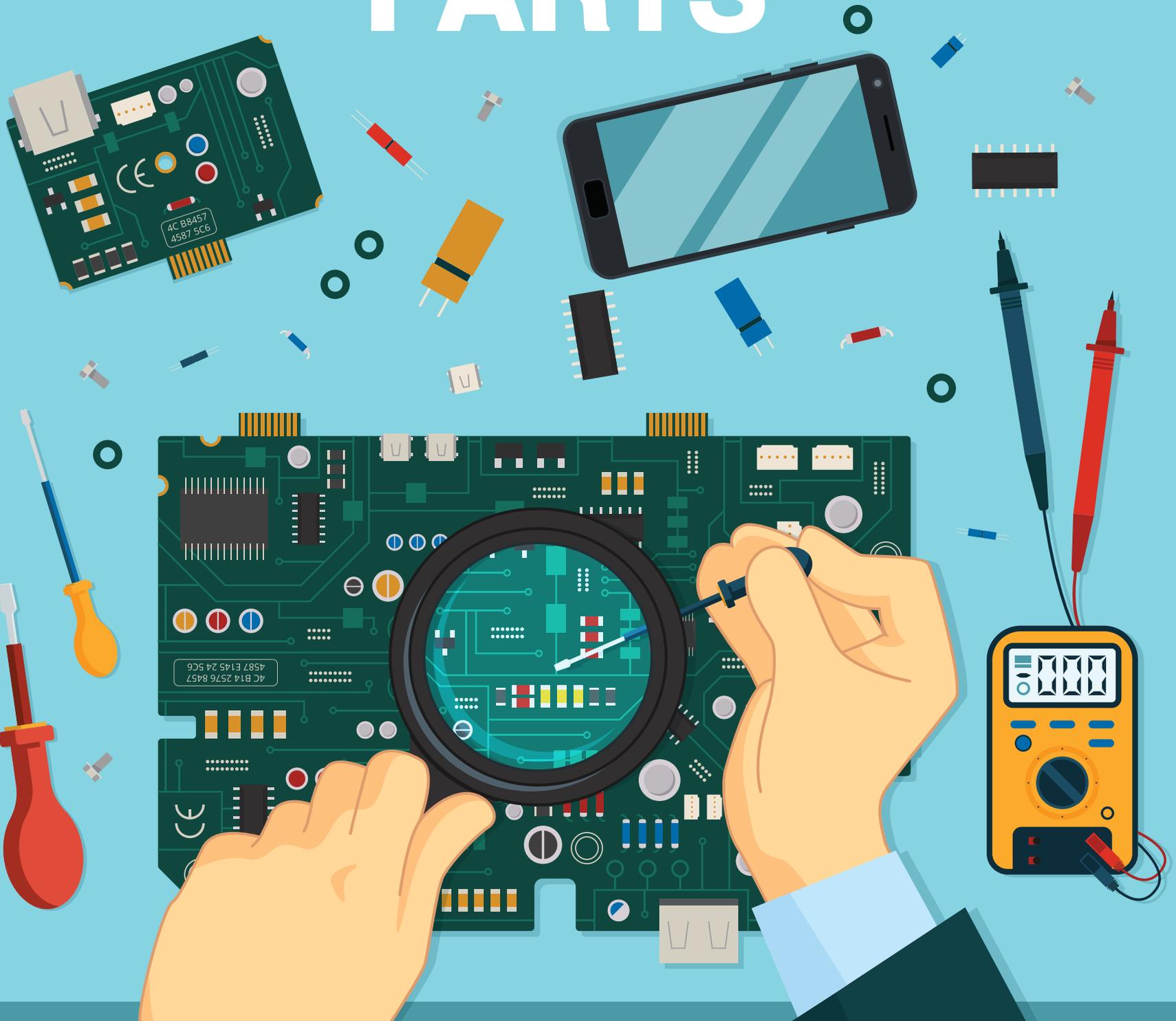


THE SUM OF ALL PARTS



As the superannuation and investments sectors continue to evolve, innovation of service offering is a constant for custodians in order to ensure success. With \$3.6 trillion in total assets and counting, it's no easy feat.

Karren Vergara writes.



01:
David Braga
chief executive
securities services
for Australia & New
Zealand
BNP Paribas



02:
Angelo Calvitto
country executive
Northern Trust

The role of custodians as gatekeepers in Australia's booming \$2.8 trillion superannuation industry has never been more crucial.

Over a period of exponential growth, since compulsory super was introduced in 1992, custodians have been compelled to respond nimbly to consolidation, new entrants and heightened regulation.

BNP Paribas chief executive securities services for Australia and New Zealand, David Braga⁰¹, says not only is the asset pool continuing to grow thanks to inflows from super funds, but the complexity of assets is also changing.

"What that means for custodians is the nature of investments and complexity we have to manage is increasing, particularly as asset owners aim to secure adequate investments to make their risk/return objectives," he says.

Depending on a fund's risk profile, custodians are seeing more complex assets such as hedge funds, global equities, derivatives, private capital and infrastructure in portfolios.

"We're managing that complexity every day on behalf of our clients and it will be a continued trend for the sector," he says.

The custodian's ability to manage such complexity over the last 10 to 15 years has not changed, Braga adds, neither has the sector's efforts to continually invest in systems and people in order to improve capabilities.

Following a comprehensive review in 2012, ASIC acknowledged the pivotal role custodians play as safekeepers of assets and key service providers in the financial services ecosystem.

But it also highlighted numerous operational challenges custodians grappled with: stiff competition, high staff turnover, reliance on manual and disparate systems, cost cutting and offshore outsourcing.

The phenomenal growth of superannuation and increased regulatory scrutiny will flow through to custodians in equal measure. Total assets under custody, which hit \$3.6 trillion at the end of 2018 (see Figure 1), will only grow and stakeholders will consequently demand more from their gatekeepers.

Can custodians rise to the occasion and face both opportunities and challenges head on?

The importance of gatekeepers

Dubbed the gatekeepers of assets, custodians provide critical services numerous stakeholders outside of super funds and fund managers also rely on.

Insurance firms, broker-dealers, endowment funds and charities, and federal and state governments also depend on the core services custodians provide such as fund accounting, trade and transaction settlement, mandate monitoring, record reconciliation, performance monitoring, tax reporting and unit registry.

Sitting between the front and back office value chain is middle-office services.

Middle-office services, says Northern Trust country executive Angelo Calvitto⁰², is also known as 'middle-office outsourcing' or 'investment operations outsourcing'.

Northern Trust recently won a few mandates, one of which is to provide middle-office trade-matching services, such as equities, fixed income and foreign exchange, for \$14.7 billion investment manager Maple-Brown Abbott (MBA).

"It's a global solution across all asset classes where we effectively take the complexity out of trade matching [and] settlement," he says.

In providing middle-office services, Calvitto says Northern Trust is at the centrepiece by managing the trades MBA executes: transactions are matched in the market and sent to the custodian and ultimately to stakeholders relying on that information.

"We then provide reporting to MBA and the underlying client," he explains.

By way of example, a fund manager will buy an equity security and place the order with a broker.

Northern Trust will pick up that transaction, match it with the broker on behalf of the client then route the transaction to the custodian (which could be Northern Trust or another custodian appointed by the superannuation fund that employs the investment manager requiring the transaction), he says.

"Our role as custodians allow us to be truly independent and unbiased, hence we provide a good, independent source of reporting," Braga says.

At the forefront of this reporting are fund accountants, who receive a barrage of data and information on a daily basis.

Once that's all compiled, it is sent to other specialists and reporting teams.



The fund accountant's role is the beating heart of everything that we do.

David Braga

"The fund accountant's role is the beating heart of everything that we do," Braga adds. "They are relied upon by so many stakeholders."

While there are more systems and controls in place these days, Braga says the fund accountant's role is "less bespoke or less artisan", meaning there are less manual processes and effort to analyse their funds.

Their role has also shifted to one that involves more oversight and valuation.

"Clients want more consultation with fund accountants and expects them to really know their funds," he says.

Whether it's a change in fund manager or investment structure; which special purpose vehicle should be used; or how tax treatments flow through, there is a notable trend in clients engaging with fund accountants – particularly when changes within the fund occur.

Nadia Schiavon⁰³, head of securities services for J.P. Morgan Australia and New Zealand, agrees that fund accountants' role is "strategically imperative to the success of the business".

With an extensive background in operations and technology, Schiavon has also spent time in front-office roles. "For me, this business cannot operate without good people. It's an operations and technology-dependent business," she says.

"Whether you're in the back office or the front office, everyone is treated the same, and everyone is considered just as important to the client."

Braga points out that BNP Paribas has built a universe of expertise that has become an important part of how it can provide comfort to clients around the operational environment. The private capital team in Australia is an example.

"It's not that things don't go wrong, it's things go wrong a lot less than they used to and we've got a lot more under control," Braga says.

Figure 1. Total assets under custody for Australian investors

Rank	Provider	30-Jun-18	31-Dec-18	% change
1	J.P.Morgan	762.6	797.8	0.1%
2	NAB Asset Servicing	553.3	529.0	-4.4%
3	BNP Paribas	485.0	470.0	-3.1%
4	Citigroup	449.6	460.9	-2.5%
5	State Street	459.0	446.5	-2.7%
6	Northern Trust	406.0	403.1	-0.7%
7	HSBC Bank	189.3	179.8	-5.0%
8	RBC Investor & Treasury Services	107.5	106.0	-1.4%
9	Bond Street	97.5	97.5	0.0%
10	Ausmaq	53.5	52.8	-1.3%
11	BNY Mellon	11.9	24.4	106.2%
12	Netwealth	20.8	19.0	-8.5%
	Total	3,630.0	3,586.9	-1.2%

Source: The Australian Custodial Services Association



03:
Nadia Schiavon
head of securities
services
J.P. Morgan Australia
& New Zealand



04:
Matthew Baldwin
managing director for
Asia
Financial Risk
Solutions



05:
Scott Hartley
chief executive
Sunsuper

Curbing complacency

One positive trend independent financial services consultant Martin Walsh is seeing among custodians is the use of more sophisticated systems designed to interface with investment offices – that is, the middle and front office.

But the challenge for custodians, he says, is managing those interfaces and providing efficient services.

Managing three separate books of records was another challenge custodians faced.

“The fund manager, custodian and the fund each have their own records; it’s important to understand there are various books of records and ensure they all line up. The industry players are doing that and it’s a good, positive trend,” Walsh says.

Even if systems are working perfectly, Walsh warns more thought should go into what could potentially go wrong. This is where establishing early warning systems in the form of tolerance checks, benchmarking and exception reporting can help.

“Given that the financial services environment has a high level of compliance, it’s important not to get complacent – it’s critical to have early warning systems in place,” he says.

Overall, Walsh has seen unit pricing and back-office operations improve over the years, saying: “Milestone Group has a product called pControl, which is the industry standard used in unit pricing. This is an example where systems and processes have got better.”

Financial Risk Solutions managing director for Asia Matthew Baldwin⁰⁴ describes unit pricing as a process that calculates the prices of underlying assets using external data feeds, often times from multiple sources.

Part of automating the process involves configuring software that puts several checks in place. It understands what tasks need to be done; when it’s due; input files validation; if a unit price moves in line with the benchmark; who to escalate to and so on.

However, Baldwin says several firms with older technology or more manual processes still conduct such checks in a “clunky and slow way”.

One of Baldwin’s global clients, which recently brought the custody process in-house, worked with an outsourcer operating an Australian back-office system that required more than 100 spreadsheets to support 300 daily unit prices.

“When we talk about where unit pricing errors areas come from – spreadsheets and manual process are key drivers,” he says.

“You’d be surprised at how many firms particularly in Australia are still using the fund accounting technology I used from the 1980s. It should be much more modern and intuitive.”

Baldwin emphasises that investing in new technology should give a sensible return on investment, namely through reduced operational risk, efficiency gains, lower staff turnover and job satisfaction for fund accountants.

“Manual checks, using systems that are hard to interact with can lead to stressful work and the implications of getting it wrong or incurring an error are big,” he warns.

Rectifying errors

The challenges in unit pricing are well known across the industry. This is because unit pricing is a complex process with tight time constraints layered with strict consumer protections, Baldwin says.

ASIC and APRA are cognisant of the fact that unit pricing errors can and still do occur – regardless of the quality of systems and controls in place.

Some errors have led to more than \$10 million in compensation – on top of substantial costs associated with rectification and reputational damage, according to the regulators.

In June 2016, Australian Ethical identified a unit pricing error in its retail super fund that dated years back. Profits took a whopping 62% hit as \$2.8 million was paid in compensation (about \$1.6m related to consultant costs).

When an error has been identified, the custodians must be committed to “limiting damage and addressing the loss to investors”, they warned, adding that compensation should be applied consistently and in good faith so that current or former unit holders are not disadvantaged.



As funds invest more globally, they have to ensure they really understand the operational risks of what they are investing.

Martin Walsh

“Where errors are not detected for long periods, compensation costs can be substantial, as unit price determines both numbers of units issued and amounts received on redemption,” they said.

Such errors can have far-reaching consequences. Regardless of the error, the regulators must be informed immediately, while the ATO may need to be involved in some instances. Issues can also arise for unit holders who commenced an income stream and require compensation.

But who will bear the costs?

For not-for-profit superannuation funds without substantial capital reserves, compensation will be an issue.

“In such a case, you may look to insurance or to a service provider that caused the error, or you may be able to draw on a compensation reserve built up over time from within the fund,” the regulators said.

Insourcing versus outsourcing

If a fund decides to insource investments, it has to be clear on what it is getting from their outsourced providers, such as custodians, Walsh says.

Each fund has a unique model in terms of members, how much is insourced and outsourced and so forth.

Funds are designing their own model, Walsh says, while custodians are adept at working with them to get the design right.

“But how a fund designs its oversight must reflect the operating model,” he says.

This is done by clearly determining the functions between the custodian and the fund and how responsibilities should be managed.

“Custodians have very sophisticated models of helping clients design services they need and custody is one element of the services provided. It’s very much a bespoke service these days,” he adds.

In Sunsuper chief executive Scott Hartley’s⁰⁵ view, in-house investment management is an “interesting experiment” which he keeps an open mind about.

Hartley told a recent Bloomberg event he ultimately believes outsourcing is the better arrangement.

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06:
Darren Speirs
head of portfolio
solutions
Bravura Solutions



07:
Tim Broome
managing director,
financial services
practice Australia
& New Zealand
Accenture



08:
Cliff Richards
executive general
manager post-
trade services ASX
Accenture

“My view is that [in-house investment management] is unsustainable if it’s successful and it’s unsustainable if it’s not successful,” he said.

In the case in-house investments is unsuccessful, that could leave a fund with say, 50 people in its Aussie equities team with jobs in limbo. If it’s successful, the team can potentially demand more remuneration and leverage its capabilities, skills and competitive advantage in the open market, he says.

This could put pressure on remuneration and create distinct cultures in the organisation, Hartley explained.

Conversely, AustralianSuper has been ramping up its internalisation strategy in recent years.

As at FY18, nearly a third (31%) of its investment portfolio was managed internally. By 2021, this proportion will hit 50%.

Meanwhile, it has taken eight years for UniSuper to build its investment team of about 50 investment professionals from zero.

Sixty-five percent of investments – global and Aussie equities, Aussie fixed income, Aussie property and cash – are managed in-house.

The move to internalise investments among several asset owners is a growing trend Schiavon is observing.

“Asset owners come to us to help access and leverage data as they look to expand investment plans and capabilities in-house,” she says.

There is a need to have infrastructure in place to support more complex strategies, she says, adding they want an aggregate view of risk and how they are performing against the benchmark.

Whether it’s investments or the back office, outsourcing these functions do have disadvantages.

Outsourcing does not protect the financial institution from the damages caused by poor service, says Bravura head of portfolio solutions Darren Speirs⁰⁶.

“A poor outsourcing decision can result in fines, reputation damage and loss of market share. Therefore, selecting the right partner is essential,” he warns.

Given custodians face numerous regulatory requirements, such as meeting minimum net tangible assets and suitable cashflows, many super funds and investment managers cannot or do not wish to meet such obligations.

Regulatory requirements therefore drive many organisations to outsource, Speirs says.

On the other hand, outsourcing to a software vendor or service provider can reduce risk and is generally, cheaper than supporting the technology in-house, he adds.

Making the move

Whether it’s changing custodians, or choosing to insource or outsource investments, major projects require careful planning and a robust implementation timeframe.

In changing software for example, the time to transition on average takes six to 18 months, Baldwin says, noting several factors come into play, such as the complexity of the fund structure and migrating data accurately.

In changing custodians, testing the accuracy unit prices is critical, as the level of testing conducted will have a significant impact on the duration of the project, he adds.

Baldwin likes to structure projects by spending time at the beginning nutting out the requirements.

“This ensures that there will be no surprises during the implementation, everything is documented and everyone agrees on who is doing what,” Baldwin says.

“Then we deliver an environment to the client ready for testing that includes data conversion; running a sequence; month-end and year-end testing; running parallel systems and so on.”

The test phase roughly takes three to six months and where a lot of “the heavy lifting is done in the project”.



Whether you’re in the back office or the front office, everyone is treated the same, and everyone is considered just as important to the client.

Nadia Schiavon

What this does is give clients “comfort” they are ready to go into production.

Tim Broome⁰⁷, a managing director in Accenture’s financial services practice in Australia and New Zealand, says the key challenge in a systems transformation does not rest in technology – but in the organisation’s people, process and culture.

“In financial services organisations, there can be over a hundred years of processes and fifty years of technology to overhaul,” he says.

This is where new digitally led organisations have the advantage, Broome notes, meaning they do not have the legacy processes to unwind.

“We’re talking about changing the heart of some of the biggest organisations in the country,” he says.

From his experience, replacing technology for a medium to large-sized firm depends on the scale.

It can take a few weeks to replace a single application to several months or even years when trying to in-house large-scale operations, he explains.

“On the latter scenario, it is more a factor of skills availability than the actual process of taking over a service. On average for a medium-sized portfolio, I’d say three months is a reasonable target,” Broome says.

Tougher regulation

As APRA and ASIC become more empowered with resources and renewed mandates to enforce tougher sanctions, regulatory requirements will flow from the trustee right through to fund accountant.

Walsh says APRA and ASIC have increased scrutiny in terms of reporting to members as transparency to consumers only continues to increase.

In terms of members’ best interest, he says it is important to get three things right: measuring costs and performance, and disclosing risk.

“Together with the custodian, it’s important to work out and provide clarity on which three components are internally managed and which are outsourced to the custodian,” he says.

The financial services Royal Commission has influenced the role of custodians in terms of increased reporting requirements, Australian Custodial Services Association chief executive Robert Brown says.

“Additional regulatory change unrelated to the Royal Commission is also having a significant impact, especially in areas of more detailed investment holdings disclosure,” he adds.

He believes opportunities are present for custodians to work with regulators to ensure that policy can be efficiently implemented.

“This includes utilisation of standards, avoiding duplication and technology. Adequate consultation on the implementation of regulatory change process is also broadly encouraged.” **FS**

Building new infrastructure

The Australian Securities Exchange is tipped to become the first major stock exchange to implement distributed ledger technology (DLT) across its clearing house system CHES.

While it’s on track to go live between March and April 2021, how have custodians contributed to the transition?

ASX executive general manager post-trade services Cliff Richards⁰⁸ says global and Australian-based custodians have been involved in the replacement project from close to its inception.

“Typically, custodians are highly engaged in the normal course of ASX’s equity post-trade business, with regular and active contributions from them and their representative associations, most notably ACSA and the Australian Financial Markets Association,” he says.

Custodians have been among the earliest firms to recognise the potential of DLT, particularly in specific use cases it can efficiencies by way of improved risk management, capital efficiencies and potential new service opportunities, he says.

“The ASX has been encouraged with custodians’ early and continuing engagement, and we are actively exploring development opportunities associated with services built with Digital Asset’s DAML smart contracting language,” Richards says.

The exchange recently opened the Customer Development Environment (CDE), which allows customers to interact and experiment with the new system directly via a DLT node.



Optimising your portfolios with future investment operating models

In a period of rapid societal, regulatory, and technological change, today asset owners are more frequently reviewing their investment and operational strategies as they continue the pursuit for operational efficiency and investment returns.

Increasing regulatory transparency and governance obligations are driving institutional investors to look for the right blend of outsourcing and insourcing of core activities to deliver the necessary governance, oversight and efficiency for their investment portfolios.

The optimal insourcing/outsourcing mix of investment, operational and execution capabilities have therefore become critical strategic decisions for today's fund executives.

At a recent FEAL luncheon briefing sponsored by BNP Paribas Securities Services (BNP Paribas), Natalie Floate⁰¹, head of Market and Financing Services, Asia-Pacific at BNP Paribas said asset owners and asset managers around the world are demanding increased visibility, accuracy and timeliness in their investment management.

"Fund managers are weighing up how much internal expertise they need to ensure they continue to meet their regulatory obligations," she said.

"They are questioning whether they should insource or outsource, and if they do outsource, they are demanding a high level of oversight and governance of their providers."

Typical questions funds are asking include: "To what extent should we outsource and

which service? Do we have the resources to manage multiple external providers and what oversight and governance do I need to maintain in-house?" Getting the model right is critical in order to gain the on-going efficiencies of an outsourced model.

"Because it would be extremely inefficient to appoint multiple external providers and then create an internal team to check everything they are doing. Whilst oversight of your providers is essential and good governance the challenge is to get the right mix between oversight and overbearing," Floate said.

Floate also commented on the importance of a clear technological transformational strategy with the flexibility to adapt to the changing business environment.

"For example, when choosing a technology solution, a closed architecture may later limit a fund's flexibility to integrate new sources of data as needed," Floate said.

This may have no impact today because you don't envisage change in your asset allocations, but what if one of your asset managers comes to you tomorrow and says 'We want to try this', and suddenly you have a new project because you are not equipped in terms of how to manage it."

Adding to the importance of a clear technological strategy, funds should also consider that their operating models support the growing need for efficient data mining and intelligent analytics, according to Bruce Russell⁰², director at Shoreline Consulting.



The quote

Asset owners increasing their in-house investment capability need to ensure that the business case for the change is understood by the appropriate stakeholders.

"Often, what begins as a risk or performance project, morphs into a more complex data management project," he says.

When working with large sovereign funds on big data management, Russell has observed the need for more real-time analysis.

"There is no point making active decisions about how to tilt the portfolio when your data is two days old and things have moved on," Russell said.

The case for insourcing

Insourcing of investment management can include directly managing an asset class or a fund/portfolio, dealing and execution, tactical and strategic asset allocation, manager research and oversight and sophisticated risk and performance analytics.

"Insourcing investment management can potentially fundamentally change a business more than initially considered," Russell said. "It is important to ensure that the market is able to provide the solutions that will meet the specific needs of the new operating model."

According to Russell: "Asset owners increasing their in-house investment capability need to ensure that the business case for the change is understood by the appropriate stakeholders. The investment and operational implications should be documented and clear, and the culture of the organisation must be ready to embrace the new model. Whilst the investment business case is often clear, the operational and



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Natalie Floate
head of market and
financing services
Asia-Pacific
BNP Paribas



02:
Bruce Russell
director
Shoreline Consulting

cultural implications of the decision may not be fully appreciated.”

Russell elaborated using the example of the risks of porting across IT solutions from an ‘asset management’ system to an ‘investment management’ system – the latter being the unique view required by asset owners.

“The requirements of the two systems can be very different. Being a fund manager and an asset owner and trying to manage whole-of-portfolio is very different from running a specific asset class, in the way you look at the portfolio or work-flows and make investment decisions,” he said.

Developing a target-operating model can help guide strategic change and ensure details and variety of scenarios are adequately considered.

“A fixed vision of what things are going to look like in five years’ time could unravel as technology, business models and regulations change,” he says.

“Road maps also need to deliver benefits along the way, in bite-sized pieces of change, rather than participants having to wait five years for the journey to pay off. It is therefore crucial to assess the strategy and make the necessary modifications during the transition”.

Outsourcing dealing and execution

To illustrate the creative solutions superannuation funds are developing, Floate described a client BNP Paribas had worked with – a European pension fund with ambitious plans to in-source their investment management that had been outsourced several years prior.

As the fund worked through the details, they realised they wanted the ability to decide what to buy – the investment decision – but then stretching this to execution and bringing the execution of trades in-house carried a range of direct and indirect costs.

For example, hiring dealers, obtaining licences, setting up the necessary systems, ensuring compliance and managing relationships with counterparties would be a huge distraction from their focus on the investment strategy and decisions.

Additionally, the fund would also need to consider periodic costs such as system platform upgrades, regulatory changes and other unforeseen factors that would compel them to redirect resources, incur additional cost and potentially adjust their operating model.

“The fund went through a comprehensive evaluation to determine the level of risk they would be bringing into their organisation around execution, when actually their core objective was investment strategy and stock selection not necessarily to execute on market,” Floate said.

This client’s solution was to adopt an ‘agency execution model’, which involved an outsourced dealing desk to handle trade execution for both internal and potentially external managers.

Optimising execution, accelerating time-to-market, netting transaction and a ‘plug and play’ solution were key selling points for the model.

The benefits of a plug and play dealing desk

Having a “plug and play” external dealing desk that has the necessary relationships reduces the complexity of pushing into new emerging markets, provided the desk has a broad enough capability in terms of market coverage and instrument expertise.

“For example, an investment manager who decides to invest in a new market – let’s say Indian derivatives. With a plug and play external dealing desk, the manager doesn’t need to worry about finding an Indian execution expert who knows intricacies of the India market. The manager simply checks if the dealing desk has the asset class covered, then decides on the investment and takes advice from the desk expert if needed,” she said.

“It’s an effective model for Australian funds who already in-source funds management to consider trialling for their offshore trades.”

Floate further explained how the plug and play model also provides greater agility for funds insourcing investment activity.

“An in-house desk is harder to close or unwind quickly, and less agile to move into new asset class or instrument types” she said.



The quote

It’s an effective model for Australian funds who already in-source funds management to consider trialling for their offshore trades.

Better transparency, staying nimble

Today, asset owners and asset managers face an increasingly complex operating environment. Rapid technological, cultural and regulatory change in an increasingly connected and globalised economy, delivers new challenges and opportunities for fund executives.

“Having transparency and better visibility, without detracting from timeliness and speed of execution, has become a common challenge for clients around the world, and as a result we are seeing increasing interest for our outsourced dealing desk solutions,” Floate concluded. “You can outsource asset allocation, you can outsource compliance monitoring, you can outsource all kinds of things, but are you getting the right information you need or do you have the internal expertise you need in regards to scrutiny and oversight?” **FS**

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