

# Performance Magazine

Issue 42

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# FOREWORD



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As we rally against an ever-evolving Investment Management landscape, focusing on flexible and forward-thinking approaches will be critical to not just keep up, but keep an upper hand. From embracing digitalization to employing tax-efficient strategies, this 42nd issue of *Performance* centers the importance of turning apparent challenges into your next advantage.

**Tokenization is a catalyst for faster settlements, efficiency gains, and fractionalization of assets,** according to John Caslin, Director of Investment Management and Innovation at Carne Group. For service providers and asset managers open to embracing this revolution and overcoming obstacles, improved diversification and liquidity await.

Specialists from Deloitte UK, Belgium and Italy examine **the European Commission's Retail Investment Strategy,** where controversy around inducements and value for money captivate the court of public opinion. While not a

complete ban on inducements, the proposed changes could significantly reshape the business models and revenues of EU retail investment firms, hinting at the need for further flexibility in the future.

**Large language models (LLMs) that are equipped with natural language processing (NLP) and neural networks,** like ChatGPT, are set to revolutionize information processing for a strong competitive edge. Alexandra Jarvis, CSO from Toppan Digital Language, brings the role of LLMs to the forefront of the financial services industry. Once we overcome technical barriers, ensure reliability, and navigate regulations, the potential of NLP could be a true game-changer.

Amid the ever-shifting landscape of Canadian investments, **CIOs face a trio of challenges,** including an uncertain external environment, evolving stakeholder expectations and intense competition in private markets. Agile adaptation is key, say our authors from Deloitte Canada, and CIOs must leverage tech, data and operations to realize a winning investment strategy.

Investment Management Tax Leader Lilly Zhou and Partner Justin Wong of Deloitte Canada turn our focus to **Canada's enticing tax-efficient mechanisms,** which have become a magnet

for investors in the funds industry. From tax-transparent partnerships to the allure of mutual fund trusts, a multitude of options exist for those who stay attuned to evolving regulations.

Contributors from HSBC invite us into **the Private Assets industry,** a place where manual, paper-based processes still have a firm grip due to complex structures and multiple providers. To effectively meet consumer needs, the next steps forward will require that global service models successfully integrate automation, standardization and technology.

Being agile and adaptive will not only help you keep your footing in this unsteady Investment Management environment, it will be pivotal to remaining a strong market player. This 42nd edition of *Performance* magazine invites you to keep your eye on the ball, ready to match challenges and seize the countless opportunities ahead.











# EDITORIAL

Like other markets across the globe, this issue's market of focus, Canada, has faced numerous challenges in the past couple of years. Inflation hikes, a rapid increase in interest rates, policy uncertainties and slowing economic growth have all presented obstacles, but Canada's investment sector approach to the evolving environment could be broadly adapted.

Canadian investment leaders must reassess their investment strategies to control the risk in this shifting environment while also delivering performance. Taking that into consideration, in this edition we examine the key components of structuring and executing a successful and comprehensive investment strategy.

Innovation and technology drive growth in the Investment Management sector. Investment managers make the most of digital currency investment by tokenizing investment funds that leverage blockchain technology and create value. Specifically, we focus on the steps of tokenizing a fund, and the benefits and regulatory challenges associated with this strategy.

The application of artificial intelligence (AI) technology is also a hot topic in the financial sector. The potential of utilizing improved natural language processing (NLP) technology to manage the investment sector's content in order to

gain significant competitive advantage must continue to be explored. Despite the technical and regulatory challenges facing the industry, the adoption of AI technology looks like a rosy-colored and revolutionary solution.

As part of the global trend to manage uncertainties, the European Commission published its Retail Investment Strategy in May with the aim of creating a safer market for retail investors. This issue outlines the most controversial and impactful aspects of the proposal, including value for money, inducements, sustainability and appropriateness, and disclosure requirements.

The high-interest-rate environment in Canada promoted a switch to fixed-income strategies which are often taxed at the highest rates. This has made tax efficiency an even more important consideration when structuring investment funds. To illustrate this, we compared the tax attributes of various Canadian investment fund products and analyzed how tax regulatory development has shaped the fund structuring strategies of investment managers.

With challenges, opportunities arise. It's our privilege to help you turn them into your next big win.



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# Breaking down barriers with new building blocks

HOW TOKENIZATION STREAMLINES FUNDS FOR FASTER  
SETTLEMENT, EFFICIENCY, AND FRACTIONALIZATION

## INTRODUCTION

Fund tokenization has the potential to revolutionize traditional funds by making them more liquid, more accessible, and more efficient.



**JOHN CASLIN**  
DIRECTOR OF INVESTMENT  
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## What is fund tokenization?

Fund tokenization is created by a piece of computer code, a file, a digital contract on a blockchain that produces a digital token to represent a unit of ownership in a fund, record its regulatory status and transaction history, and the asset characteristics of the fund's underlying assets.

The digital token will be stored at an address on a computer network, and the investor will receive a pair of keys: a public key and a corresponding private key. The investor's public key will be linked to their network address and can be thought of as akin to an IBAN for a bank account. Their private key, similar to the PIN number of a bank account, will be secured in a digital wallet.

For decades, paper records of asset ownership and transactions were dematerialized and stored electronically, leading to the question: How is a token in a tokenized fund different from a dematerialized paper record of asset ownership?

Dematerialized paper records are held in a centralized database managed by a trusted party. In contrast, tokens are held on a blockchain, which forms part of a decentralized ledger technology (DLT). The blockchain is decentralized, meaning each node of the DLT maintains a synchronized ledger of all token transactions across all the nodes of the network.

It is easier to own and transfer tokenized funds because the rules governing these two activities are embedded in software code, thereby reducing the dependence on certain intermediaries.

To date, investing in private debt, private equity, infrastructure, and real estate has been largely restricted to institutional investors whether by regulation, large minimum investment amounts, requirements for long lock up periods, absence of any realistic secondary market, limited liquidity, or other barriers to investment.

## How does one tokenize an investment fund?

The first step in tokenizing a fund is to choose the jurisdiction of issue, taking into account the legal and regulatory framework.

Thereafter, funds need to consider the following:

- 1 The choice of blockchain network: This entails deciding between a private or a public blockchain, considering ownership of the data infrastructure, and determining whether a permissionless or a permissioned blockchain is more suitable for the use case.
- 2 Governance of the blockchain: Particularly in relation to the handling of forks as these have serious legal and tax consequences for investors in the fund.

- 3 Characteristics of public blockchains, such as the Bitcoin peer-to-peer network
  - a. Pseudo anonymous in terms of the identity of holders of bitcoin, the number of bitcoin at an address on the network, and transactions made by the holder of the private key to that address on the Bitcoin network,
  - b. Censorship resistant in that no single entity or group can easily manipulate or block transactions, control the supply of bitcoin, or prevent users from participating in the network,
  - c. Transparency, and
  - d. Reliance on probabilistic settlement.

By contrast with public blockchains, a tokenized fund requires:

- (i) Identification of unit holders for KYC-AML-CFT purposes;
- (ii) Compliance to provide access to the blockchain for financial services regulators and auditors;
- (iii) Confidentiality in relation to the identity, number of holdings, and transactions carried out by the holder of the private key to an address on the network;
- (iv) Deterministic finality as investors cannot accept an investment fund in which their purchase of tokens representing units in the fund has only a high probability of settlement but lacks an absolute guarantee.

Settlement finality is usually achieved by ensuring that both the buyer and seller involved in a token transaction acknowledge the finality of the transaction.

- 4 The characteristics of the tokens representing the units in the fund, e.g., any lock-up period, any investor qualification rules, such as professional investors only, jurisdiction of residence of investors, and division of assets with traditionally high minimum investment amounts into smaller and more affordable tranches.
- 5 The extent of any secondary market trading in the tokens and choice of a suitable trading venue.
- 6 The choice of entity to provide the tokenization service.
- 7 The information to be encoded in the token such as the private placement memorandum and compliance requirements for the transfer of tokens.
- 8 Choice of authorized and regulated service providers that can collectively work together to deliver services to a tokenized fund.
- 9 Decision regarding whether a custodian will hold the private keys to the investors' tokens, if investors will hold their own private keys, or if investors will have a choice in how they hold their private keys.
- 10 How investors will interact with the tokens and underlying blockchain, e.g., via a smart phone app linked to their bank account.



**11** Oracles<sup>1</sup> required to provide real-world data to the blockchain, for example, updates on the state of assets with limited useful life that depreciate in value over time, updates to footfall in relation to retail outlets in a real estate fund, or to the price of gold in a physical gold fund.

**12** Writing the code for the relevant smart contracts for the tokens to pay dividends to the token holders or permit the transfer of ownership of a token assuming such code is not embedded in the base layer of the blockchain.

Once these matters have been resolved and the offering documents have been approved by the relevant regulators, tokens may be issued to new subscribing investors.

Thereafter, tokens can be listed on any agreed trade execution venue to create a secondary market in the tokens, thereby increasing the liquidity of the tokenized fund.

## What are the benefits of tokenization?

### Benefits for investors:

1. Fractionalization of ownership of units in a UCITS or AIF allows funds, that traditionally have had high minimum initial investment amounts, can be offered in more affordable tranches, expanding the potential market for funds investing in sectors like private debt and private equity. This allows

investors to diversify their portfolios and gain exposure to a wider range of assets while enhancing liquidity.

2. Secondary market trading of tokenized fund units among existing unit holders in the fund which creates a more liquid secondary market for the fund tokens, thereby widening the attraction of traditionally less liquid funds.
3. Appealing to a generation of technology-savvy investors who transact their banking and investments via smart phone and expect 24/7 service.
4. Increased transparency of certain underlying investments such as real estate AIFs.

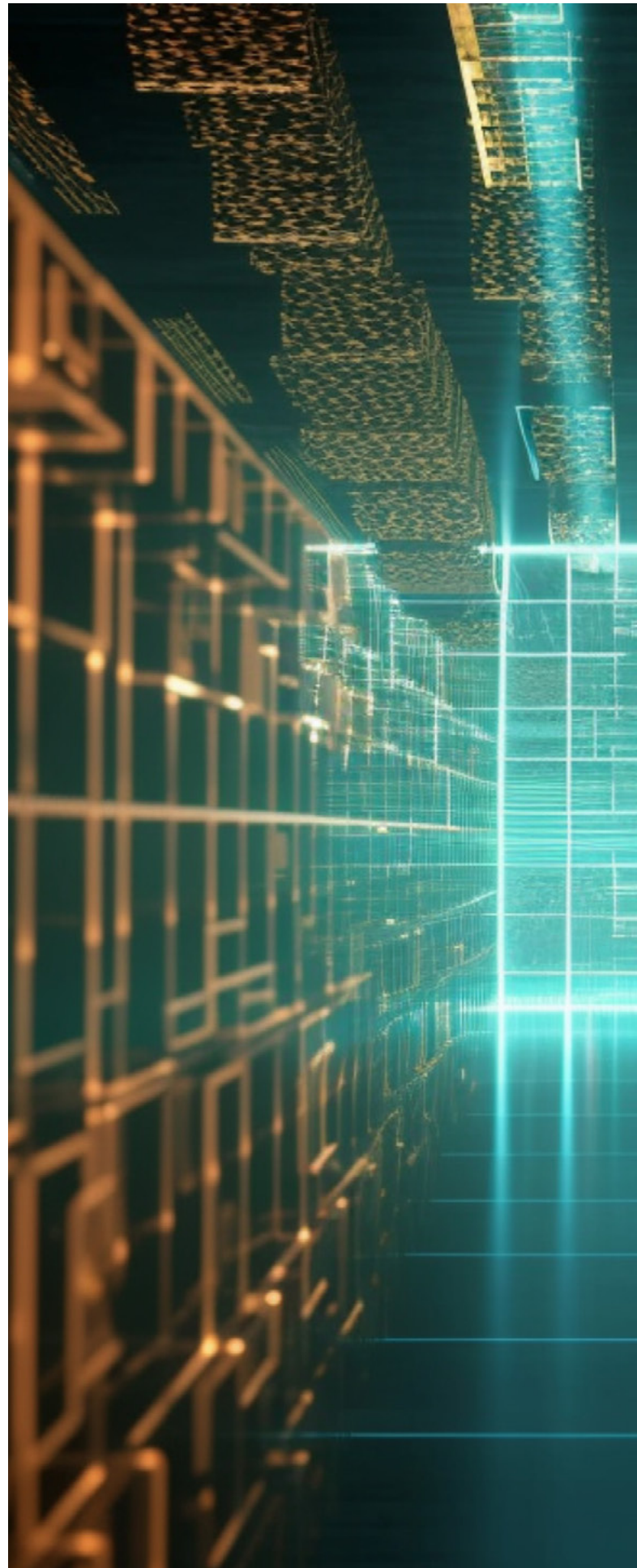
### Benefits for asset managers:

1. Tokenization allows asset managers to create more diversified portfolios with both tokenized traditional funds and crypto-assets, all of which could be held by an investor within a single digital wallet.
2. Lower operating costs for a UCITS or AIF once the entire workflow has been digitized.

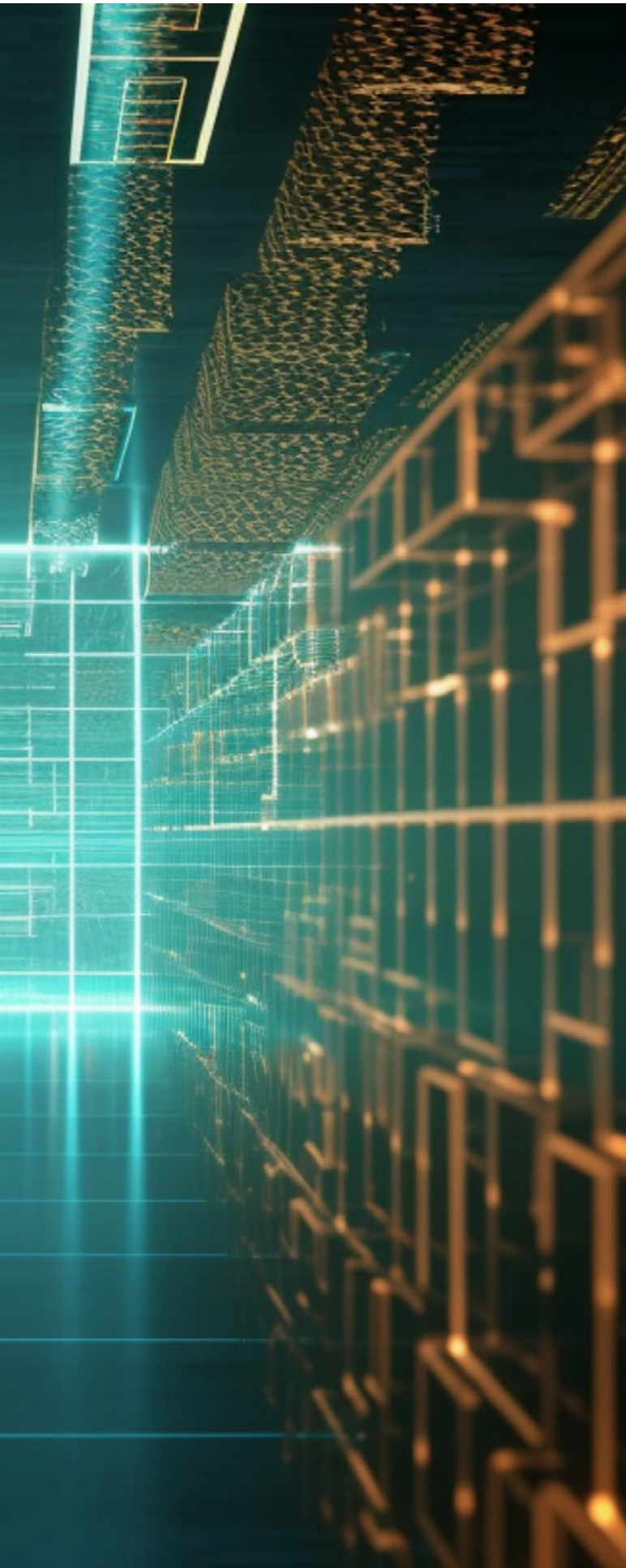
### Benefits for service providers:

1. The blockchain provides a shared single source of truth for all fund service providers eliminating the need for constant reconciliation, removing the delays caused by sequential processing by fund service providers, and automating workflow processes such as payment of dividends or profits and communicating with token holders. Reconciliation reduction does not preclude continuing regulatory requirements for data and asset integrity oversight by certain service providers.

<sup>1</sup> Blockchains are typically designed to operate in a self-contained manner, with limited access to external information. Oracles bridge this information gap by fetching real-world data from trusted external sources and making it available on the blockchain.







2. Settlement of trades in the tokens is faster.
3. The blockchain provides an auditable trail of transaction history and ownership records.

## What are some of the biggest challenges in tokenizing assets?

Tokenization lacks a fully developed and comprehensive legal and regulatory framework. However, jurisdictions like Singapore, France, Germany, and the United Kingdom are making significant strides in the development of a comprehensive legal framework for tokenization.

As tokenization is a “new technology,” it requires significant investigation, internal reviews, and board approval by organizations all of which take time.

KYC-AML-CFT may also need to extend to the payment of “gas” fees<sup>2</sup> to entities staking crypto-assets in a proof of stake consensus mechanism on the blockchain employed for tokenization.

## Are tokenized units in AIF and UCITS funds regarded as crypto-assets for regulatory purposes?

In the EU, tokenized units in AIF and UCITS funds are regarded as financial instruments under

MiFID rather than crypto-assets under the forthcoming EU MiCA Regulation.

## How might fund tokenization change the shape of private equity, private debt, infrastructure, and real estate funds?

From a regulator’s perspective, tokenization has the potential to reduce information asymmetries. At the 2023 Managed Fund Association’s global summit in Paris, regulators noted a lack of visibility of concentration risks, liquidity risks, and synthetic leverage risks<sup>3</sup> in private funds which might potentially alert regulators to links to other parts of the financial sector.

Fund tokenization can provide clear information regarding the issuer of the token, the asset characteristics of a fund, and details of the buyer, seller, and price at which transactions are executed thereby reducing information asymmetries and potentially improving the price discovery mechanism.

## Is tokenization suited to cross border distribution?

Conceptually, tokenization is very suited to cross border distribution. The EU regulatory framework for the distribution of units in AIF and UCITS funds is particularly suited to the cross-border distribution of tokenized funds.

<sup>2</sup> Gas fees refer to the cost associated with executing transactions or smart contracts on a blockchain network. Gas fees are primarily associated with blockchain platforms that utilize a mechanism called “gas” to allocate computational resources and prevent network abuse.

<sup>3</sup> Particularly in relation to uncleared bilateral derivatives.



However, the regulations and the legal status of tokens in a tokenized fund vary across international jurisdictions potentially hampering their global cross border distribution.

## Have any asset management firms tokenized funds or other assets?

At time of writing, the author is aware of four investment management firms that have reported tokenized funds or assets. Table A below summarizes details of their tokenization of assets.

Asset Management Firm	Type of Asset or Fund Tokenized	Brief Details
Apollo	Digital Mortgage Loans	Provenance blockchain with Figure Lending LLC, a fintech company, to facilitate the origination and transfer of digital mortgage loans using blockchain technology.
Franklin Templeton	US Government Money Fund	Polygon blockchain enables the fund to be compatible with the Ethereum blockchain.
Hamilton Lane	Global Private Assets Fund	The minimum investment size was reduced from US\$125,000 to US\$10,000. Tokens are listed on ADDX, a digital securities exchange in Asia.
KKR	Private Equity Fund	The minimum investment amount was reduced, and Securitize, a digital asset securities firm, was used to issue, manage, and trade the digital securities on the Avalanche blockchain. A trading system for the tokens may be offered at a later stage.

## What are the management challenges in tokenizing funds?

To get the maximum benefits from tokenization, an organization must add the new and disruptive technology of blockchain to its existing IT infrastructure which requires the digitization of the entire workflow.

The management challenges include:

- The coordination of the legacy and new blockchain technology.
- Differences in culture between the operators of the legacy technology and those of the new blockchain technology.

- The transition to tokenized funds presents a somewhat all-or-nothing scenario where incorporating a small number of the tokenized benefits can hinder efficiency improvements. To achieve cost savings and revenue growth, it is necessary to fully digitize the workflow surrounding and within the blockchain technology.

For the best customer experience, the infrastructures of different blockchain venues and pools of liquidity for units in funds must interact seamlessly with one another and with centralized systems linked to blockchain networks. Standards of interoperability need to be negotiated within the industry to deliver this high level of customer service and gain the network effects that increase the attraction of adoption for other players.

## CONCLUSION

While fund tokenization is not without its management, legal, and regulatory challenges, it has the potential to transform the shape of private asset funds and resolve the concerns of regulators regarding such assets. There are significant benefits in terms of lower costs and higher revenues for service providers and asset managers. Investors find the ability to diversify their portfolios and enhance the liquidity of their investments very appealing. A number of major players in public and private markets are starting to successfully tokenize funds or other assets.



## TO THE POINT

- Tokenization is streamlining funds for faster settlement, efficiency gains, and fractionalization.
- Fund tokenization has the potential to reshape private asset funds and address regulatory concerns despite the management, legal, and regulatory challenges it presents.
- Service providers and asset managers stand to gain substantial benefits, including cost reduction and revenue growth, through the adoption of tokenization.
- There is a growing trend among major players in public and private markets to successfully tokenize funds and other assets, highlighting the increasing adoption of tokenization.
- Investors find the diversification opportunities and increased liquidity that tokenization offers for their investment portfolios appealing.



# European Commission targets better value and a safer market for retail investors

HOW THE PROPOSALS COULD AFFECT EU BUSINESS MODELS, REVENUES AND OPERATIONS

## INTRODUCTION

The European Commission published its [Retail Investment Strategy](#) on 25 May, covering retail and insurance-based investment products. The package consists of legislative proposals for an Omnibus Directive and a Regulation amending the Packaged Retail and Insurance-based Investment Products ([PRIIPs](#)) Regulation. These will now be debated by the European Parliament and the Council before becoming law, after which further detail will be fleshed out via [delegated acts](#). The proposals have some controversial aspects – particularly on inducements and value for money – so negotiations could be lengthy, and the text could change significantly. Nevertheless, the proposals indicate the key impact areas, and if enacted, could significantly affect retail investment firms’ business models, revenues, and operations. This article outlines the most significant impacts we anticipate if the proposals became law as they currently stand.



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## Value for money – product manufacturers

Product manufacturers would be required to assess whether all costs and charges related to the product are justified and proportionate. This includes comparing against benchmarks on costs and performance which would be developed by ESMA and EIOPA for products with similar levels of performance, risk, strategy, objectives or other characteristics. Where a product deviates from the relevant benchmark, the manufacturer should only approve it if additional testing and further assessments establish that the costs and

charges are nevertheless justified and proportionate. Delegated acts would specify the criteria for carrying out these assessments. UCITS and AIF managers would also be required to prevent undue costs being charged to investors and to reimburse investors if undue costs are charged.

[Experience from the UK](#) (where authorized fund managers must already assess value) suggests that the elements needed to assess effectively whether costs and charges are justified include: an assessment framework that is consistent across products but flexible enough to reflect each product's purpose; a sufficiently granular assessment (e.g. at share class level); due consideration given

to different value indicators; and robust governance and challenge. Given the importance of pricing, firms would want to engage senior management early when developing their frameworks. Where a fund is manufactured by a third-party management company, the management company would need to cooperate closely with the investment manager.

In our view, to create meaningful comparisons, ESMA and EIOPA's benchmarks would need to use narrowly defined peer groups so that the products are genuinely comparable in terms of investment objectives and charging structure. Since investment products are often non-standardized, there would still be cases where products





would provide value despite deviating from the benchmark, but firms would need robust justifications. At this stage it is not clear how factors such as service quality or sustainability would be considered.

## Value for money – distributors

### **Distributors assessing distribution costs**

Distributors would have to identify and quantify distribution costs and any further costs and charges not already considered by the manufacturer, and assess whether the total costs and charges are justified and proportionate. This would include comparing against ESMA and EIOPA's benchmarks, which would include distribution costs. If a product, together with the distribution costs, deviates from the benchmark, the firm should only distribute it if additional testing and further assessments establish that the costs and charges are nevertheless justified and proportionate.

Since distributors would have to quantify any costs and charges not considered by the manufacturer, end distributors would presumably need to consider not only their own costs and charges but also those of any other firms in the distribution chain, such as platform charges. If they cannot justify these, they may need to consider using alternative providers.

### **Distributors assessing product costs**

To act in the client's best interests, firms providing advice would be required to recommend the most cost-efficient product among those identified as suitable



and offering similar features. They must also recommend, among the range of products identified as suitable, a product or products without additional features that are not necessary to achieve the client’s investment objectives and that incur extra costs. Further details would be set out in delegated acts.

At this stage, there is no definition of “additional features,” although examples given include funds with an investment strategy which implies higher costs, a capital guarantee, and structured products with hedging elements. The broader the definition, the greater the impact would be. Advisors would need to examine their product range to determine which product features are necessary to achieve particular investment objectives. In some cases, they may need to add new products so that they have cost-efficient products for all investment objectives, or they may remove less cost-efficient products.

These requirements are likely to result in downward pricing pressure on investment products, and could lead to more investment in simpler products, which may include index-trackers. It may also put a downward pressure on inducements, since products that have higher levels of inducements are likely to be less cost-efficient for the investor.

## Inducements

The Commission supports a full ban on inducements, but notes that an immediate and full ban could disrupt distribution systems and cause unintended consequences. Therefore, it proposes a “staged approach” to allow firms time to adjust.

This includes:

- a ban on inducements for execution-only transactions for retail clients under MiFID, and a similar a ban on inducements for non-advised sales of insurance-based investment products under IDD (with some limited exclusions);
- requirements for advisors to provide cost-efficient product options (see above);
- standardizing the presentation of investor disclosures on inducements; and
- introducing a harmonized regime for independent advice under IDD and banning inducements for it (to align with MiFID).

Three years after the package is adopted, the Commission would assess the effects of inducements and, if necessary, propose legislative measures which could include a full ban.

Many distributors in the EU receive inducements for execution-only business, so this would affect their revenues. For most distributors, inducements for execution-only business

are much lower than from advice. However, some firms – including some investment platforms – rely more on inducements for execution-only business. Firms losing this revenue may want to consider the implications for their pricing and product offering strategies.

Firms would still be able to receive inducements from advice, but the requirement to provide cost-efficient product options may put a downward pressure on these revenues and affect decisions around revenue models.

## Suitability and appropriateness

When conducting suitability tests, firms would have to obtain information about the composition of any existing portfolios, and the need for diversification. Currently, some firms offer advice that considers only one transaction, and this means that advisors would always have to consider the client’s whole portfolio.

These firms would need to change their suitability model, which would increase their costs.

The proposals introduce a form of simplified advice, where advisors do not have to obtain information on the client’s knowledge and experience or on their existing portfolio composition if the advice is independent and restricted to well-diversified, non-complex and cost-efficient products. In our view, firms doing this would need strict controls around the types of products they recommend to avoid unsuitable advice.

For the appropriateness test, firms would have to ask clients about their capacity to bear full or partial losses and their risk tolerance, in addition to asking about knowledge and experience. Given these changes, firms that use the appropriateness test for all their non-advised sales to simplify their operations may decide to restrict it to where it is required.





## Disclosures and marketing communications

The proposals aim to standardize investor disclosures and make them more suitable for digital communication. This includes more standardized disclosures on costs, charges and inducements. They also require marketing communications to be balanced when presenting benefits and risks, and Boards to receive annual reports on their firm's marketing practices.

Firms would be required to display risk warnings for particularly risky investments. This could discourage investors from investing in riskier products, depending on the content of the warnings and what counts as "particularly risky", which are still to be specified. As [UK experience](#) shows, there can be a trade-off between making the warnings simple to understand and providing more nuanced information about the risks.

Proposed amendments to the PRIIPs KID include moving to a digital-by-default format, introducing an "ESG dashboard", and removing the comprehension alert for complex products. In our view, PRIIPs manufacturers may want to start considering how to display information clearly and informatively, particularly given the increased flexibility to use layering and interactive tools under an electronic format, with notable care given to explaining technical terms, including those related to sustainability.

## Other proposals

Other proposals include:

- minimum knowledge and competency requirements for advisors (one area where advisors may need to upskill is on sustainability)
- widening the range of investors that can be treated as professionals on request under MiFID;
- requiring Member States to promote measures that support financial education; and
- strengthening supervisory cooperation and enforcement.

## Next steps

Negotiations in the Council and European Parliament will begin soon. Given next year's Parliament elections, a final agreement may not be reached until 2025. Once the final text enters into force, under the proposals Member States would have 12 months to transpose the Omnibus Directive. Firms would have to comply 18 months after the text's entry into force.

## CONCLUSION

- Although the proposals are likely to be much debated before being finalized, many firms are already starting to assess the potential impacts on their business model, strategy and operations.
- The proposals on value for money and inducements could have a significant impact on firms' business model and revenues. The proposals on suitability and appropriateness, and on disclosures and marketing, could have a significant impact on firms' operations and IT systems. The proposals on knowledge and competency may require some advisors to upskill, especially on sustainability.

*This article is adapted from a previous [article](#) published by Deloitte's EMEA Centre for Regulatory Strategy.*





## TO THE POINT

- The European Commission published its much-awaited Retail Investment Strategy in May. The proposals include some controversial aspects, particularly regarding inducements and value for money, which are expected to generate extensive debate before their finalization. Nevertheless, they give an important indication of what the key impact areas are likely to be.
- While the strategy does not include a full ban on inducements, some of the proposals – especially those on value for money and inducements - could have a significant impact on EU retail investment firms' business models and revenues. Manufacturers may need to consider amending pricing or product features to make them more cost-efficient, while distributors may need to review their product ranges and consider their own revenue models.
- In their current form, the proposals could also impose significant operational impacts, as firms would need to:
  - have strong governance and operational processes to assess whether costs and charges are justified and proportionate;
  - evaluate whether product features are necessary to achieve particular investment objectives; and
  - redesign suitability and appropriateness tests.Firms may also need to update their IT systems to comply with the new investor disclosure rules.



# AI's game-changing role in managing content in the finance sector

REDEFINING THE FINANCIAL LANDSCAPE WITH NATURAL  
LANGUAGE PROCESSING



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## INTRODUCTION

Information is a key asset and resource in the financial services industry. The ability to obtain better, faster, and more accurate information brings competitive advantages, as information exchange underpins all parts of the industry, including financial markets. Yet, while there has been a revolution in quantitative data tools, such as algorithmic trading, a revolution of the same magnitude relating to natural language information has not yet occurred.

Natural language information is written or spoken information in any human language, pertinent examples being an annual report, a meeting transcript, a clinical trial report, a news article, a prospectus, or a training video. The challenge has been that, until very recently, the ability of machines to understand natural language has been poor, and therefore we have relied on humans for the production and analysis of this information.

However, the advent of Large Language Models (LLMs), such as ChatGPT, presents the stunning possibility to overcome human-scale limitations and exponentially change the magnitude, speed, and accuracy of human-language information processing.

There are significant incentives in the financial services industry to embrace these technologies quickly, to gain competitive advantage and boost productivity. Below, we set out, at a high level, some of the potential opportunities, but also considerations and challenges of adopting these new technologies.



To many, ChatGPT may have appeared to burst onto the scene from nowhere. It is seriously impressive, but it's worth understanding its context. The ChatGPT application uses artificial intelligence known as Natural Language Processing (NLP). NLP is a field of science that has been around for many decades but has made incredible progress in the past five years due to the switch from statistical models to self-learning neural networks.

When trained on large volumes of high-quality data, neural networks learn to 'make sense' of human language and can perform several tasks. These tasks include relatively simple actions, such as keyword and named entity recognition, tagging, text classification, and parsing, through to more complex actions, such as translation (Neural Machine Translation or NMT), summarization or paraphrasing, as well as the significantly more difficult tasks of question-answering and natural language generation. It is the progress in these last highly complex tasks, achieved by training on vast datasets with billions of parameters, that have "completed the set" and generated excitement (not to mention, launched a few thousand VC pitches).

Furthermore, NLP is increasingly combined with Automatic Speech Recognition and synthetic voice for text-to-speech, speech-to-text, and speech-to-speech. With the right training data, it is now theoretically possible to build almost any language-related application using the blocks described above, presenting significant benefits in the financial services industry. These could be applicable for the following:

- Knowledge gathering from a much greater variety of sources, in any language or format
- Assisted or fully automated authoring
- Content transformation or repurposing, such as summarizing, re-phrasing, or translating
- Content analysis and insights, including contextual insights such as reliability scoring

Imagine if all company announcements released on a given day could be analyzed in seconds, with summaries created in any language. Or consider the ability to scan a prospectus for anomalies and risks, contextualized within other companies in its sector or the market overall. An ESG report would be automatically generated by pulling data directly from the company's systems, with the correct taxonomy applied for the jurisdiction, or a report could be generated to explain a set of statistics to a non-expert.

What is stopping us? There are probably five key areas where we must pause for thought:

#### Technical challenges

There is good news: the NLP community is open-source by nature, and indeed open-source algorithms and engines are advancing extremely quickly. This means that organizations are not going to be reliant on just a few providers. Nevertheless, there is a scramble to assemble the rare skill sets required to build these new applications, which require not just technical skills, but also domain-specific subject matter expertise.

#### Reliability

NLP can produce extremely fluent, convincing-sounding sentences, and it is usually optimized to do so. However, it can be wildly wrong and has

no "audit trail" regarding how it came up with a particular response. In the translation industry, Machine Translation is still largely used as an assistant and is edited by humans – and despite its significant progress, no one would yet rely on it for high-stakes content. Reliability and accuracy will improve over time, but caution must be exercised.

#### Security

Many organizations have already created policies prohibiting or constraining the use of public LLMs at work, to prevent information leakage and comply with data protection regulations. Organizations must ensure that their applications and data are well protected.

#### Regulation

In addition to the data protection considerations above, AI is likely to become increasingly regulated in the coming years. With the benefits of NLP, additional layers of compliance will emerge. Interesting conundrums around intellectual property and inside information may also need to be dealt with.

Change management. Enhancing existing processes with AI or fundamentally re-engineering them will be a significant change management exercise, impacting not only a company's systems but also the redefining of employee roles. Mapping this path and executing any such change is going to be high on the list of many businesses, presenting medium to long-term challenges.







## CONCLUSION

The game-changing role of NLP in financial services content is just unfolding. As we navigate the challenges and risks, staying focused on the immense potential and opportunities that AI brings is crucial. With the right balance of technology and human insight, the future of financial services content looks promising and exciting. Financial institutions can look forward to a more efficient and globally interconnected future by embracing AI's capabilities and preparing for the changes it brings.

## TO THE POINT

- Large Language Models (LLMs) like ChatGPT will improve natural language information processing in the financial services industry, providing significant competitive advantages.
- LLMs employ Natural Language Processing (NLP) and neural networks to understand human language and perform tasks, such as translation, summarization, paraphrasing, question-answering, and natural language generation.
- Potential financial services applications include knowledge gathering, automated authoring, content transformation, (summarizing or translating), and insightful content analysis.
- Challenges to adopting NLP in financial services include technical challenges, ensuring reliability and security, navigating regulation, and managing changes in existing processes and employee roles.
- Despite these challenges, the role of NLP in financial services content is poised to be game-changing, and with the right balance of technology and human insight, the future looks promising





# The impetus for refreshing an investment strategy

## NAVIGATING CANADA'S CHANGING INVESTMENT LANDSCAPE

### **INTRODUCTION**

As the markets shift to a higher probability period of market dislocation, chief investment officers (CIOs) must be well-equipped to navigate these changes. With alpha generation becoming increasingly challenging, and client and member expectations influencing investment decisions, it is crucial for CIOs to articulate a robust investment strategy that can withstand external pressures and deliver persistent returns. While this may seem daunting, we believe that a winning investment strategy, rooted in a firm's comparative advantage and investment ideology, and supported by robust capabilities and management systems, will help the firm navigate through the unpredictable and evolving market conditions.





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In today's rapidly evolving market landscape, Canadian investment leaders face a multitude of factors that drive the need to reassess their organization's investment strategy.

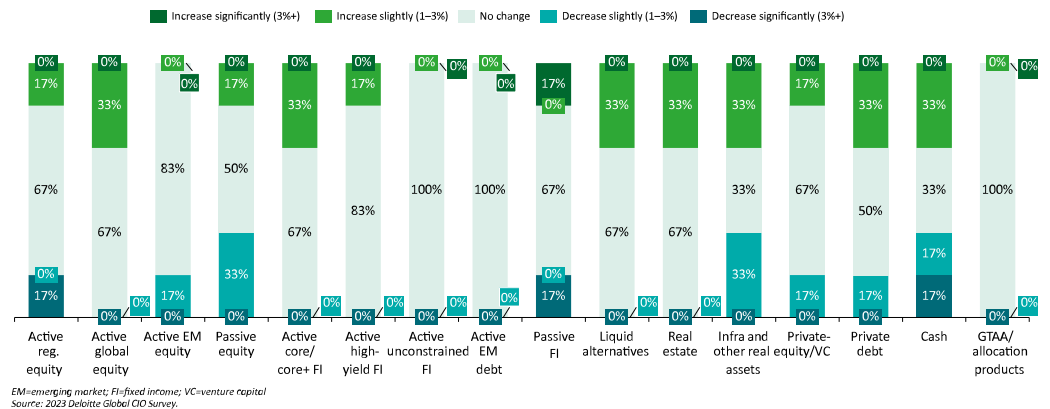
- **Uncertain external environment:** Emerging geopolitical risks, heightened inflationary pressures, increased market volatility and an uncertain market outlook have prompted investment leaders to re-evaluate their strategic allocation and risk exposures.
- **New expectations among stakeholders:** Clients and members' expectations are expanding beyond just financial performance. For example, given increased societal focus on ESG, many have been turning to their investment managers to ensure investments reflect this preference.

- **Emerging pressure on private markets:** In Canada, private assets under management (AUM) saw incredible growth between 2020 and 2022, increasing from \$188.4 billion to \$322.6 billion.<sup>1</sup> This points to a heightened competitiveness between firms for deals in real estate, infrastructure, private equity, private debt, and other alternative asset classes. The challenge is compounded by the headwind of rising interest rates, that add leverage costs and tighten the share of available credit.
- Chief investment officer's (CIO) must be nimble in their response to build portfolio resiliency and address the needs of clients/members. CIOs need to consider the current market outlook across both public and private assets and define comprehensive

investment strategies to remain nimble in adapting to market fluctuations, reinforce their competitive edge, mitigate investment risk, and generate alpha, all the while addressing the preferences of their clients/members.

For pension plans in particular, the accuracy and implementation of these adaptations are crucial to balance risk, maintain investment returns, and ultimately meet their pension obligations. In response, we are seeing Canadian pension managers adapting their target allocations to account for these new market conditions (see figure 1, from the 2023 Deloitte Global CIO Survey).

**Figure 1: Canadian pension plan portfolio allocation shifts planned for the year ahead**



1. "Private capital in Canada 2023: Preqin territory guide," Preqin, April 20, 2023, <https://www.preqin.com/insights/research/reports/private-capital-in-canada-2023-preqin-territory-guide>

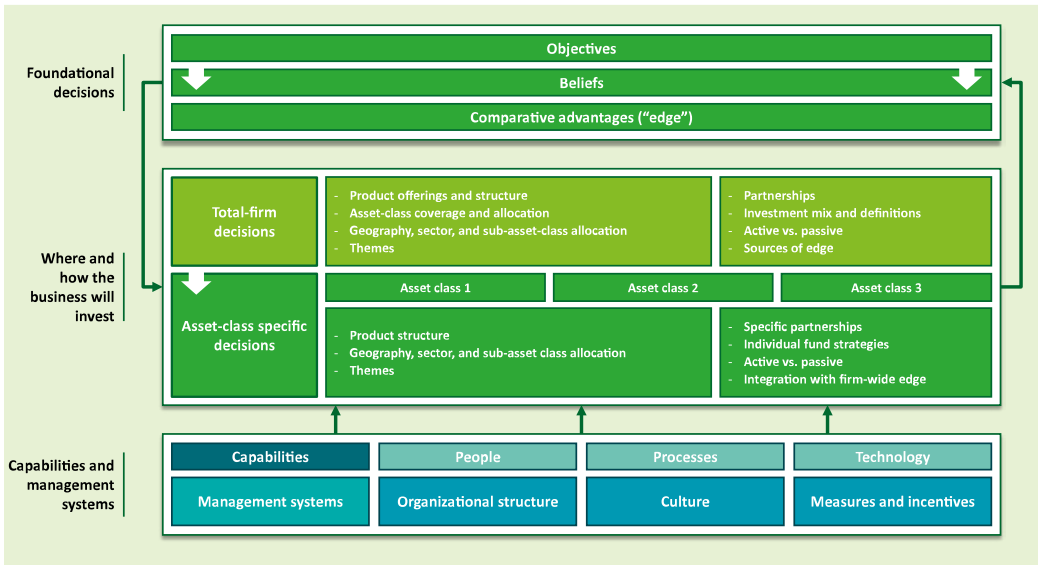


# Breaking down a thorough strategy

At its core, a successful investment strategy must be cohesive and all-encompassing, accounting for specific aspects of the market landscape and client needs. Our framework outlines what we consider to be the three critical components of a winning strategy (see figure 2):

1. foundational decisions surrounding investment targets and thesis,
2. choices about where and how to invest
3. capabilities and management systems

**Figure 2: Critical elements of an investment strategy**



As depicted in figure 2, a comprehensive investment strategy requires a strong bedrock of firm-held investment targets, ideology, and comparative advantages, informed by both their unique perspective on the market landscape and articulated client/member preferences. By establishing this steady foundation, a firm will be better positioned to optimize its investment outcomes and position its North Star, which will inform future strategic decisions.

In the next tier of our framework, investment managers must decide where and how to allocate funds to best achieve the firm’s investment objectives, align with its investment beliefs, and make use of its comparative advantages. These key decisions include how to allocate capital across market segments, geographic regions, and asset classes—considering both firm-wide and specific asset-class goals—and examining investment styles (e.g., thematic) and partnership approaches, among other factors.

Finally, an effective investment strategy should identify the capabilities and management systems a firm must build or refine to best support its investment decisions and optimize its comparative advantages. Examples include establishing a private equity arm, redesigning incentive structures, and standing up a relationship management team.







## From design to reality

With structural and investment choices established, investment managers can then adjust their existing portfolio, both in terms of allocation and new holdings/asset classes, to meet the objectives set out in their investment strategy. For this process, we recommend a dial-up/dial-down approach, in which investment managers define the specific investment (dial-up) and divestment (dial down) changes required across a given portfolio to achieve target state holdings. This dial-up/dial-down strategy is represented in figure 1 through the allocation shifts that Canadian investment managers intend to make within the next year.

To implement and operate a target state investment strategy successfully, required capabilities and management systems must first be established, with specific asset types necessitating distinct sets of capabilities and systems. For example, when considering investing in private equity assets, an investment manager might first develop co-investment channels with existing partners that partake in private equity investments (i.e., the capability) and establish an organizational structure for its new private equity arm (i.e., the management system).

The following are several critical initiatives that can provide the necessary foundations to support a comprehensive investment strategy:

- **Data and technology modernization:** This involves modernizing the existing investment technology stack and data platforms to provide enhanced investor decision

making capabilities for the front-office (e.g., self-serve access to high quality data & analytics) and streamline the existing middle- and back-office functions (e.g., increased straight through processing).

- **Preferred partner program:** This initiative aims to define an approach to building relationships with external parties to get preferred access to new investment opportunities (e.g., stock issuances, bond issuances, new alternative assets), secure required funding for an investment, gain understanding of technology or concepts, and more. This approach can include establishing tailored relationship-tracking technologies and management systems, with an overall aim of better defining and maintaining important external relationships.
- **Operating model design:** A streamlined model helps ensure optimal structure across asset classes, regions, and industries to offer scalable investment coverage. It also allows teams to better collaborate and tap into the broad expertise of members.
- **Mandate oversight process:** This involves defining a robust process to oversee and monitor the performance of specific investments (e.g., asset classes) and external managers to enable nimble and swift adjustments to individual holdings and overall strategy.
- **ESG considerations:** These involve adjusting existing investment processes to help ensure ESG metrics are properly considered when assessing new and current investments as well as incorporating ESG metrics as measured KPIs throughout the investment selection and monitoring process.





## Key factors for execution

Firms can improve their chances of a successful investment strategy refresh by addressing common challenges in both the design and planning phases, and the rollout stages. Methods include incorporating regulatory considerations into strategy design and decision-making, such as by considering the effects of changes in asset allocations and approaches, proactively managing internal and external stakeholder expectations, and

working to ensure effective change management is in place to support new and existing talent.

It is also critical for firms to keep their investment strategies current, while enabling nimble decision-making in the face of market volatility and changing external factors. Firms should ensure to consider the role of data management and technology as part of the strategy, including integrated systems and data integration, to allow for rapid decision-making and effective adaptation of the strategy.

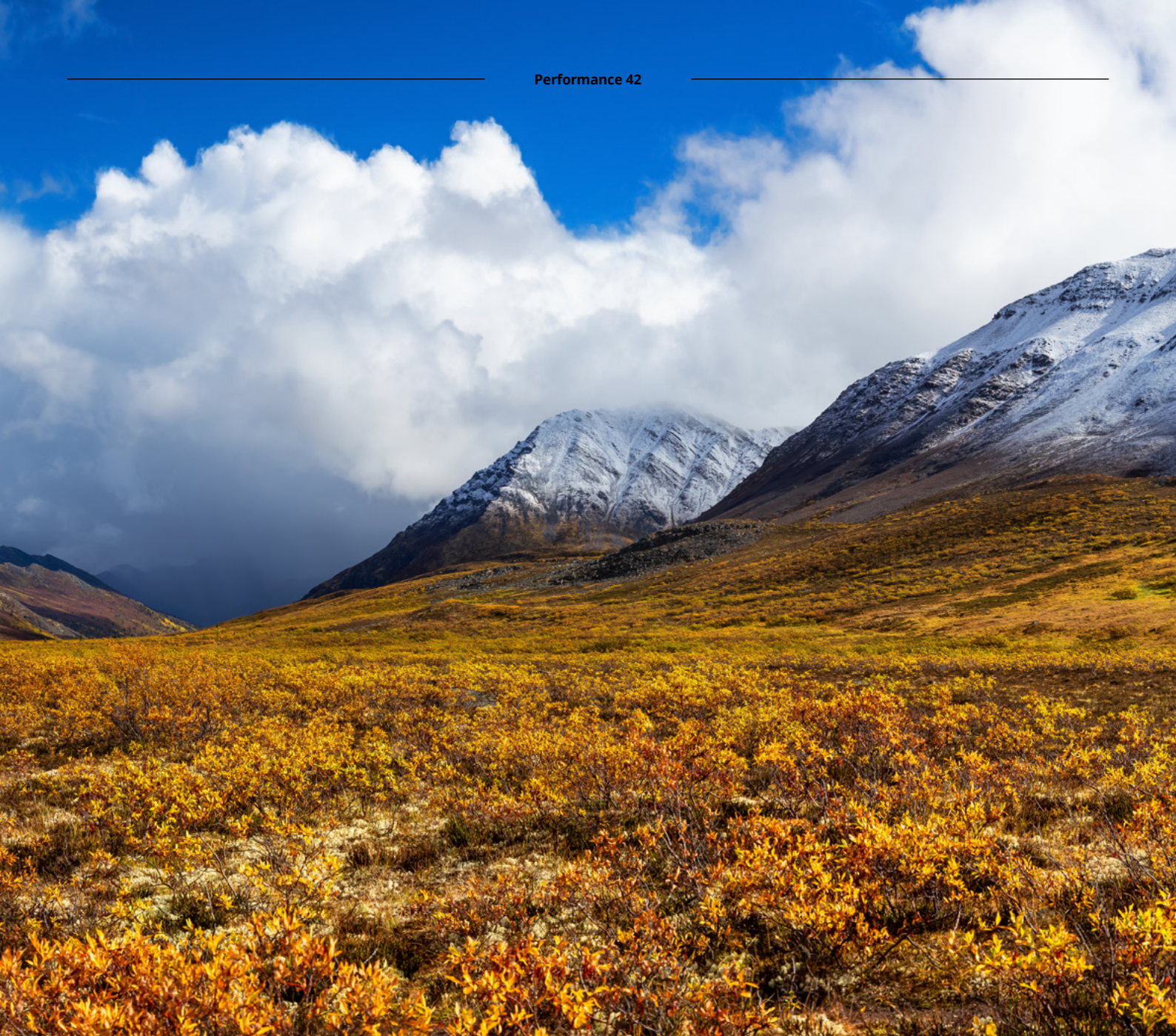
## CONCLUSION

A successful investment strategy requires a cohesive and collaborative approach that accounts for the specific aspects of client / members needs, the firm's investment beliefs, and the market dynamics. A winning strategy will capture the firm's specific foundational investment targets and thesis, outline the specific choices on where and how the firm will allocate capital, and finally define the capabilities and management systems enabling the strategy. The deliberate identification and design of the capabilities will help ensure the correct

management systems are in place to allow the firm to successfully meet the objectives set out in the strategy.

Ultimately, a comprehensive investment strategy coupled with a well-planned, intentional approach for its execution can position investment managers for success in the evolving, increasingly competitive and complex market landscape.





## TO THE POINT

- Canadian investment leaders face factors driving the need to reassess their investment strategy:
  - Uncertain external environment: Geopolitical risks, inflation, market volatility.
  - New stakeholder expectations: Expanding beyond financial performance to ESG considerations.
  - Pressure on private markets: Intense competition, rising interest rates.
- Chief investment officer's (CIO) must be nimble and consider market outlook to adapt portfolios and meet clients' needs.
- Three critical components of a winning strategy:
  - Foundational decisions on investment targets and ideology
  - Allocation choices and investment styles (where and how to invest)
  - Capabilities and management systems
- The capability and management systems required to execute on the investment strategy will be pervasive across the enterprise, and establishing alignment with the technology, data, and operating strategies are critical to success

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# Tax efficiency of Canadian investment vehicles

OPPORTUNITIES, CHALLENGES,  
AND EVOLVEMENT



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## INTRODUCTION

The tax landscape in Canada has undergone significant changes over the past decade and recent regulatory developments have spurred Canadian fund managers to adapt to the evolving landscape. However, the general Canadian tax framework for Canadian investment funds and investors has remained relatively stable, creating a conducive tax and regulatory environment for fund managers. Like tax rules in many other countries, the application of Canadian tax rules varies depending on the legal structure of investment vehicles. The legal entities that Canada recognizes in tax law are trusts, partnerships and corporations. While partnerships are transparent for tax purposes, trusts and corporations are not. Nonetheless, investment funds structured as trusts and corporations also benefit from tax efficiency through various mechanisms.



### Partnership funds – Flow-through feature

Canada treats partnerships as flow-through entities that are generally not subject to taxation. For tax purposes, income earned by a partnership fund retains its character and is allocated to investors of the fund and taxed in their hands. Fund managers and investors often choose limited partnerships as the vehicle for private equity and alternative investments because of their tax-transparent nature. This setup enables investors to access partnership losses in the initial years when the funds may not have income.

Canadian investors in a partnership fund are subject to different tax rates depending on the character of the income allocated by the partnership. As a general rule, Canada taxes capital gains at 50% of the rate it taxes interest income and foreign-sourced (non-Canadian) dividends. Canada taxes dividends from Canadian corporations at a rate higher than capital gains but lower than interest and foreign dividends. An investor who is a non-resident of Canada may be subject to Canadian withholding tax on Canadian-sourced income at a rate of 25%, subject to any available treaty relief.

A partnership fund with non-Canadian resident investors may be exempt from filing information returns with Canada's taxation authorities provided the fund does not carry-on business in Canada or dispose of taxable Canadian property. This compliance exemption reduces the administrative burden for funds with diverse investor bases.

### Mutual fund trusts and unit trusts – Embracing tax efficiency

Most regulated investment funds in Canada are structured as trusts due to regulatory requirements. Trusts are taxable entities under Canadian tax law. Nevertheless, they can be tax-efficient because trusts can allocate and distribute income and capital gains, so the amounts are taxed at the investor level and the trust itself is not taxable. Unlike a partnership, a trust cannot allocate its losses to investors. However, losses incurred by the trust can be carried forward to offset taxable income in future years, subject to certain limitations.

Investment trusts are generally set up as "unit trusts" from a Canadian tax perspective. A mutual fund trust is a unit trust that meets additional conditions. Specifically, to qualify as a mutual fund trust, it must maintain at least 150 unitholders that meet certain minimum unit holding requirements. Mutual fund trusts enjoy tax benefits not available to unit trusts. As an example, tax-exempt retirement plans can invest in mutual fund trusts without being subject to penalty taxes. In addition, mutual fund trusts are exempted from many penalty taxes and adverse rules that may apply to unit trusts. Furthermore, these mutual fund trusts may also reduce their capital gain distributions to investors using a mechanism called the capital gains refund and can shield remaining unitholders from immediate taxation on realized capital gains due to liquidating investments to fund redemptions. Both unit trusts and mutual fund trusts can use other mechanisms to allocate capital gains resulting from redemptions.

Income and capital gain distributions made by mutual fund trusts and unit trusts to Canadian investors retain their character, leading to different tax rates based on the type of income. For non-resident investors, income distributions and capital gain distributions from these trusts are generally subject to Canadian withholding tax at a rate of 25% or 12.5%, unless a treaty relief applies. However, capital gain distributions from mutual fund trusts to non-resident investors are usually exempt from withholding tax, making mutual fund trusts more tax-efficient for non-Canadian investors.

Canadian-resident trusts are required to file annual income tax returns and information returns with the Canadian taxation authorities. Trusts are responsible for providing tax slips to both Canadian and non-Canadian investors and for reporting those tax slips to the Canada Revenue Agency.

### Mutual fund corporations – A previously popular investment vehicle

A Canadian mutual fund corporation is typically an umbrella entity with multiple classes of shares representing distinct investment strategies. Mutual fund corporations are taxable entities subject to Canadian income tax on interest and foreign-sourced income. Provided the corporation makes sufficient distributions, Canadian dividend income and capital gains dividends are usually taxed in the investors' hands and not at the corporate level. Unlike trusts and partnerships, mutual fund corporations cannot allocate other types of income and are thus less tax-efficient vehicles given the potential for tax leakage.

At one time, mutual fund corporations offered investors the opportunity to switch between classes on a tax-deferred basis which made them attractive investment vehicles. This led to large fund managers establishing mutual fund corporations in Canada, with an array of 30 to 100 different classes. When Canada permitted investors to switch classes on a tax-deferred basis, Canadian mutual fund corporations experienced exponential growth despite the potential tax leakage with certain investment income.

In 2017 Canadian tax rules were altered to prevent tax-free class switches. This eliminated the main tax advantage of mutual fund corporations over mutual fund trusts. Since then, many fund managers have shifted from mutual fund corporation structures to trusts.

Canadian mutual fund corporations must file annual income tax returns and issue tax slips. Corporate tax filings are generally more complex and onerous compared to trust tax filings, resulting in higher administrative and compliance costs for corporate structures.



## CONCLUSION

Canada promotes the attractiveness of its investment funds industry by providing tax efficiency through a diverse range of mechanisms. Partnerships are attractive because of their flow-through and non-taxable status. Trust funds are taxable but are still effective flow-through vehicles that can allocate income to

investors for taxation. Recent tax rule changes have limited the attractiveness of mutual fund corporations, making them the least favored vehicle, and leading many fund managers to adopt trust structures instead. Therefore, monitoring regulatory changes in Canada is crucial for fund managers seeking to navigate the evolving tax landscape effectively.

## TO THE POINT

- Tax efficiency in Canada: Canada offers tax-efficient mechanisms for investment funds, attracting investors to the industry.
- Canadian investment vehicles: Partnerships' tax transparency makes them favorable for certain funds in Canada. Trust structures, especially mutual fund trusts, provide tax advantages, including capital gains refunds, while the appeal of mutual fund corporations declined after tax rule changes, resulting in conversions into trusts.
- Monitoring regulatory changes: Fund managers must stay vigilant to adapt to evolving tax regulations in Canada's investment funds industry.



# Private Asset services in transformation: the road ahead is digital

EMBRACING CHANGE DRIVEN BY AUTOMATION, INTEGRATION, AND GLOBAL SERVICE MODELS

## INTRODUCTION

The entire funds industry recognizes the needs for more automation, standardization, and increased use of new technology in the Private Assets (PA) ecosystem. The global service model of the future to support Asset Managers and Owners in the PA arena needs to incorporate the following elements to offer scalability and control combined with high levels of service and data transparency.



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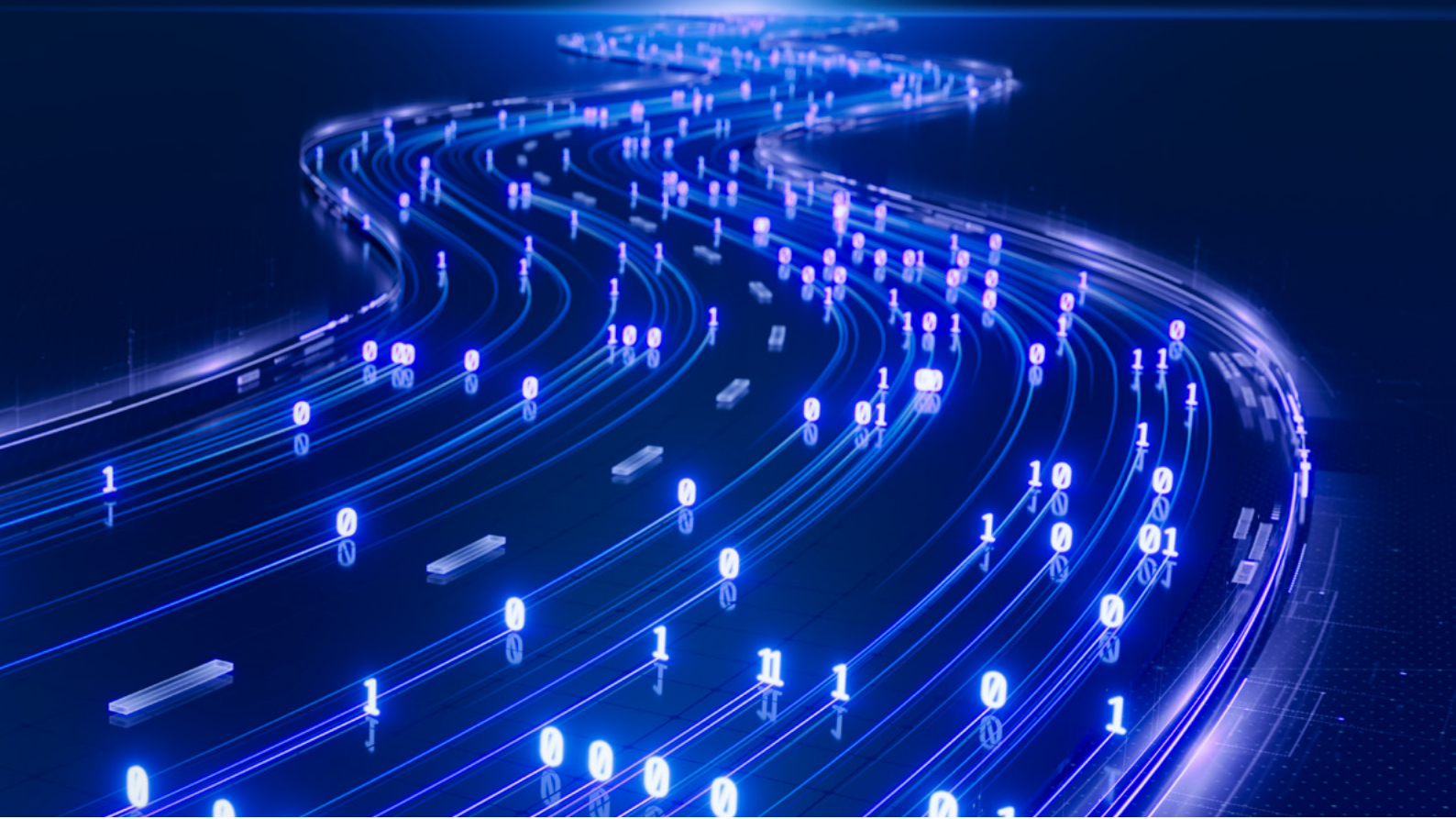
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## Digitalization of tasks and processes:

All stakeholders recognize the key challenges when servicing or investing in PAs, and the abundance of tasks that are manual in nature or paper based. Invariably, this is either caused or exacerbated by having multiple service providers, different entities in different jurisdictions, complex structures, and investments with look-through requirements. In addition, there is an overarching need to manage day-to-day activities, such as capital calls and payments in a scalable manner.

While there is a need for tailored and specific solutions, the ultimate goal is to be able to digitalize and industrialize these processes.

### **How can we reconcile these seemingly opposing objectives?**

One successful pathway is to use technologies optimized for different types of investments and wrap them into a common data architecture and digital channels (e.g., global portals) that facilitate access to key insights, data and reporting for clients and their investors. It is important to enable access to this data via multiple channels, including cutting-edge digital experiences for individual users or highly automated system-to-system data exchange (e.g., via Application Programming

Interface, more commonly called APIs).

A secure portal offers clients a single and unique access to all of their data and data points, including data drilldown and exporting capabilities.

As mentioned above, digitalization and automation are not the only elements to consider when developing a compelling, holistic platform for private asset services. In our experience, clients value a partner who can match their business ambitions by providing a broad scope of services and solutions, be that in terms of geographical, functional or asset class coverage. An overall platform-based solution that integrates broad functional (e.g., loan administration) and

geographical coverage (multiple Special Purpose Vehicle, or SPV, domiciles), and integrates outsourced partners under a single contractual and governance model can allow clients to outsource more and minimize the overhead associated with their own service provider oversight.

The PAs space is still inherently paper based and manual in some areas. In our experience, it is even more important to focus on the elements of the value chain that can be digitalized and employ flexible, universal solutions to those elements. An example would be investor onboarding, an element of the value chain which is entirely suitable for automation and digitalization with the right technology solutions. A global web portal



with automated workflow, document exchange and digital signature capabilities can integrate with client Customer Relationship Management (CRM) systems and fund administration systems via APIs, automating the onboarding process from prospecting and fundraising to initial commitment or subscription processing. Tomorrow, digitization will go beyond this. We may potentially see tokenization of fund units. Already, proprietary banks are beginning to use digital asset platforms, such as HSBC Orion's bond tokenization.

Even if we achieve this digital industrialization of all investment vehicle activities and services, we will only have built a partial global service model. What else do we need to consider?

## Cash Services:

We know that PAs companies need a banking partner that understands their needs with a full range of cash services that goes from payments solutions to liquidity capabilities and sophisticated FX solutions. These services need to be available 24/7 in all currencies and markets. We also know that while these services are reasonably common, they are not sufficiently offered by commercial banks and this, in turn, can impact the PA global service model. Fortunately, some commercial banks have realized the business opportunities related to cash services, expanding their clients' services and coverage teams and have developed technological solutions, such as APIs and mobile apps.

This complete and comprehensive suite of cash services further completes our PA global service model.

## Financing:

Capital call facilities or equity bridge facilities are provided by commercial banks, and therefore can only be integrated in a global service model when the other two components (fund administration and cash services) are also provided by the same entity. Typically, commercial banks will offer these on a global scale, at an asset manager, fund, and portfolio level, and may complement equity bridge facilities with Net Asset Value (NAV) credit facilities. Fund financing provides a number of benefits for a PAs firm, such as reducing the administrative burden, allowing sponsors to commit very quickly during the acquisition process and enhancing fund performance. Fully integrating financing into the global service model further enhances all processes and even increases the safety of them.

## CONCLUSION

While not being completely mature and defined, we can now see the rise of a Private Assets global service model in the industry that will enable Asset Managers and Owners to focus on their core investment activities, while relying on a limited number of partners who go well beyond the role of a traditional service provider. By adopting digitalization of tasks and processes into cash services, financing and more, Private Assets entities will drive efficiency and profits, while meeting consumer expectations for greater data transparency.





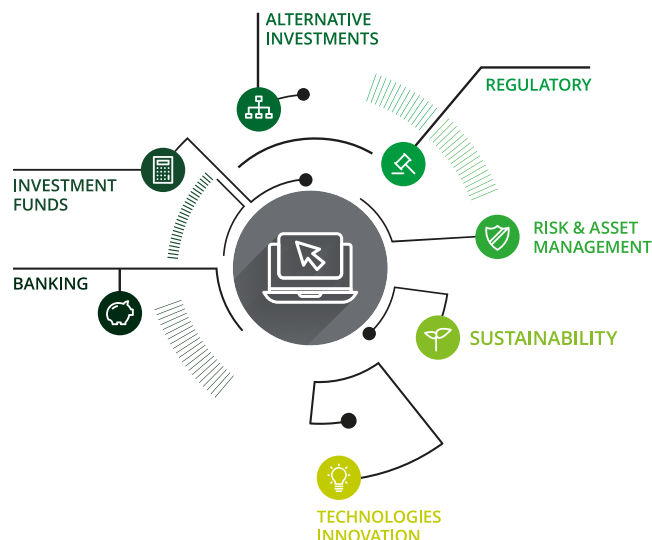
## TO THE POINT

- The Private Assets (PA) industry still relies on manual, paper-based processes due to multiple providers and complex structures.
- To support Asset Managers and Owners in the PA industry effectively, future global service models must incorporate automation, standardization, and technology to provide scalability, control, and data transparency – aligned with consumers' expectations for quality service.
- Commercial banks offer capital call and equity bridge facilities for integrated global service model to enhance fund performance.
- The rise of a global service model allows Asset Managers and Owners to focus on core investments with select partners beyond traditional providers.



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