STATE OF THE NATION REPORT

Key Industry Findings From TNF Annual Meeting 2019

Part 2: Regulation

The clearing industry is helped and hindered by regulation of clearing ~

Custodian banks, CSDs and CCPs inhabit one of the most regulated industries in the world. The regulatory measures adopted since the financial crisis of 2007-08 have, by forcing providers to change how they do business, delivered benefits as well as compliance costs. “Regulation is both a help and hindrance,” said a panellist.

He noted how the first iteration of the Markets in Financial Instruments Directive of 2007 (MiFID I) had altered trading and clearing across border in Europe and how T2S had forced CSDs and custodians to re-think settlement and asset servicing. But nothing illustrates the ability of regulation to both foster growth and constrain it than the history of clearing in Europe since the great financial crisis in 2007-08.

Regulators have encouraged competition between 19 CCPs in Europe – 11 compete for equity clearing business alone - as a contribution to efficiency and innovation. However, the encouragement of competition has strict limits for them as well. “Regulators have one set of red lights that start flashing and that is when CCPs start competing on margin,” is how one panellist described the principal constraint.

The second major constraint stems from what make competition between CCPs possible: inter-operability. Regulators insist that the risk of default which arises between them inter-operating CSDs (and their members) is covered by additional collateral. As volumes have increased, the cost of this collateralisation has risen. “It is high time to re-visit the way inter-operability is set up today,” said a panellist. “Setting aside additional collateral is a very expensive way of operating.”

One suggestion was that regulators take into account the risk, recovery and resolution plans of each CCP. Central banks were thought unlikely to endorse this idea. Stipulating that additional collateral be set aside is much simpler than attempting to understand the risk, recovery and resolution plans of individual CCPs and how they might interact in a default or a major crisis. “The central banks are not interested in the costs to the clearing house and its members,” said a panellist. “They are interested in the societal and financial stability costs.”

This means that in order to thrive, as well as survive, European CCPs need to find new sources of growth. Promising areas include smaller capitalisation stocks, though their relative illiquidity means they demand higher collateral haircuts and benefit less from netting trades with counterparties through a CCP. “The key benefit of clearing is the netting efficiency, and you do not have that for some of the low liquidity securities,” said a panellist, though another panellist thought that clearing would in and of itself enhance the liquidity of small capitalisation stocks.

But the largest opportunity for CCPs is thought to lie in equity derivatives. One panellist said that term contracts for differences (CFDs) alone have a notional outstanding of US$3 trillion and that, as regulation increases the margin cost of bi-lateral trading, market participants will be attracted by the capital savings as well as the benefits of reduced counterparty risk and netting. “It is important we explain to our customers what the benefits are,” said a panellist. “Particularly around reducing position exposure, counterparty risk and lowering your cost of capital.”

However, the greatest potential source of growth lies in the globalisation of clearing – and it is in this area that regulation is proving least helpful. The scope to globalise clearing was greatly reduced by bifurcation of regulatory approaches between North America and Europe in the wake of the financial crisis of 2007-08. The early introduction of Swap Execution Facilities (SEFs) in the United States, for example, had fragmented liquidity pools in equivalent instruments.

The solution, thought a panellist, lies in the recognition of regulatory equivalence. The European Union (EU), for example, offers equivalence to 24 countries, all of which reciprocate. The United States, by contrast, has offered the EU only “47 per cent equivalence,” as a panellist put it. He added that one CCP based in the EU was obliged to share 4,217 pages of information with American regulators to secure that partial equivalence but received in return a mere four pages of information about American CCPs.

"Should regulators in different jurisdictions offer each other more deference to allow the continuation of our financial sector on a global basis?" asked a panellist. He detected signs of a growing willingness to endorse equivalence on the part of American regulators. It was also encouraging, he thought, that the EU had offered temporary regulatory equivalence to the United Kingdom pending Brexit. But he warned that any reduction in the fragmentation of liquidity between markets would still be subject to constraints "There might be situations where financial stability is at stake, and that might require certain additional rules," he said.

The industry is not well prepared for CSDR ~

In securities settlement and safekeeping, the regulatory pressure is much more direct. "Be afraid, be very afraid," is how one panellist summed up the impact of the settlement discipline regime imposed by CSDR. Yet, five years after CSDR was adopted by the European Union (EU), the most striking feature of the regulation is the lack of excitement associated with it. Many CSDs have yet to be authorised under CSDR and the documentation of the regulation itself is far from finalised.

The standards that govern the settlement discipline regime under CSDR were not published at all until 2018 and remain subject to further interpretation. While the financial penalty regime for failed settlements is well-defined by the European Securities and Markets Authority (ESMA), the buy-in regime is not. This helps to explain why a poll of the audience found a low level of preparedness for CSDR (see Chart 11).

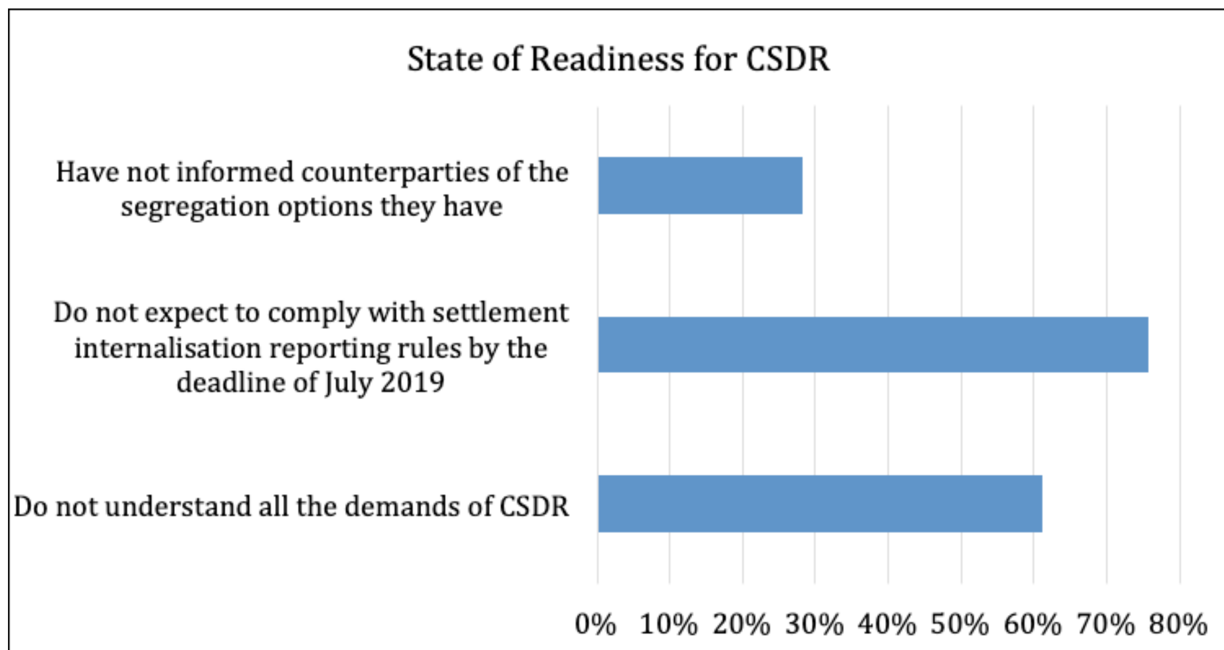

Chart 11.

The poll suggests the market has solved the easiest question raised by CSDR – the ability to offer clients segregated accounts at authorised CSDs – without being ready to implement the demands of the reporting and settlement discipline regimes. "CSDR is very easy to say but very hard to explain," joked a panellist. "There is a lot of information that needs to be shared and understood." He thought the industry even less prepared than the poll indicated. In fact, a more searching poll of regulatory anxieties found that only cyber-security worried the audience more than reporting (see Chart 12), on which CSDR places a substantial burden.

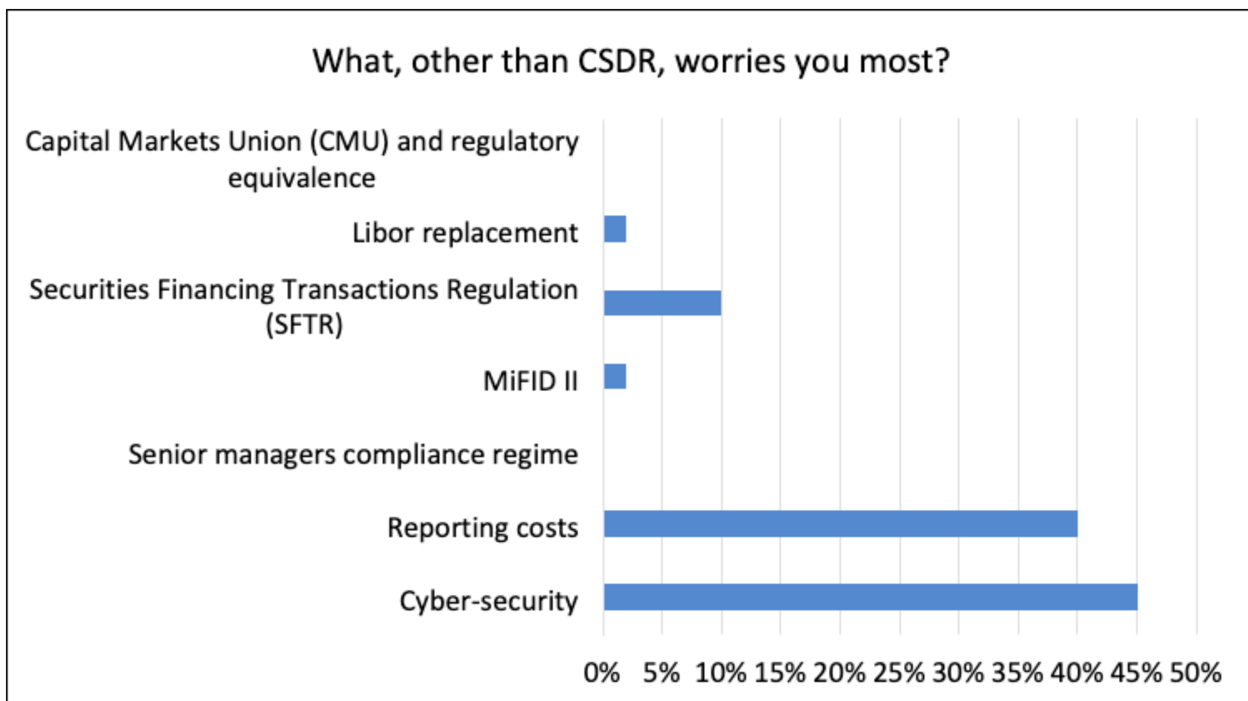

Chart 12.

A panellist agreed with the audience about the importance of reporting as an issue in CSDR. Although his own firm was ready to offer clients segregated accounts and to report on internalised settlement – SWIFT is creating message types for that purpose - he expected different interpretations of CSDR to lead to a high degree of variation in reporting by firms. But he added that the settlement discipline regime is "the biggest issue for everyone in this room." Indeed, a poll of the audience (see Chart 13) indicated the industry was definitely not well-prepared for it.

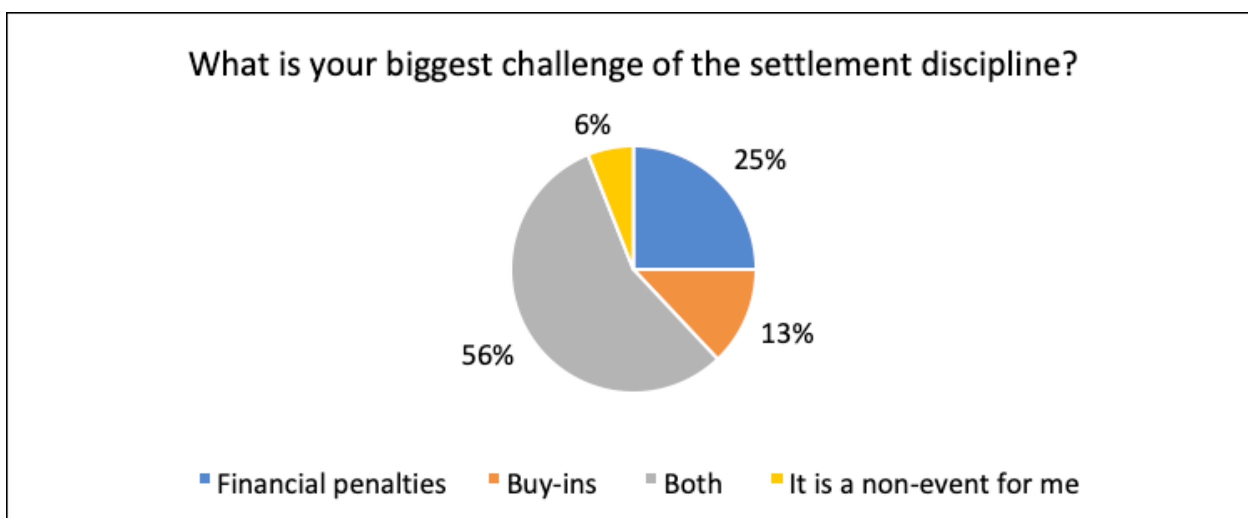

Chart 13.

This is one reason why a sub-custodian thought the settlement discipline regime an ideal area for collaboration between custodian banks. "The CSDR penalty regime does not bring any value to any of us, but we must comply with it," he said. "It is an ideal place to work together, collaborate and deliver something as an industry."

The CSDR financial penalties regime is well-understood ~

In fact, the European Central Securities Depositories Association (ECSDA) is preparing to publish a detailed guide for CSDs to implement the financial penalties regime, so that its application will be uniform across all the CSDs of Europe. Likewise, the Association for Financial Markets in Europe (AFME) is co-ordinating work on the buy-in regime. In fact, AFME has issued a questionnaire to CSDs to establish how they will exchange information with banks.

A panellist thought the financial penalties regime comprehensible but was concerned about two issues. The first was reconciliation of the penalties levied. The second was that, given the size of the penalties varies by the liquidity of the security, some latitude would be required to take account of shifting patterns of liquidity.

"The question is how dynamic that liquidity list actually is," he said. "Who decides how liquid an instrument is and how often does that instrument shift?" In fact, he thought the accompanying buy-ins under CSDR might make instruments temporarily illiquid quite often.

A network manager explained that he also understood how the financial penalty regime worked but was not yet clear on how to build the necessary links between his multiple internal systems and the CSDs. He faced the same problem in linking to the sub-custodian banks that make up his European clearing and custody network. The links created issues of cost allocation, he said, and posed the question whether "we need to build a reconciliation tool [for the financial penalties] or take people at face value."

Buy-ins under CSDR are an unsolved problem ~

But he was clear about where the most significant problem lay. "The biggest challenge for us as a firm is buy-ins," he explained. "The whole buy-in part of the settlement discipline regime is something that has got a long way to go in terms of the industry conversation. Who is able to act as a buy-in agent? How will that process work? Do we build in-house or do we outsource to a third party? If you are going to build in-house you need to start thinking about it now because technology spend is at premium and it is not necessarily going to be an easy thing to build. For us, the big challenge is buy-ins."

He agreed that the potential volume of buy-ins might turn into a market liquidity issue. One estimate he had seen was for an average of 18,000 trades to fail every day, across European equity markets currently achieving c.99 per cent settlement efficiency rates. "Even a thousand buy-ins a day will create a lot of additional work for everybody is this room," he said. "How we manage that is something we need to work out and work out pretty quickly."

Certainly, without a substantial improvement in settlement efficiency, it is clear that financial penalties and buy-in costs will inflate. When the audience was polled, a substantial majority thought the daily level of fines and buy-in costs would amount to at least €1 million a day, and nearly half those polled thought the cost would be more than €5 million a day (see Chart 14). Even at the lower end of these expectations - €1 million a working day – CSDR fines and charges would amount to a tax of roughly €250 million a year on the clients of the industry.

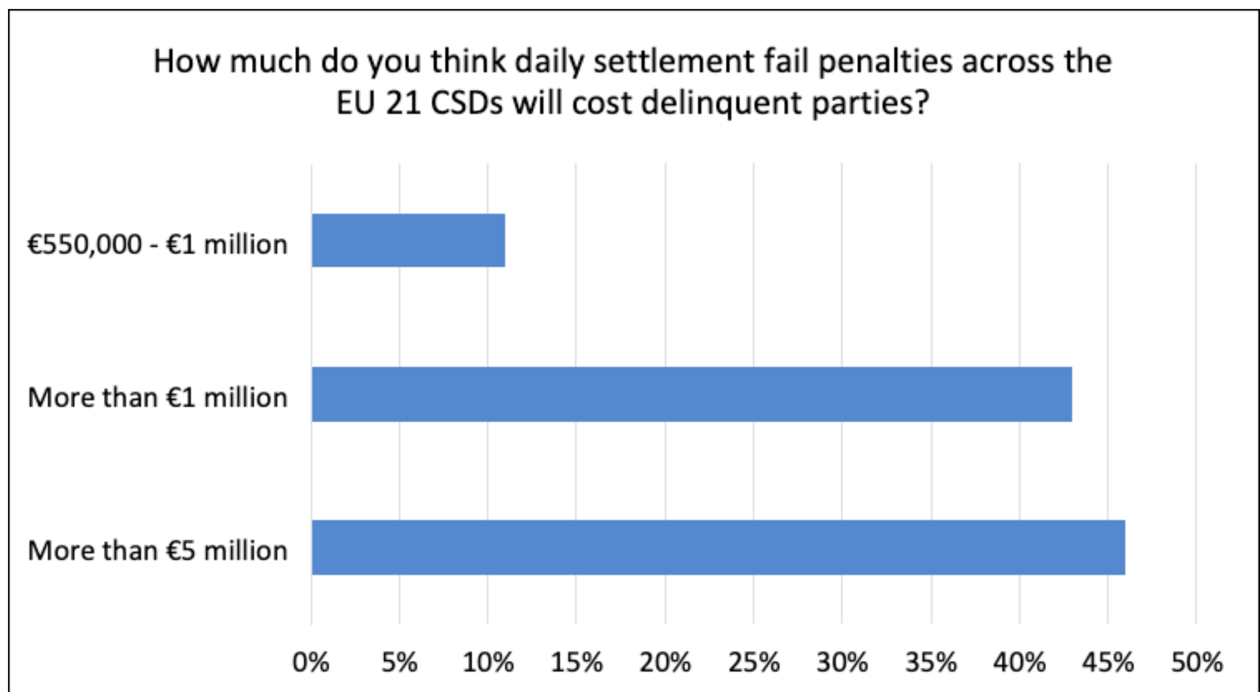

Chart 14.

A custodian bank panellist drew attention to a commercial difficulty. "Buy-in is a dirty word," he said. "No-one likes to do buy-ins. We will react when a counterparty of our clients initiates the buy-in, but we prefer not to initiate the buy-in. Having that enforcement on buy-ins through this regulation is probably one of the biggest attention-getters that the industry can get because it is such a horrible phrase to use."

Buy-side firms are not prepared for the costs of late settlement under CSDR ~

Certainly, many buy-side clients are likely to be unpleasantly surprised when banks pass on to them the costs of financial penalties and buy-ins. "Client engagement is going to be critical," warned a panellist. "Lots of people will never have expected to pick up a fine. They are not used to being in that scenario where they are going to get hit with a fine from their broker or their banker. Nobody is going to sit and absorb the costs associated with CSDR. A lot of these businesses are low margin businesses today and when you look at the fines, whatever number you decide to accept, if you do not get this right, some of those low margin businesses will be out of business very quickly."

Another panellist reported low levels of awareness of CSDR in the front office of sell-side firms, let alone understanding of the costs it might entail for their clients. "If you are facing off to one of your traders and one basis point of a spread is going to be completely removed by something that is your problem because you are in the back office, that trader is going to go absolutely crazy," he said. "The other challenge here is going to come from the front office. As soon as they see those charges, they are going to come running downstairs to the back office."

Having had conversations with front office traders in recent months, a network manager was now working to establish what was causing settlement failures. European Central Bank (ECB) data indicated that 2 per cent of transactions fail to settle because of incorrect instructions and 4 per cent because of unreleased instructions, when banks withheld settlement instructions for credit or liquidity reasons. "A 6 per cent level of fails will lead to a lot of penalties under CSDR," noted a panellist.

Market infrastructures are developing CSDR risk mitigation services ~

"The numbers are scary," agreed another. However, help is available from market infrastructures. The Depository Trust and Clearing Corporation (DTCC) has added an exception management tool capable of taking in SWIFT messages to track settlement failures that occur after being matched through its Omgeo service, complete with a chat capability so users can sort problems out directly with counterparties. DTCC has also launched a data analytics tools to help firms understand why trades are failing.

SWIFT is creating messages for financial penalty reporting by TARGET2-Securities (T2S) users to CSDs. It is aligning the messages with the new penalty sequence in MT548 and MT537 messages for penalty reporting from CSDs to sub-custodian participants in CSDs and sub-custodian CSD participants to their clients. SWIFT is also working on messages to cover settlement fail reporting to regulators and developing data analytics to show why trades are failing.

Banks are examining data to work out why trades are failing to settle on time ~

But SWIFT cannot of course look at customer data. This means banks have to do their own customer analysis. Robotic process automation (RPA) is proving helpful. "RPA is seen as an alternative to a lot of the offshoring work that has been done and to the repetitive, low value-added activities that take place still," explained a panellist. "But RPA is not just about cutting the costs. It also means that processes are actually completed faster, which gives you a greater window, not to resolve fails but to anticipate them, and to avoid them in the first place." He added that historical data was useful for predicting the trades likely to fail, and to benchmark the settlement performance of clients.

A network manager added that his firm was doing "a lot of remediation work" to find out why trades were failing to settle. "Was it late matching, late settlement? Was it static data? Is it certain counterparties?" he asked. "We are trying to get in front of it as much as we can. We have a whole project team doing that. I think it is incumbent upon everybody to be doing that, so we are as prepared as possible." He added that many London-based firms had shifted booking locations as part of their preparations for Brexit, introducing additional settlement legs that further increase CSDR risk.

One sub-custodian was doing similar work. They had calculated their settlement failure rate averaged 2.7 per cent across the client base, but at some clients the rate rose as high has 8-9 per cent. "We are trying to work out why and talking to clients about how to improve once the penalty regime starts," said the custodian. "We are also re-writing legal agreements to make sure that, when a CSD charges us, we can pass the cost on to clients. We are adding capacity to investigate why a trade fails, because we expect disputes with clients as to who is to blame. If one trade fails, two more might fail as a result, so who is to blame?"

A global custodian said his firm had a comparable project in hand to identify clients with high settlement failure rates and warn them they would incur fines once the CSDR settlement regime came into effect in November 2020. "We are an agent, so we are only as good as our clients," he said. "If our clients are not strict enough with their own process and protocols, then we are simply going to process it, and the fines will come back to them."

CSDs will play a major role in administering financial penalties under CSDR ~

Those fines will be administered by CSDs - this is one of the certainties about CSDR – which are expected to follow the CSDR Penalties Framework published by ECSDA in January 2019. "All CSDs will follow the Framework," explained a panellist. "Details are missing but the missing details are not from the CSDs but from the regulators. We have quite a big list of questions which we have sent to the regulators, for which we are still awaiting the answers. Unfortunately, we cannot influence the speed of their work." However, a sub-custodian said conversations with CSDs in eight markets covered by the bank found no commonality in how they were implementing the financial penalty regime.

The regulation does of course impact CSDs in other ways. "CSDR completely changes the way that CSDs do business," explained a panellist. "Every aspect of the business is now regulated." The biggest challenges, he thought, were tighter scrutiny of banking licences held by CSDs and of the settlement links between CSDs based outside as well as inside the European Union (EU). Because both issues raise regulatory concerns about systemic resilience, CSDR makes obtaining a banking licence complicated and expensive and sets limits on the use of commercial bank money. It also regulates how inter-CSD links must operate.[1]

The Shareholder Rights Directive II (SRD II) affects CSDs and custodians ~

CSDR is not the only regulation affecting custodian banks and CSDs in Europe. The second iteration of the Shareholder Rights Directive (SRD II) - which aims to make it easier for shareholders to exercise their rights and enlarge their influence over the management of the companies in which they are invested - also asks both custodians and CSDs to play a part in fulfilling this ambition. The measure is currently being transposed into national law, and firms must comply from September 2020, but awareness within the industry is not high (see Chart 15).

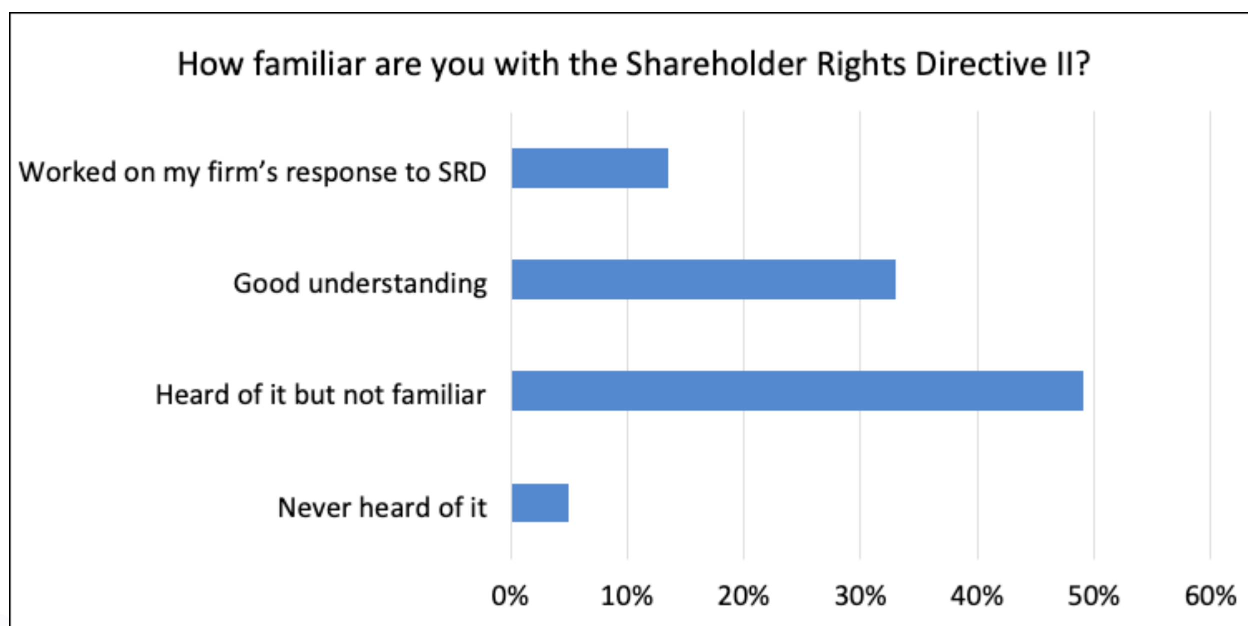

Chart 15.

1. The European Central Securities Depositories Association (ECSDA) has published a due diligence questionnaire that CSDs can use to assess links with CSDs based inside and outside the EU.

2. Financial Action Task Force (FATF), Guidance for a Risk-based Approach: Securities Sector, October 2018. The latest version of the 40 Recommendations can be found in Financial Action Task Force, International Standards

SRD II allows issuers to find out who their shareholders are and prescribes in detail how quickly and in what form they must be given that information. CSDs not only maintain the integrity of securities in issue but in some cases maintain the register that records ownership. Even where they do not, the transactions they settle are used to update the register of shareholders. Many CSDs also provide information about corporate actions and provide the proxy voting services by which shareholders make their views known to issuers.

Custodians, on the other hand, intermediate the distribution of information about corporate actions and voting opportunities at annual general meetings (AGMs) and extraordinary general meetings (EGMs). They also handle instructions from investors on how they wish to respond to corporate actions, and how they wish to vote at AGMs and EGMs. Importantly, SRD II applies to foreign investors in European stocks as well as European investors in European stocks.

SRD II expects information of this kind to be distributed more quickly, votes to be reconciled on a daily basis, and outcomes confirmed to investors. In tandem with the right for issuers to know who their shareholders are, within 24 hours of the request being submitted, it is clear that SRD II effectively requires information to be processed and delivered more quickly.

Neither custodians nor CSDs are well-prepared for SRD II ~

Custodians will receive requests for disclosure of shareholders from issuers. "There is no limit on the number of times an issuer or third party can ask for disclosure," warned a panellist. "It can be once a day if they like. Blue chip issuers already seek information once a month and are happy to spend US$200,000 or more to get it, so we can expect greater frequency, at least initially. Issuers will go to registrars first, who will pass it on to custodians, who will have only 24 hours to act."

Asset managers will also continue to rely on custodians to process corporate action instructions and vote their proxies. The tighter deadlines will put custodians under pressure. "Custodians will have to change their operational processes," predicted a panellist. "They will have to check the eligibility of investors to vote, check stocks on loan, and check investors coming in and out of the stock." He also predicts that custodians will have to support "US-style collaborations between investors to oppose management."

Likewise, just as custodians can help asset managers, CSDs can help custodians by operating efficient shareholder voting services and (where they are responsible) publishing prompt and accurate information about corporate actions. Yet, because levels of awareness of SRD II in the industry are not high (see Chart 15), levels of preparedness are correspondingly low (see Chart 16).

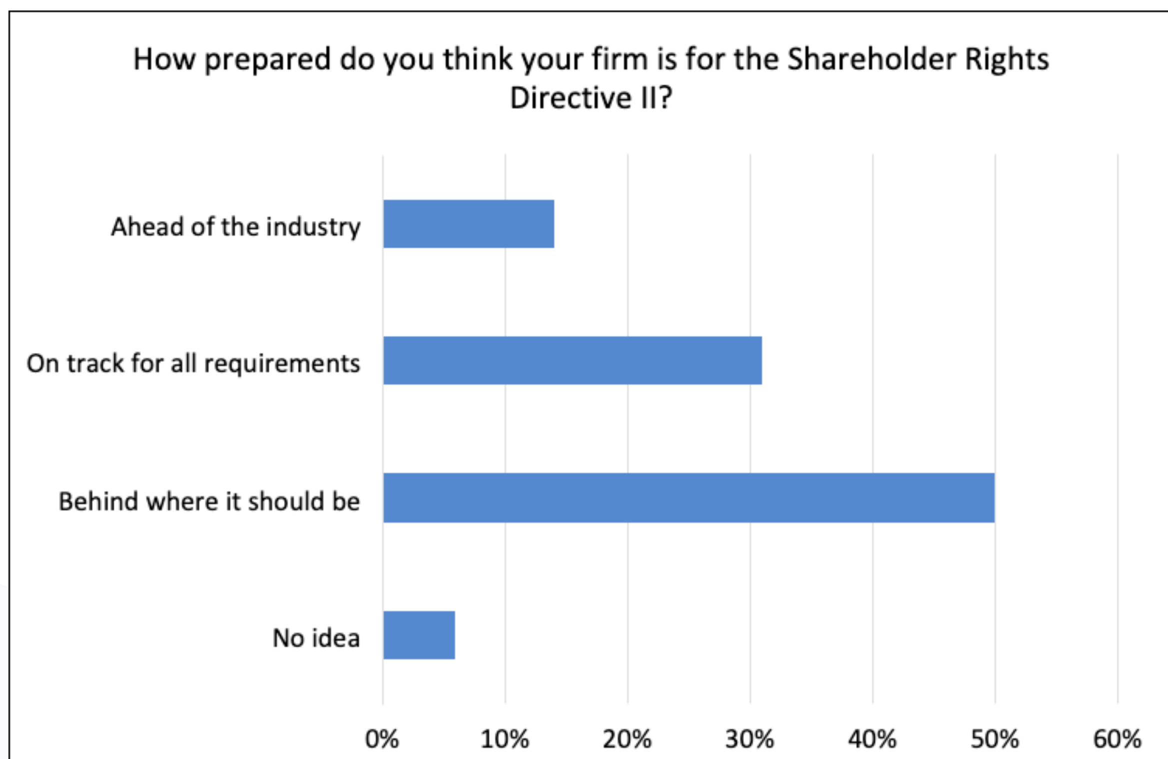

Chart 16.

Some custodians nevertheless welcome the increased responsibility under SRD II as an opportunity. "It is about being smart about how you respond to the regulation," said a sub-custodian. "Are there opportunities in that regulation that allow you to think about things differently? SRD II is forcing custodians to think about how they share information, which means they can increase efficiency as well as achieve compliance."

Judging by a poll of the audience this is not yet a common pattern of thought among custodians (see Chart 17). Although a minority believe they have SRD II under control – most probably the larger financial institutions - a majority are daunted by the timetable and the operational complexity of the faster and more detailed information flows that are required.

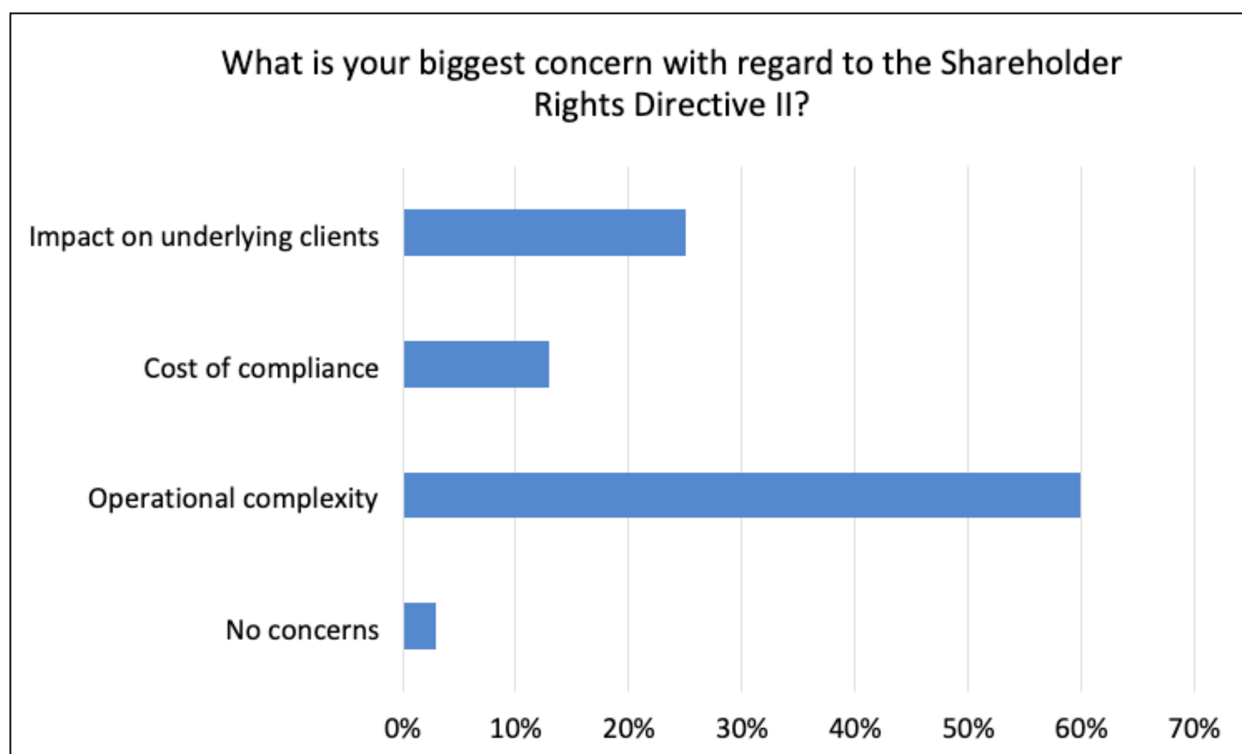

Chart 17.

"Custodians know SRD II is costly and complicated, but they are not very advanced in their preparations," noted a panellist. "This must be done by September 2020. The proxy season cycle is heavy from March to June so they had better get going on any changes required." The changes include, incidentally, a switch from the ISO 15002 standard to the ISO 20022 standard in proxy voting messages. "You need to ensure your systems can meet the new standard," he added.

T2S is delivering less meaningful benefits than expected ~

One area where custodians are already obliged to use the ISO 20022 message standard is T2S. With the transition of the Baltic states and Spain to the T2S platform in September 2017, and the addition of the Danish Kroner in October 2018, only the Finnish CSD now remains outside the ambit of the pan-European settlement platform. With the migration of CSDs now almost complete, T2S is free to develop its investor CSD capabilities. These have yet to emerge.

For sub-custodians, having a single settlement system spanning multiple markets in Europe has improved inter-operability, and made it easier to move collateral efficiently. "T2S has provided a great opportunity by bringing cash and securities together in an integrated model," as one speaker noted. Auto-collateralisation – a collateralised intra-day credit granted by the central bank to settle delivery-versus-payment (DvP) transactions – had proved, said a sub-custodian, "very helpful."

He added that T2S had also increased the opportunity for banks to benefit from balance sheet netting of repo transactions, which have traditionally settled gross, by linking securities accounts at the national CSDs to cash accounts at the central banks. This enables users to net purchases and sales across multiple markets at T2S as a single settlement location, though it is valuable to a minority of banks using multiple CSDs only.

Likewise, a single settlement system is useful mainly for multi-market sub-custodians that connect to multiple CSDs. It spares them the cost and complexity of upgrading interfaces to each national CSD. The standardisation of the European settlement timetable on T+2 further reduced complexity and made it easier for them to comply with the reporting and settlement discipline requirements of CSDR.

Other benefits listed by sub-custodians included the reduction in risk and capital costs associated with settlement in central bank money. "A lot of commercial bank money settlement is still going on in government bond markets," noted a CSD. "Central bank money would help." The European Distribution of Debt Instruments initiative (EDDI), which aims to offer debt issuers a single route to European investors, is expected to lead over time to greater use of central bank money in the bond markets – though volumes are not expected to climb rapidly.

Sub-custodians were also impressed by the 99 per cent up-time of the core T2S platform, and its ability to cope with the transaction volumes submitted. There is, as one sub-custodian put it, "value in the system itself." In addition, the work of the European Central Bank (ECB) on harmonising the processing corporate actions in Europe - to ensure securities posted as collateral to central banks do not need to be substituted - was described by one sub-custodian as a "useful knock-on effect" of T2S.

T2S has failed to deliver on costs and consolidation ~

However, sub-custodians were disappointed by T2S too, particularly in terms of price. "Where T2S has not helped is in not reducing the headline costs of settlement or creating a competitive market in CSDs, which would have added improved settlement product quality and economies of scale by a process of competition," said a sub-custodian.

He elaborated on the second point. "T2S is neither a consolidated monopoly nor a competitive environment," he said. "The current set-up is the worst possible set up. Asset servicing is not a competitive arena, because CSDs compete on settlement but not asset servicing. How can we get CSDs to inter-operate to create competition?"

A poll of the audience (see Chart 18) indicated considerable sympathy for this assessment. Its findings show that custodians felt that, although T2S had encouraged harmonisation in areas such as settlement timetables (through the adoption of T+2), collateral management (through the Eurosystem Collateral Management System, or ECMS, scheduled for launch in November 2022) and corporate actions (a sub-set of the collateral management harmonisation project), it had failed to deliver on the core promises made at the outset of the project in 2006: a lower cost of settlement and elimination of a layer of infrastructure.

Worse, in January 2019 T2S raised the fee charged for a basic delivery-versus-payment transaction from €0.15 to €0.235. The main cause of the increase, in a system which operates on full cost recovery, was the failure of transaction volumes to rise to the level predicted when the original price was set in 2010.

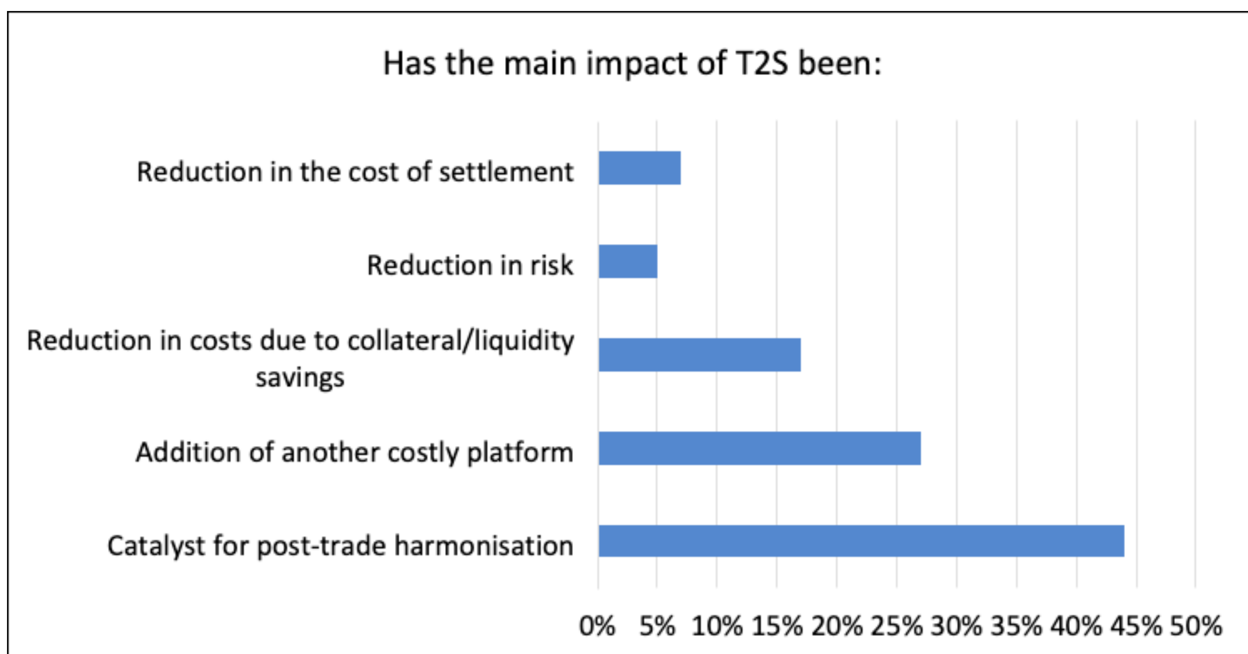

Chart 18.

"The industry accepts the costs T2S sets," protested a panellist. "There is no argument about that. But the ECB also made the mistake of counting the United Kingdom in in 2010, and further added to the projected transaction volumes in T2S up by adding Eurobonds and mutual funds to the mix." Another panellist disputed this, saying the ECB never expected the United Kingdom to join T2S.

Reasons for the T2S price increase ~

Markets had proved unfavourable since 2010 too. In fact, volumes in T2S had remained flat at around 600,000 transactions a day for two years. Auto-collateralisation movements – also charged at €0.235 per transaction - had grown more slowly than anticipated too, at 6 to 10 per cent of the overall value of collateral posted. "There is too much liquidity for T2S to create meaningful savings on that front," explained a panellist.

"We talk too much about the fees," argued another panellist. "The overall cost of settlement is driven by fragmented technology and long chains of intermediaries, including CSDs that charge on top of T2S. The focus should be on those costs, not T2S fees. A single securities account, instead of one in each national CSD, would help to save money. It would generate a lot of savings on collateral, for example."

"The T2S cost is a fraction of the total cost of settlement," agreed another panellist. "In 2007 the DvP cost of CSDs in Europe averaged 73 cents. They are now 23.5 cents. And imagine the cost of implementing CSDR in 21 separate CSDs. With harmonisation on T+2, the only new element in CSDR is the calculation of penalties by CSDs."

One solution to the limited volumes processed by T2S was to add the settlement of Eurobonds. This idea was rejected by a panellist. "People use the international CSDs (ICSDs) to settle Eurobonds for real reasons, which including not settling in central bank money because they are not European banks with access to central bank money," he said. "Eurobonds are also issued in other currencies, such as US dollars, so they are not denominated in euros only."

Low volumes were not the only cause of the price hike anyway. Other factors at work included a longer-than-expected migration period and higher-than-expected running costs incurred by the European Central Bank (ECB), which built and operates T2S. These are not expected to return to the projected levels until 2021.

A new set of contracts with T2S connectivity providers, refreshing prices first agreed in 2013, are also expected to yield reductions in connectivity costs for T2S users. "The competition in 2013 to have network service providers submit maximum prices for connectivity to the European Single Market Infrastructure Gateway (ESMIG) went well, and there were no complaints," explained a panellist. "Smaller countries benefit from maximum prices. I think the market will like the new prices."

Regulators fear securities markets are vulnerable to financial crime ~

In addition to regulatory interventions such as T2S, and direct regulatory measures such as CSDR, regulators have in recent years sought to encourage the securities industry – as opposed to the cash payments industry - to pay more attention to the money laundering and terrorist financing opportunities its activities represent.

Although the vulnerabilities of the securities markets are less obvious than those of the payments industry, they are more numerous. They include securities themselves, digital trading platforms, settlement (especially free-of-payment deliveries), funds, data vendors, the widespread use of outsourcing services, centralised financial market infrastructures that concentrate risks (such as CSDs) and the extended and densely populated chains of intermediation that separate issuers from investors.

With barriers to criminal behaviour in cash payment markets becoming more effective, regulators are concerned that money launderers and terrorists will turn to the securities markets. Accordingly, they are pressing the securities industry to tighten its anti-money laundering (AML) defences and its measures to counter the financing of terrorism (CFT). The Financial Action Task Force (FATF), for example, recently published a paper on how securities firms should adopt a risk-based approach to implementing its longstanding 40 Recommendations on AML and CFT. [2]

ISSA has published principles to help firms with financial crime compliance ~

The International Securities Services Association (ISSA), which represents both custodian banks and CSDs, has drawn on the FATF Recommendations to prepare a set of principles to help firms in the securities industry comply with the tightening financial crime regulations.[3] The principles overturn a long history in securities services of reliance on representations and assurances from the previous link in the often long chains of intermediaries that characterise the industry.

"The goal of the principles is to derive practical yet effective standards," explained a panellist. "It was obvious that you could no longer expect to escape liability by assuming your client is compliant, or its jurisdiction does a good job."
He added that the principles also aim to switch the attention of the industry from monitoring securities transactions to understanding the ultimate beneficiaries of transactions, since this is a surer guide to the legitimacy of a trade. "You also need to understand the economic interest in the transaction," added the panellist. "You need to know not just the underlying fund but the underlying investors in the underlying fund."

Know Your Client's Client (KYCC) as well as Know Your Client (KYC) can seem a daunting agenda. The model due diligence questionnaire prepared by a task force convened by the Association for Financial Markets in Europe (AFME) has some value for this purpose. But it covers a lot of issues and is bedevilled by less-than-universal application. As a poll of the audience found, the constant addition of bespoke questions also makes it hard to re-use answers and make comparisons (see Chart 19).

2. Financial Action Task Force (FATF), Guidance for a Risk-based Approach: Securities Sector, October 2018. The latest version of the 40 Recommendations can be found in Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation: The FATF Recommendations, June 2019.

3. ISSA, Financial Crime Compliance Principles for Securities Custody and Settlement, Second Revision, May 2019,

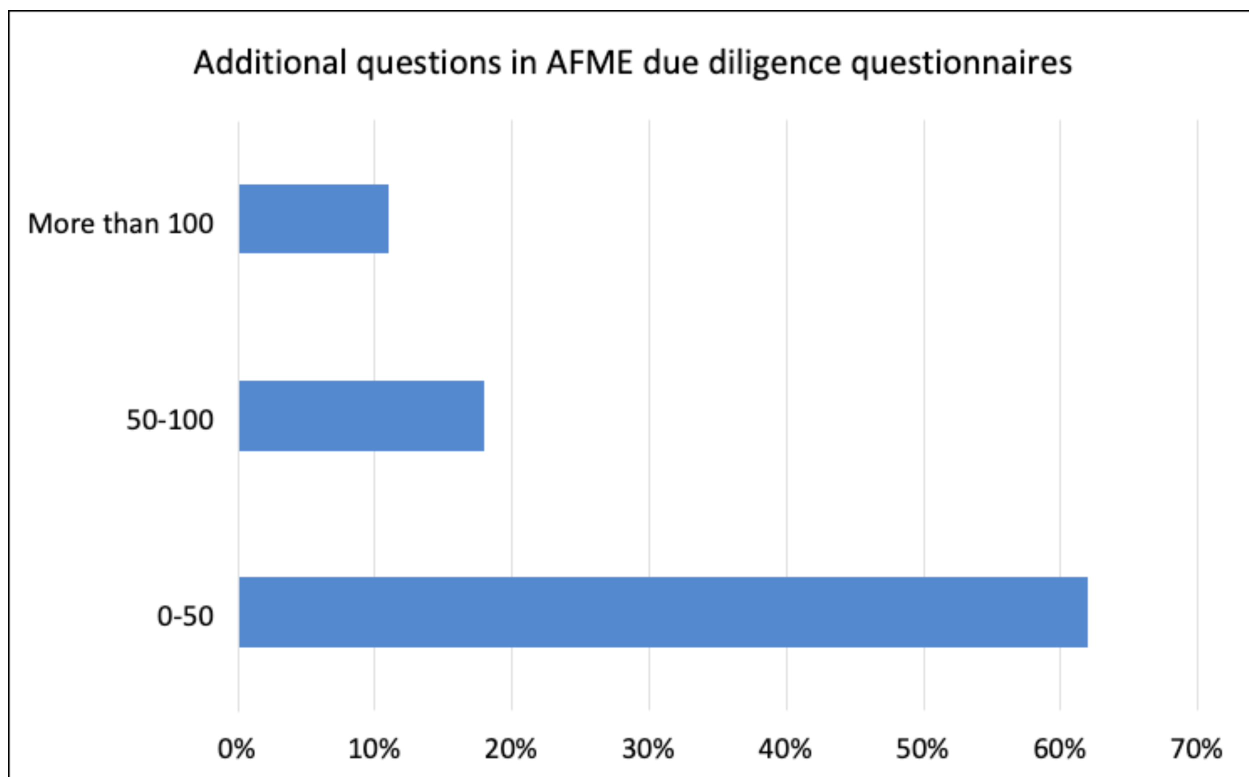

Chart 19.

"80 per cent of our clients are using it," joked a panellist. "And it covers 80 per cent of the questions they ask." He added that the remaining 20 per cent added little value. A review of the hundreds of additional questions asked had concluded only handful were worthwhile. "There will always be some additional questions, but the questioners could question their own questions more," he concluded.

And no questionnaire can substitute for the hard work of identifying bad actors. "The pitfall is the `warehouse of names,' i.e. you do not know who the underlying investors are," argued a panellist. "The sheer number of names is very high, and the industry sets itself up to avoid that work." Instances of avoidance cited included opening a securities account without a cash account to avoid conducting KYC tests on cash that might fail KYC or AML tests, and taking comfort from the fact that the employee used by the suspicious client was too junior to be involved in money laundering.

Instead of avoiding awkward questions, because they entail more work, it is important to ask the right questions. A private client invested with alternative assets in custody is worth investigating if 70 per cent of the assets are visible but the remaining 30 per cent is held in a special purpose vehicle (SPV). Positions in unregulated securities such as penny stocks, or securities issued offshore, or positions held by a group of investors related to the same party, or investment funds whose investment strategy is unclear, are all "red flags" that warrant further investigation.

If questions are not asked, the consequences can be expensive. Five years ago, for example, both Clearstream (which was fined $152 million) and Brown Brothers Harriman (which was fined $8 million) were subject to enforcement actions by American regulators because they had failed to conduct customer due diligence on the owners of the securities clients of their clients were trading through omnibus accounts.

"Yet in both cases the custodian was many places removed from knowing who the end-beneficiary was," noted a panellist. "Intermediation is efficient for the custody industry but it comes at the expense of transparency into beneficial ownership. So we need to work out how to mitigate the risk."

How the ISSA principles work in practice ~

The ISSA principles aim to achieve this by encouraging compliance throughout the chain of intermediaries. They specify that it is the responsibility of the custodian to communicate its financial crime compliance principles to its account-holders, and that it is the responsibility of account-holders to comply with the principles.

Furthermore, where the client of the custodian is an intermediary, the clients of the intermediary are subject to the principles laid down by the custodian. To enforce compliance at that level, the ISSA principles recommend that an intermediary be forbidden from depositing securities with a custodian if its clients do not confirm that they meet the standards set by the custodian.

ISSA has also prepared a Financial Crime Compliance Sample Questionnaire for securities firms to issue to their customers in order to check whether they have adequate AML and CFT controls in place.[4] It focuses on account-holders, account-holder monitoring, clients of account-holders and how assets are held in custody. "We are benefiting from the ISSA papers," said a global custodian.

Cyber-security is also a high priority in due diligence ~

Other due diligence questionnaires increasingly address the separate but related area of cyber-security. The Association for Financial Markets in Europe (AFME) due diligence questionnaire used by custodian banks does ask questions about cyber-security, but they are not detailed. "We beefed up the cyber-security section this year, but it did not really cover everything," explained a panellist familiar with the questionnaire. "When you get into the depths of that subject, it really has to go expert-to-expert".

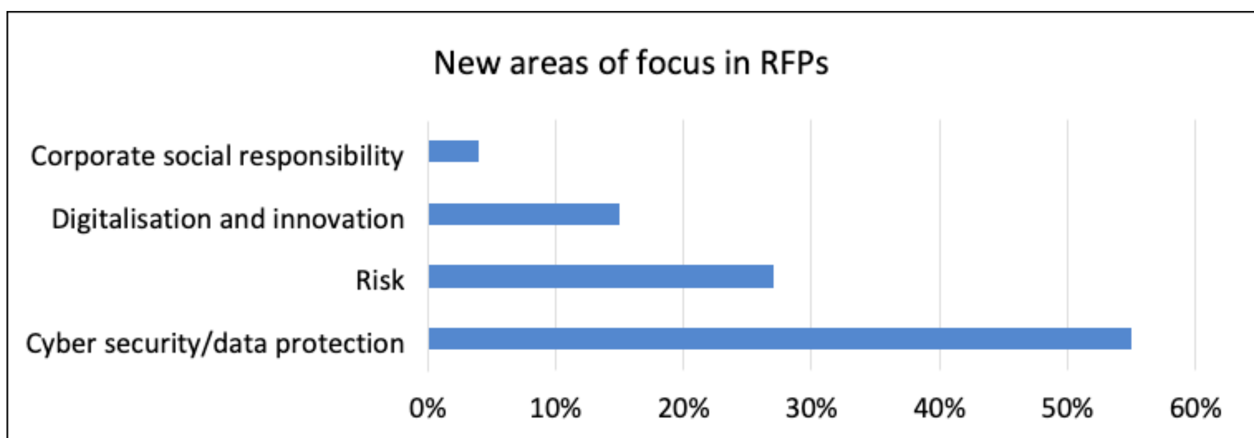

Chart 20.

"We are getting a lot of client queries on cyber-security," said a sub-custodian. A poll of the audience supported that view (see Chart 20). The inclusion of cyber-security in the questionnaires certainly reflects an understandable concern that, even if a firm implements robust cyber-security measures of its own, its counterparties will not necessarily follow their example.

Yet cyber-security is not a field in which securities firms have a high degree of confidence in their own defences, let alone those of their counterparties, judging by a poll of the audience (see Chart 21). "Are 11 per cent really saying they can never be hacked?" asked a panellist. "They can say that only if they are completely paper-based."

4. ISSA Financial Crime Compliance Sample Questionnaire, Version May 2019.

A sub-custodian admitted that "we need to do more due diligence on client IT infrastructures." One inhibitor of effective cyber-security due diligence of this kind is that firms fear inadvertently disclosing security procedures and protocols to potential criminals if they share information with service providers or clients. "We can show anything that does not endanger our bank," said a sub-custodian. "We disclose what we can disclose. We can also show clients on-site, but not in a document. How you disclose something matters."

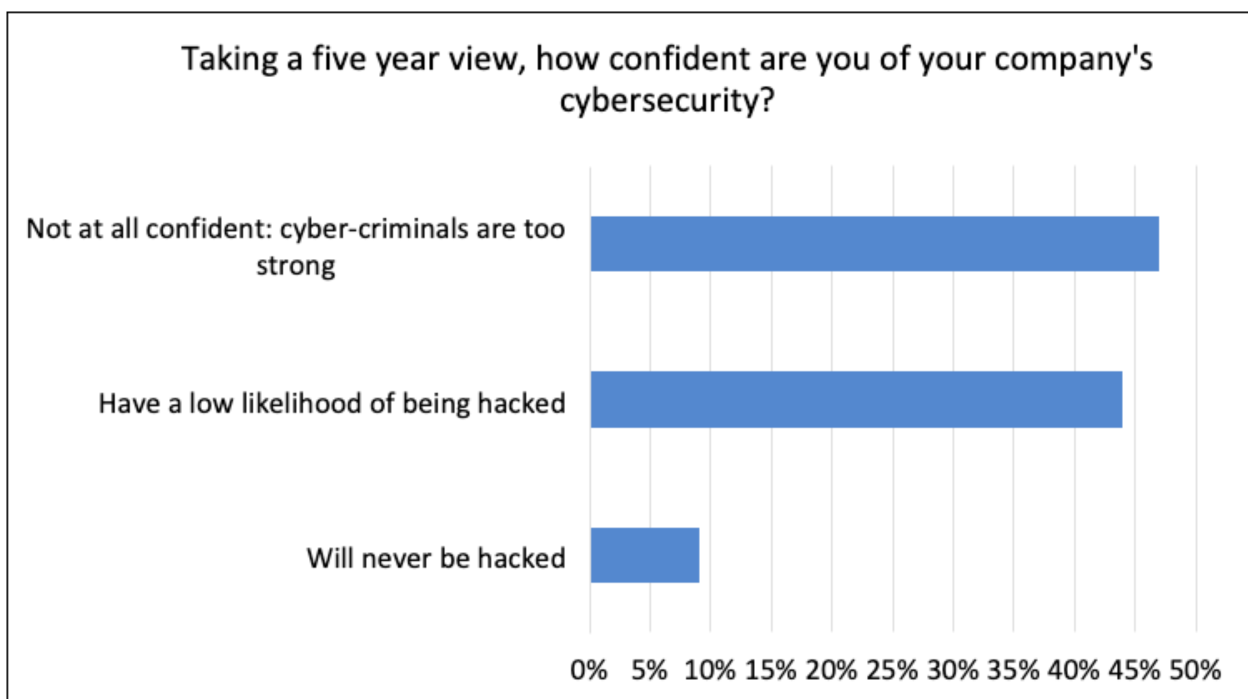

Chart 21.

The SWIFT customer security programme (CSP) relies on counterparties attesting that they comply with an evolving list of cyber-security controls. These attestations are used increasingly as a measure of cyber-security by banks appointing new counterparts. Importantly, members of the SWIFT CSP community are expected to share information about cyber-attacks they have suffered or discovered, through a dedicated portal that disseminates the information to others. "SWIFT invests huge amounts in the safety and security of its network, and it is increasing," noted a panellist.

Tax fraud is an issue custodians are expected to address ~

Another area in which custodians are under pressure to lift the performance in AML and financial crime generally is tax, where a series of supranational standards[5] confront the day-to-day reality that tax remains firmly in the control of the nation-state. "Regulators are pressurising sub-custodians to solve tax fraud," said a panellist. "For investors, withholding tax is primarily their responsibility, but long form claims are not efficient, and sub-custodians are not compensated for the risks or the costs. Investors are not paying custodians in a way that incentivises the custodians do more work. If they send a document to an investor, once the investor responds, the custodian has to do more work."

He suggested that network managers add questions about tax to the due diligence questionnaires they use for sub-custodian banks. His proposals included questions about the tax treatment of different account structures; the frequency of market updates about local taxation of securities; the proportion of tax reclaims processed manually, as opposed to on an automated basis; whether the tax reclaim reporting capability is real-time or not; and what proportion of tax repaid is processed as relief-at-source as opposed to being reclaimed.

5. These include the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI BEPS); the report of the Tax Barriers Business Advisory Group (TBAG) of the European Commission; the TRACE project run by the OECD to facilitate claims under double taxation treaties; and the European Union (EU) Code of Conduct on "harmful tax competition."