FINANCIAL MARKETS - BASICS

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Workshop agenda

- Financial markets – the assets
- Financial markets – the players
- Investment company organisation
- Closer look at investment funds
- Trading financial instruments – market structure
- Trading financial instruments – anatomy and mechanics
- Financial market regulation

Investment company organisation
Front Office

Function: generates revenue and is responsible for the buying and selling of financial products.

Typical Front Office functions include:

- Sales desk: suggests trading ideas to clients (institutional & HNWI) and takes orders
- Trading desk: executes trades:
    - on behalf of the sales desk
    - on the investment company's own account (proprietary/ principal/ own-account trading)
- Repo desk: supports the trading desk by borrowing cash (to finance long positions) or securities (to facilitate short positions).

Additional Front Office functions include:

Investment banking	Market makers
Research	Investment managers
Stockbrokers	Inter-dealer brokers

Investment company organisation
Middle Office and Back Office / Operations

Middle Office: supports and controls output from the Front Office, providing a link between the Front Office and Operations (Back Office).

Typical Middle Office duties include:

- Monitoring trades to check that they comply with pre-agreed limits, e.g.:
  - Counterparty limits
  - Traders' limits
  - Trader must be authorised to trade that specific security
- Exchanging post-trade confirmations with counterparties, identifying potential discrepancies.
- Ensuring that trades are correctly booked, valuations have been made and that the relevant reports have been produced.

Back Office: ensures settlement of trades, i.e. delivery and receipt of securities together with the receipt or payment of cash.

Investment funds
Open-end funds

Open-end funds: Accept new investment money and issue additional shares at a value equal to the net asset value (NAV) of the fund at the time of the investment. Money can also be withdrawn at the NAV per share.

Advantage:

- Easy to grow in size.

Disadvantages:

- Need to liquidate assets which manager does not want to sell to meet redemptions.
- Need to keep cash for redemptions – less than 100% investment.
- Need to find new assets to invest inflows.

Investment funds
Closed-end funds

Closed-end funds: No new investment money is accepted into the fund. New investors invest by buying existing shares. Investors liquidate by selling their shares to other investors. Unlike open-end funds in which new shares are created and sold at current NAV per share, closed-end funds can sell for a premium of discount to NAV depending on demand.

Advantages:

- No pressure to liquidate assets to meet redemptions.
- No need to keep cash buffer - may be fully invested.
- No need to find new assets to invest inflows.

Disadvantage:

- Restricted ability to grow.

Investment funds
Active versus passive management

Active management: manager seeks outstanding performance (relative to benchmark/index or absolute) through selection of appropriate stocks to be included in the portfolio.

Passive management (index funds): manager seeks to match/track the performance of an index.

Fees: management fees are higher for actively managed funds. The higher fees reflect the goal of outperforming the index as opposed to just matching it. Higher fees are also required to pay for the research conducted to actively select securities.

Capital gains tax: the level of trading in an actively managed fund is much higher than in an index fund, so the actively managed fund tends to have more opportunity to realise capital gains. This results in higher taxes relative to an index fund, which typically uses a buy-and-hold strategy.

Investment funds - ETFs
ETF share creation/redemption

ETFs: combine features of closed-end and open-end mutual funds.

- ETFs trade like closed-end mutual funds.
- Like open-end funds, ETF prices track net asset value due to an innovative creation / redemption procedure.

ETF share creation / redemption:

- ETFs are created by fund sponsors who determine which securities will be included in the basket of securities.
- To obtain the basket, the fund sponsors contact an institutional investor who deposits the securities with the fund sponsor.
- In return, the institutional investor receives creation units that typically represent between 50,000 and 100,000 ETF shares.
- These shares can then be sold to the public by the institutional investor.
- The institutional investor can redeem the securities held in the ETF by returning the number of shares in the original creation unit.

Investment funds - ETFs
Comparison to index mutual funds

- Investors investing in an index mutual fund buy the fund shares directly from the fund and all investments are settled at NAV.
- In the case of an ETF, however, investors buy the shares from other investors just as if they were buying or selling shares of stock.
- This setup includes the opportunity to short the shares or even purchase the shares on margin.
- The price an investor pays is based on the prevailing price at the time the transaction was made. This price may or may not be equal to the net asset value at the time, but it represents the price at that time for a willing buyer and seller.
- In practice, the market price of the ETF is likely to be close to the net asset value of the underlying investments.

Investment funds - ETFs
Comparison to index mutual funds

- Expenses are lower for ETFs but, unlike mutual funds, investors do incur brokerage costs.
- All purchases and redemptions in a mutual fund take place at the same price at the close of business. ETFs are constantly traded throughout the business day, and as such each purchase or sale takes place at the prevailing market price at that time.
- In the case of the ETF, dividends are paid out to the shareholders whereas index mutual funds usually reinvest the dividends. Hence, there is a direct cash flow from the ETF that is not there with the index mutual fund.
- The minimum required investment in an ETF is usually smaller. Investors can purchase as little as one share in an ETF, which is usually not the case with an index mutual fund.

Trading financial instruments
Market structure

Over-the-Counter Markets (OTC)

- Swap execution facilities
- Organised Trading Facilities

Regulated Markets

- Stock exchanges
- Derivatives exchanges

- Multilateral Trading Facilities
- Automated Trading Systems
- Electronic Communications Networks

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Clearing
Process overview

Clearing: the process of transmitting, reconciling and, in some cases, confirming payment orders or security transfer instructions prior to settlement, possibly including the netting of instructions and the establishment of final positions for settlement.

- Clearing is the post-trade preparation for trade settlement.
- It should be completed shortly after the trade has been executed.
- Clearing typically involves the following steps:
  1. Trade capture
  2. Trade enrichment and validation
  3. Trade reporting
  4. Confirmation / affirmation
  5. Clearing instructions
  6. Forecasting – cash
  7. Forecasting - securities

Clearing
Clearing instruction types

Instruction	Description
Receive versus payment (RVP)	Buyer's instruction to settle its purchase of securities against simultaneous payment of cash.
Delivery versus payment (DVP)	Seller's instruction to settle its sale of securities against simultaneous receipt of cash.
Receive free of payment (FoP)	Buyer's instruction to settle its purchase or inbound transfer of securities. Cash paid separately.
Deliver free of payment (FoP)	Seller's instruction to settle its sale or outbound transfer of securities. Cash received separately.

Financial markets regulation
UCITS and AIF - Luxembourg example

	RAIF	SIF	PART II UCI	PART I UCITS
Applicable law	RAIF Law	SIF Law	Part II of the UCI Law	Part I of the UCI Law
Regulatory authorisation	No, only RCS registration	Yes	Yes	Yes
Classification from EU perspective	AIF	AIF/non-AIF	AIF	UCITS
Eligible investors	Well-informed investors	Well-informed investors	Retail, institutional and professional investors	Retail, institutional and professional investors
Eligible assets	Unrestricted	Unrestricted	Unrestricted	Restricted list of instruments, as per applicable law, regulations and guidelines

Financial markets regulation
UCITS and AIF - Luxembourg example

Investment restrictions	No specific investment or borrowing restrictions, but risk diversification requirement: max. 30% of the RAIF's assets can be invested in securities of the same type issued by the same issuer (unless the RAIF invests exclusively in risk capital)	No specific investment or borrowing restrictions, but risk diversification requirement: max. 30% of the SIF's assets can be invested in securities of the same type issued by the same issuer	Yes, both quantitative and qualitative	Yes, both quantitative and qualitative
Borrowing restrictions	None	None	- Max. 200% of the fund's net assets (for directional strategies); - Max. 400% of the fund's net assets (for market-neutral or relative-value strategies for which short positions are covered by long positions) - Derogations may be applied for on a case-by-case basis	Borrowing for investment purposes in principle prohibited, except that UCITS may borrow on a temporary basis up to 10% of their assets (but the use of derivatives may allow equivalent economic results).
Cross-border distribution	AIFMD passport applies	AIFMD passport applies	AIFMD passport applies	Cross-border distribution permitted via European passport within the European Economic Area (EEA)

MIFID II
Markets in Financial Instruments Directive

MIFID 2 establishes rules on selling, making markets in and advising on financial instruments in the EU. Focal points:

- Investor protection
- Functioning of financial markets

Investor types:

- Eligible counterparties
- Professional clients
- Retail clients

Various Elements of MiFID II Investor Protection Requirements
Source: Aite Group

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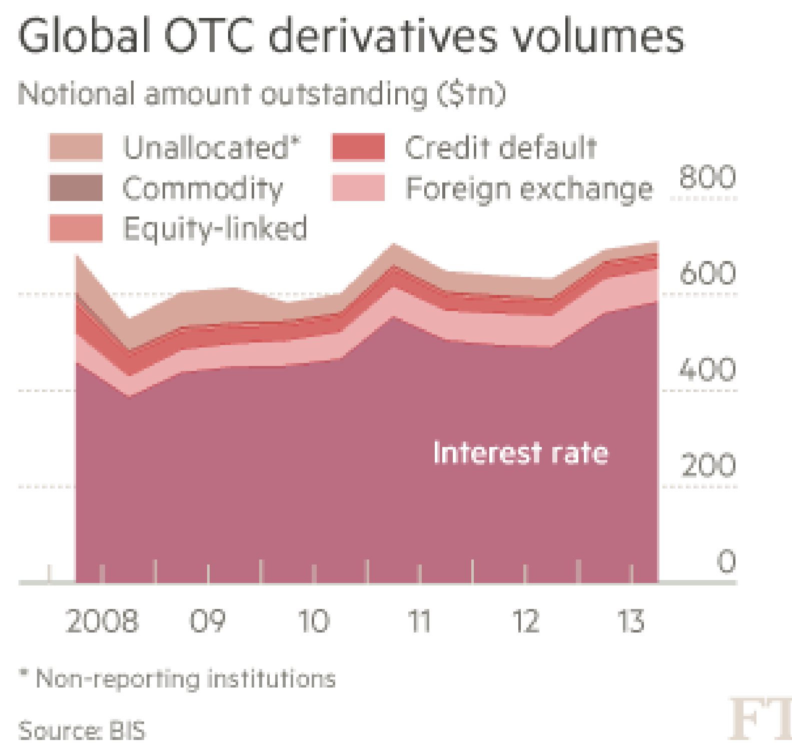
Financial Markets Regulations
European Market Infrastructure Directive (EMIR)

Background: lack of transparency in bank derivative exposures seen as one of the reasons impending recovery post financial crisis of 2008:

Over-the-counter derivatives ('OTC derivative contracts') lack transparency as they are privately negotiated contracts and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence which can make it difficult to identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability. This Regulation lays down conditions for mitigating those risks and improving the transparency of derivative contracts.

Source: EMIR Directive, Official Journal of the European Union



Financial Markets Regulations
European Market Infrastructure Directive (EMIR)

EMIR establishes rules on:

- Clearing and bilateral risk management requirements for OTC derivatives
- Reporting requirements for derivative contracts in general
- ***Central counterparties*** and ***trade information repositories***

Clearing: process of establishing positions, including the calculation of net obligations, and ensuring that financial instruments are available to secure resulting exposures

Central counterparties (CCPs):

- Inserted between the counterparties to the contract (novation) – the CCP becomes legal counterparty for both sides who no longer have default risk against each other
- Once a contract has been novated, any relationship to the original counterparty is broken
- The CCP imposes margining requirements with the ability to close out the contract in cases where sufficient collateral is not maintained