works to ensure that the value of the information is balanced against the cost of collecting, standardizing, performing analytics and reporting data, without the need for the manager to invest in systems and resources to do so.

As the regulatory environment continues to evolve, new regulations in multiple jurisdictions present a challenge for alternative managers to understand and implement practical and cost-effective solutions. J.P. Morgan has developed a range of regulatory reporting solutions to assist clients with their reporting requirements, for instance, for Form PF and AIFMD.

Regulatory change and investor pressure are pushing the industry toward standardization and transparency. J.P. Morgan understands the complex interplay of requirements facing fund of funds managers and continues to invest in the tools and solutions that enable us to grow together with our clients.

“Investors in private equity have become progressively more sophisticated. They are increasingly approaching us for assistance in constructing customized portfolios that fit their unique risk-return and cash flow profiles.”

Kevin Callahan, CFA
Chief Operating Officer and Head of Client Service
Adams Street Partners
As firms and their employee benefit plans face fundamental changes driven by regulation, fiduciary obligations, disappointing investment returns and increasing correlations, they seek partners to provide effective solutions in risk-controlled environments.

When one such business needed an investment solution that offered flexibility and control, J.P. Morgan employed its firm-wide resources, including its robust technology infrastructure, which supported the implementation of a custom target-date fund structure into their retirement plan in a cost-efficient and flexible manner.

The client
A leading global financial services firm sought to enhance its defined contribution plan, or 401(k), through the addition of target-date funds. The client also wanted the ability to customize underlying investments and gain access to emerging investment strategies and new asset classes.

The need
J.P. Morgan’s client received feedback from its plan participants that the investment decision-making process was difficult and overwhelming. Despite a variety of educational tools, employees still struggled to make adequate investment and asset allocation choices. Additionally, the client observed that many of its employees were taking no action to save for their retirement, thereby putting themselves in a more challenging financial situation. To address this concern, the plan’s investment committee sought to implement an auto-enrollment feature obligating new employees to participate in retirement planning even if they took no explicit actions.

To represent the best interests of plan participants, the client identified its main investment priorities:

- Diversification and exposure to new asset classes
- Open architecture to allow for changes to the underlying fund manager lineup
- Cost efficiency
- A comprehensive solution for ease of implementation and administration.

The solution
In this scenario, the breadth of services offered by our firm helped to assess the issue and recommend a solution. To start, J.P. Morgan Asset Management successfully partnered with the client to provide first-class investment management and advice.

J.P. Morgan Investor Services then provided asset servicing support, particularly in the form of J.P. Morgan CARS™ (Cash Allocation and Rebalancing Solution). It was this product, the firm’s integrated, target-date fund solution at a compelling price, and the ability to support complex, customized open architecture, that was a key factor in developing a resolution to the client’s need.

CARS delivers highly flexible, controlled and scalable support of complex funds. It enables plan sponsors to create and deliver innovative fund of fund structures, particularly custom, open architecture target-date funds, with efficiency and control. CARS also supports custom target-date funds by enabling clients to implement a unique glide path with any configuration of underlying fund types. Furthermore, CARS is integrated with J.P. Morgan’s custody and accounting systems.

Target-date Fund Features
U.S. federal regulation mandates what type of investment options may be used in auto-enrollment activities. The Pension Protection Act of 2006 requires use of a qualified default investment alternative or QDIA. Target-date funds, among others, were highlighted as acceptable options.

One attractive feature of a custom target-date fund is the flexibility offered by an open architecture design. Open architecture can permit a firm to more easily make changes to underlying fund managers as they deem appropriate. For example, if a new asset class or investment strategy arises, management can add that as a component of a target-date fund with greater ease. This functionality may also allow plans to offer investments with attractive risk/return profiles, lower costs and diversifying characteristics, and to replace underperforming managers.
"As the focus on new developing and emerging markets continues to grow," Network Market Manager Raushanah Bowdre said recently, "J.P. Morgan remains committed to servicing our clients' needs by building and deepening relationships with regulators, stock exchanges and central depositories in local markets. We are actively advocating for the changes necessary to bring undeveloped markets into alignment with international best practices."

Sri Lanka, as one example, is a market where foreign investors have experienced barriers to entry related to new account openings, which typically take longer due to the detailed scrutiny and approval required from the Central Depository System (CDS) of the Colombo Stock Exchange and the Securities and Exchange Commission (SEC).

Following J.P. Morgan’s meetings with the SEC and CDS in Sri Lanka to provide continuous dialogue with these local market infrastructures throughout 2012 and 2013, the SEC this past August released a formal circular clarifying account opening requirements in order to provide a standardized set of required documentation. This eliminated additional documentation requests from the SEC and is expected to shorten the account opening timeline. The new requirements are applicable across all market applications in Sri Lanka (e.g., government securities, equities and corporate debt) with immediate effect. J.P. Morgan has revised its Investor Kit with the updated market requirements.
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