

# **ISSA**



## **Financial Crime Compliance Principles for Securities Custody and Settlement**

### **Background & Overview**

**May 2019**

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This document does not represent professional or legal advice and will be subject to changes in regulation, interpretation, or practice.

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# 1. Introduction

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This background and overview document is intended to provide financial institutions with an introduction to ISSA's Financial Crime Compliance Principles<sup>1</sup> which are intended to provide guidance in the application of risk-based measures to protect the global system under which securities are safe kept and settled from criminal abuse.

This guide provides firms with a summary of the reasons why ISSA and its Board identified a requirement to address financial crime compliance, the expected costs and benefits of doing so, and the measures that firms may need to consider in order to ensure compliance with the Principles.

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<sup>1</sup> ISSA Financial Crime Compliance Principles for Securities Custody and Settlement, originally issued on August 27, 2015 / subsequently revised in May 2017 and May 2019.

## 2. The Case for a Structured Approach to Financial Crime Compliance

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At its May 2014 Symposium, ISSA decided to address the financial crime compliance in the areas of custody, settlement and distribution of securities and investment funds. This decision was taken in response to three principal drivers:

- To provide a meaningful and substantive framework to guide custodians and fund distributors in the application of the IOSCO *Principles on Client Identification and Beneficial Ownership for the Securities Industry* of 2004;
- To address issues raised by recent enforcement actions with a view to minimizing any gaps between market practice and the expectations of regulatory and enforcement authorities;
- To articulate standards in securities custody and fund distribution that address those specific characteristics of conduct risk in the securities field which are otherwise absent in correspondent banking services.

### 2.1 Financial Crime Compliance is Increasingly a Focus Area

Compliance has become a major focus for financial services. Recent trends affecting the industry include:

- Regulators have increased their attention and focus on sanctions enforcement and counter-terrorism measures. Recent enforcement actions involving securities custody have highlighted differing expectations between the industry and the authorities;
- Concerns about the lack of transparency in securities holding chains have led regulators to articulate expectations that depart from their traditional guidance;
- The development of due diligence, disclosure, compliance monitoring and screening practices in securities settlement could lead to significant operational costs and frictions if not accompanied by appropriate cross-industry standards.

## 2.2 The Benefits of Intermediation

The international system under which securities and mutual funds are safe kept, settled and distributed intermediates many institutions, transforming ownership interests multiple times. The system brings enormous benefits to the global economy because it achieves significant scale benefits which result in low transactional costs and a high degree of securities mobility.

Registering securities in the names of brokers, custodians and their nominees facilitates the clearing and settlement of transactions. The system enables financial institutions to commingle the ownership interests of many investors and then to concentrate those holdings in the custody chain. The system gives rise to a number of important benefits:

- The costs of safekeeping benefit from the economies of scale by concentrating securities ownership interests into the hands of only a handful of significant intermediaries: global custodians, agent banks and (I)CSDs;
- The mobility of securities exchanges across geographies and different markets is enhanced by allowing trading and settlement of securities to be effected globally free from the constraints of national depository and market windows;
- The commingling of fungible interests enables alternative settlement venues in addition to the issuer CSD (or place of primary deposit), facilitating competition for the provision of settlement and ancillary securities services, tending to drive down transactional costs still further;
- The mobility of collateral and hence the practicality of securities as a collateral class is accelerated.

## 2.3 Transparency in Intermediated Custody Chains

But by substituting a record of the end investor's identity for a record of the Custodian's or the broker's identity, the nominee model can reduce transparency.

This is true not only of the omnibus model which commingles multiple ownership interests but also of the segregated model because in most jurisdictions a Custodian sub-depositing securities or distributing mutual funds remains the unique legal owner of the securities. The only safekeeping model which provides the sub-custodian and the CSD with the full transparency about the identity of the Ultimate Assets Beneficial Owner is the end-investor accounting model, where each investor opens an account with the issuer CSD in the name of and for the account of the buyer or seller of a security.

In the majority of markets, intermediation to some degree characterizes the safekeeping model, reducing the visibility of Upstream Custodians over the identity of the end holder and the purpose of the holding. Consequences include:

- Issuers and Upstream Intermediaries cannot readily identify investors and shareholders, reducing the utility of shareholder registers and sometimes requiring complex disclosure processes;
- The management of the risks arising from money laundering, terrorist financing, market manipulation, tax evasion and capital flight becomes more challenging as a result.

## 2.4 Regulatory Standards

In comparison to other areas of financial services, there has been relatively little discussion at policy-making level about how compliance risks should best be managed in the context of the nominee account. Under current global compliance standards custodians, depositories and clearing agents must perform customer due diligence for all accounts and enhanced due diligence on financial institution customers intermediating third party interests.

According to the IOSCO's Principles on Client Identification and Beneficial Ownership for the Securities Industry 2004, securities custodians are entitled to perform specific (or "enhanced") due diligence on their regulated financial institution customers in order to rely on those customers' client and beneficial ownership identification and due diligence programs.

Where a securities intermediary is a regulated financial institution (and so is "equivalently regulated"), it does not therefore generally disclose to its custodians, settlement agents and depositories for whom it is acting. Its correspondents may rely on the fact that it itself has performed due diligence and KYC on its own clients.

In its 2004 paper, IOSCO also recommended that Custodians accepting deposits of securities or mutual funds on account of financial institutions acting for third parties:

- Understand the business and professional reputation of the Omnibus Account Holder;
- Assess the adequacy of the Omnibus Account Holder's Client due diligence process;
- Assess the regulatory and oversight regime of the country of the Omnibus Account Holder in order to establish that it is subject to equivalent Client due diligence standards.

Partly as a result of how the IOSCO recommendations have been translated into national regulation, securities intermediaries are of course bound by very high compliance standards. KYC is practised on regulated and unregulated customers alike who are weighted by country and other risk factors. Transactions are

routinely screened by Custodians against SDN (Specially Designated Nationals) and PEP (Politically Exposed Persons). Regulated Account Holders are required under the terms of participant agreements not to cause their custodians, settlement agents and depositories to violate laws and regulations which intermediaries routinely communicate to their participants.

Other regulators have explicitly endorsed this approach. For example, FinCEN and the SEC jointly issued a rule under the Patriot Act in May 2003 specifying that “with respect to an omnibus account established by an intermediary, a broker dealer is not required to look through the intermediary to the underlying beneficial owners, if the intermediary is identified as the account holder.” Similarly, in guidance issued in October 2003, the US Treasury and the SEC made clear that even when broker-dealers have information regarding a financial intermediary’s underlying customers, they should treat the intermediary itself – that is the account holder – as the sole “customer” for purposes of the customer identification program rule. FinCEN and the CFTC issued almost identical guidance in February 2006.

Regulatory guidance, although explicit on exempting regulated firms from any requirement to look through their regulated Account Holders, has been silent on the consequences of a violation caused by the conduct of an unidentified Client of a regulated Account Holder. Before now the industry had not developed market standards that address the question of how the 2004 IOSCO Principles should be applied in practice. In the absence of a codified framework, there are signs that regulators are increasingly likely to challenge the principle of “equivalent regulation” in the area of Beneficial Ownership Identification. The principle is challenging to enforce in a cross-border context because, for example:

- Not all regulations and regulators are equal;
- Depending on requirements, financial institutions have varying standards and different attitudes to control frameworks;
- Even where standards are genuinely equivalent, the competence of financial institutions to uphold them is not equivalent.

## 2.5 Conduct Risk and Enforcement Actions

A joint report of the FATF and Moneyval was published in 2009 on the risks of the money laundering and terrorist financing in the securities sector. The report specifically highlights that a vulnerability to money laundering exists because “a securities intermediary may not know the beneficial owner of an investment if held in an Omnibus Account maintained for a (foreign) financial institution”. To an extent, this finding has been left hanging until now. In some jurisdictions there has been an explicit debate on whether securities intermediaries should be required to identify the Ultimate Assets Beneficial Ownership of assets deposited and transacted on Omnibus Account but that has not so far resulted in any jurisdiction that permits nominee accounts to actually require it.

Recent enforcement actions involving securities custody in the area of financial crime have not fundamentally challenged the principle of equivalent regulation. However, both OFAC in its settlement with Clearstream in January 2014 and FINRA in its settlement with BBH in April 2014 emphasized the need for Custodians to remain vigilant in respect of custody accounts and both have exercised the right to hold intermediaries accountable for the conduct of their regulated Account Holders.

The cost of enforcement actions in the United States and in the EU both in financial and in reputational terms is rising significantly. The cost of a single failure of market abuse, sanctions or money laundering compliance can lead to substantial penalties which must also be factored into banks’ calculations of their operating risk capital requirements.

### Recent Enforcement Actions

*Clearstream provided the Government of Iran with substantial and unauthorized access to the U.S. financial system. Today’s action should serve as a clear alert to firms operating in the securities industry that they need to be vigilant with respect to dealings with sanctioned parties, and that omnibus and custody accounts require scrutiny to ensure compliance with relevant sanctions laws.*

**OFAC Director, Adam Szubin**

*BBH was obligated under federal law to investigate customer activity on a risk basis: omnibus accounts transacting in higher risk activity, such as suspicious penny stock transactions, merited additional scrutiny.*

**FINRA Letter of Acceptance, Waiver and Consent, 2 April 2014**

## 2.6 The Experience of Cross-Border Payments

Significant differences now exist between how the securities and the correspondent banking sectors address the issue of transparency. The correspondent banking industry has experienced significant pressure over the past 10 – 15 years to provide greater levels of transparency in the execution of payment transactions. These measures have led to a factor increase in the operating costs of correspondent banking.

In its “Anti-Money Laundering Principles for Correspondent Banking”, the Wolfsberg Group has articulated the following principles:

- Foreign correspondent banking relationships should be subject to specific formal governance oversight;
- Foreign correspondent banking relationships should be subject to “appropriate” due diligence;
- Financial institutions should not rely solely on the fact that a foreign correspondent is subject to an internationally-recognized regulatory environment and must consider the particular risks that it poses;
- The financial institution should assess the foreign correspondent’s geographic risk, its branches, subsidiaries and affiliates, its ownership and management structures, its underlying business, its customer base, the products and services offered, its regulatory history and the effectiveness of its anti-money laundering controls;
- The downstream relationships of the correspondents should be understood.

There are notable parallels between the situation of a correspondent bank offering services to foreign financial institutions and the situation of a securities intermediary offering Client Accounts. An equal amount of value is transferred cross-border by securities intermediaries in the form of settlement messages as it is by the cross-border payments industry. A financial institution settling a securities trade is in a position similar to that of an intermediate financial institution; assets can be transferred between parties whose identities are not known to the institution.<sup>2</sup>

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<sup>2</sup> In the case of cross-border payments, this problem is addressed by transmitting ordering and beneficiary party details to upstream correspondents executing cover payments. The case of securities is different both because of novation by CCPs and because exposure to underlying beneficial owners is continuing and permanent rather than transactional in nature.

Securities custody and funds distribution is, however, distinguished from correspondent payments activities in the following ways:

- A payment represents only a transactional exposure to financial crime risk since it involves the correspondent only at point of execution. A property interest in a security or fund is continuing and permanent so that an intermediary's exposure to the Ultimate Beneficial Owner's conduct exists irrespective of whether or not a transaction occurs;
- Securities are held and transacted by a significantly smaller set of underlying owners and include a high proportion of professionals acting as asset managers, brokers and so forth. Securities are transferred primarily to complete trading contracts or to transfer collateral interests. Cross-border payments can be conducted by virtually anyone for virtually any purpose and therefore represent a considerably more heterogeneous risk for correspondent banks.

Cross-border payments and securities / funds custody therefore expose financial institutions to financial crime risks that are similar in nature but far from identical to those faced by a correspondent bank. ISSA recognizes that there is a strong case for the articulation of an effective market-led framework for the remission of financial crime risk but that it must also address the specificities that are peculiar to securities and funds custody and which distinguish the securities services industry from its correspondent banking cousins in payments and trade finance.

The ISSA Financial Crime Compliance Principles are designed to provide that framework. They are designed to remit financial crime risks in a manner which is effective and which will minimize disruption to the markets. The Principles aim to preserve the benefits of the various custody models used around the world whilst effectively addressing the externality that in certain circumstances they may be open to abuse.

### 3. Summary of the Principles

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The ISSA Financial Crime Compliance Principles seek to codify current practice in order to mitigate the risk that the cross-border custody, settlement and distribution of securities and investment funds can be abused for financial crimes.

The Principles incorporate best practice from the world of correspondent banking where those practices are relevant to securities services as well. Regulators and compliance professionals within financial institutions are familiar with those practices which have, by and large, proved robust.

The Principles do not aim to distinguish between different custody models and account structures. Member firms are encouraged to apply the Principles irrespective of which account structures they or their Customers use. Some commentators have suggested that the imposition of a given account structure could provide a silver bullet mitigation of financial crime risk in securities services. ISSA has, on the other hand, taken account of the experience of Unidroit and acknowledges that different account structures all bring distinct benefits and costs to the markets they serve. End-investor account models, for example, are frequently used in developing economies where the management of capital inflows and outflows is of paramount importance. Omnibus models maximising scale efficiency and mobility are more frequently used in mature economies where capital market efficiency and stability are the overarching policy concerns. In any event, a solution that relied upon the imposition of a given account structure would take many years if not decades to implement and would involve dependencies on legislative processes that are well beyond the control of member firms. In formulating the Principles, ISSA has explicitly sought to avoid a beauty parade between different models.

In the context of these Principles, Custodians include but are not limited to banks acting as global custodians and sub-custodians, fund distributors, trustees / depository banks, brokers, prime brokers, International Central Securities Depositories and Central Securities Depositories, to the extent that cross-border operations are involved. These Principles do not address the conduct of the issuer or its agents (and therefore do not address fund transfer agents or administrators).

The Principles focus on the Custodian's relationship with its Account Holders, including other Custodians and address cross-border relationships which are defined as relationships in which the Account Holder is foreign, which concern the deposit of foreign or international securities or which are denominated, settled or otherwise transacted in foreign currency.

### **3.1 Third Party Client Business**

The novel element of the Principles is the focus on third party Client business. The focus of the Principles is about how Custodians can ensure that their compliance standards and legal obligations can be imposed on their investors who may be at several steps removed from themselves in the custody chain.

Because interests in securities are generally not transitory or transactional in nature but are continuous, control methodologies in securities services must focus on asset holdings and not just on the execution of transactions by asset owners. Transactional risks are addressed (mainly by Principle 17) but the main focus has fallen necessarily on the risks inherent to the custody of securities and investment funds.

The Principles distinguish between Segregated Accounts, which contain securities interests legally owned by a single party and Omnibus Accounts which commingle the interests of various parties.

### **3.2 Segregated Accounts**

The Principles (6, 7 and 8) establish that the ownership interests in Segregated Accounts should be known to Upstream Custodians. A Segregated Account is always held for the account of a single legal owner. It may be held for a single Ultimate Assets Beneficial Owner, in which case the owner should be identified to Upstream Intermediaries, or it may be held for a Downstream Custodian which is itself commingling assets in omnibus form. In the latter case, Custodians should apply the Omnibus Account Principles (9 – 16).

### **3.3 Omnibus Accounts**

The overarching principle in relation to Omnibus Accounts is for Custodians to take steps to confirm that their Omnibus Account Holders have compliance objectives that are compatible with their own and those Account Holders have the means and control organisations to meet those objectives effectively. The Principles foresee that arrangements for all Client Account (third party) business will be subject to bilateral agreement between the Custodian and its clients and this is particularly the case with Omnibus Accounts. The Custodian will be entitled (and expected) to verify its Customers' compliance with those objectives.

**Figure 1**

*Illustration of the contractual compliance framework governing Client Account relationships using the case of a European Custodian depositing securities in the United States on behalf of a Latin American Customer*



The illustration above conveys the mechanisms by which the Principles operate:

- It is the responsibility of the Custodian to communicate its KYC standards and other requirements to its Account Holders;
- It is the responsibility of the Custodian's Account Holder to comply with those requirements;
- Where the Account Holder has clients who themselves accept deposits of third party Client securities, the Account Holder should ensure that those clients are subject to the requirements of the jurisdictions in which the securities entitlements are held, including the requirements of the relevant Custodian(s);
- It is the responsibility of the Account Holder to sub-deposit securities with the Custodian only when the beneficial owners have been subjected to satisfactory due diligence. On a risk-led basis, the Custodian should be entitled to verify that its due diligence requirements have been met.

## 4. Implementation

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### 4.1 Glossary of Terms Used in this Document

**Account Holder:** Account Holders in the context of the Principles are regulated financial institutions holding accounts directly with the Custodian. The term expressly excludes the notion of direct end investor records at the level of the CSD which is the arrangement in place in some markets and which are sometimes called “accounts”.

**Buyers and Sellers to a securities transaction:** The individuals or moral persons which effectively are the parties to a buy / sell transaction of securities. In these Principles, they correspond to the Ultimate Assets Beneficial Owners.

**Client:** Any customer of the Account Holder, which deposits securities with the Account Holder, which the Account Holder in turn deposits or plans to deposit with the Custodian.

**Custodian:** A professional securities custodian may be defined as a regulated financial institution providing securities custody / safekeeping accounts, securities settlement and related services to its Clients (typically institutional, collective and private investors, investment managers, and broker dealers) and to other financial institutions.

**Downstream:** Parties in the intermediary chain in the direction from the issuer or investment fund towards the Ultimate Assets Beneficial Owner or investor.

**Intermediary Assets Holders:** The Custodians acting as intermediaries in the custody chain in-between the Ultimate Assets Beneficial Owner and the Sub-Custodian at the end of the custody chain where the assets have been deposited.

**Omnibus Client Account:** A securities account opened by the Account Holder with the Custodian in which securities are deposited on behalf of several Direct Clients of the Account Holder.

**Segregated Client Account:** A securities account opened by the Account Holder with the Custodian in which securities are deposited on behalf of a single Direct Client of the Account Holder.

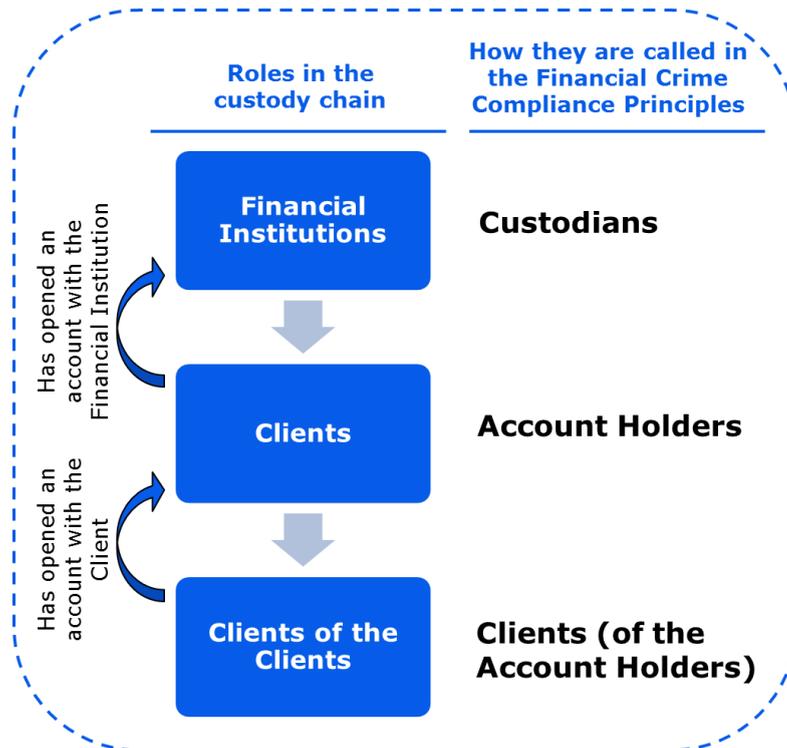
**Ultimate Assets Beneficial Owner:** The natural or moral person(s) on whose behalf or under whose ultimate control a transaction is being conducted. In these Principles, they correspond to the Buyers or Sellers to a securities transaction.

**Ultimate Entity Beneficial Owner:** The natural person(s) who ultimately own(s) (as shareholders) or control(s) (as Directors / executive committee members) an entity.

**Upstream:** Parties in the intermediary chain in the direction from the Ultimate Assets Beneficial Owner or investor towards the issuer or investment fund.

**Figure 2:**

*Illustration of the terms used in the FCCP to describe roles performed in a cross-border custody chain*

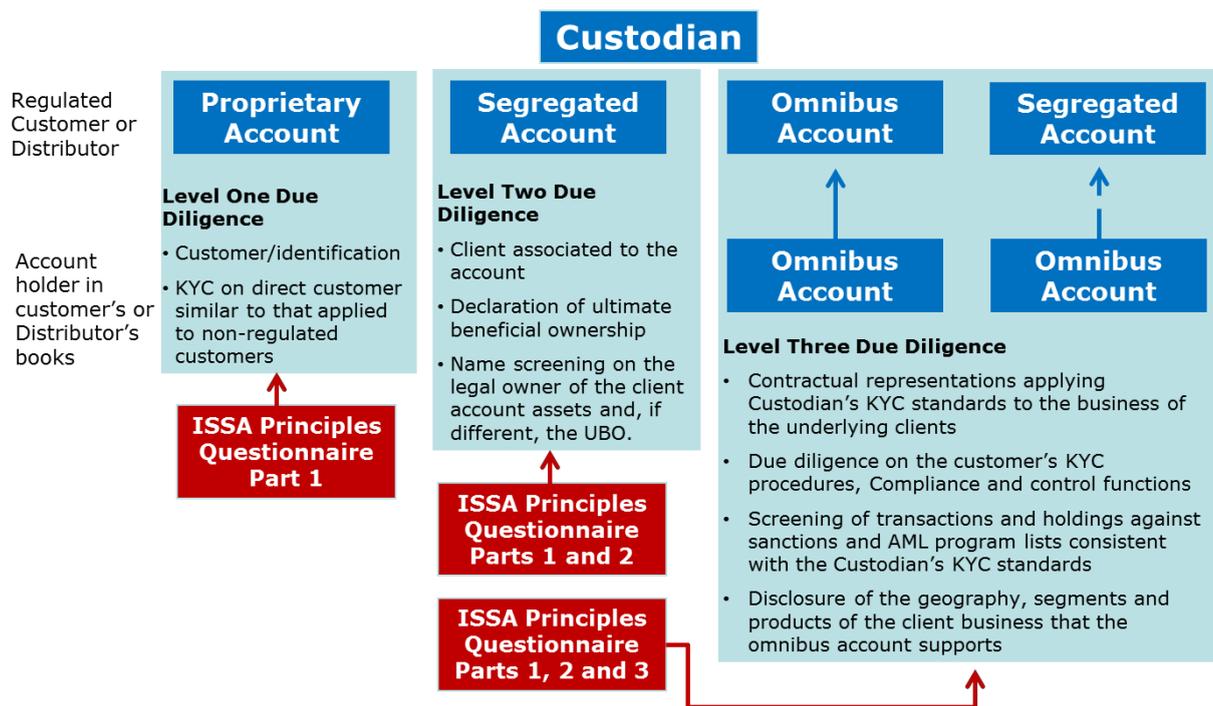


## 4.2 Due Diligence Framework

ISSA will develop a Due Diligence Framework to provide guidance to Custodians in the assessment of their financial institutional Customers in particular in relation to third party Client business. Its use is not mandatory and is not designed to replace firms' own processes where they are sufficient to fulfil the objectives of the Principles.

**Figure 3:**

*The ISSA FCCP Due Diligence Framework*



The Framework is intended to provide general guidelines for the incorporation of essential information and representations which a financial institution Account Holder should provide to its Custodians.

### 4.3 Communication of Requirements to Downstream Clients and Distributors

The Principles are designed to guide Custodians in notifying their Account Holders of their KYC standards and related requirements. It is axiomatic that Account Holders cannot comply with requirements they do not know.

In communicating requirements to Account Holders, Custodians should bear the following in mind:

- ISSA will not perform any actions aside from publicizing these through its membership and relevant industry bodies, and hosting the Principles on its website;
- The Agreement to abide by these Principles and to implement the Custodian's requirements Downstream will be a bi-lateral arrangement. There will be no ISSA database or tracking of parties agreeing to these Principles, or conversely parties that have declined these Principles;
- Custodians should take reasonable steps to ensure that the Account Holder has taken the appropriate measures to comply with the requirements of the Custodian;
- Custodians should verify the respect of those arrangements in the course of their own due diligence programs which will reflect their own policies and regulatory requirements.

The requirements that a Custodian should communicate to its Customers are:

- Any standards that go beyond FATF norms, or
- Any requirements of the Custodian's own depositories and sub-custodians which go beyond FATF norms;
- Any national requirements, especially as regards sanctions (e.g., Customer will not use Custodian to effect any transactions that would violate the laws of the jurisdiction in which Custodian is incorporated or acts for the Customer).

Examples of requirements that Custodians should consider communicating to their Customers might include:

- Excluding entities from specific sectors for ethical reasons; cluster munitions manufacturers or internet gaming, for example;
- Policies relating to specific asset classes; low value stocks, for example.

Custodians are not expected to communicate standards, such as the commitment to identify customers, which are existing regulatory or statutory obligations of both the Custodian and its Customer. Therefore the communication of the Custodian's requirements is not expected to include the general elements of the Custodian's KYC policies.

## 4.4 Contractual Arrangements

It is a core feature of the Principles that requirements should be transmitted and representations relating to them should form the subject of bilateral agreements between Custodians and their Account Holders. It is envisaged that bilateral terms will be agreed between the Custodian and its Account Holder. ISSA does not recommend a standard template contract side letter, since existing agreements and local regulatory provisions are diverse and it would be impractical to cover these in a standard letter. ISSA has, however, produced examples of standard language to guide in-house legal teams in formulating appropriate language (cfr ISSA website).

ISSA notes that one particular advantage of an agreement-based model is that it in principle enables a financial institution in a higher risk jurisdiction to meet and to demonstrate to its Custodian(s) that it has met higher standards than those required under its local regulation. Whilst a level of de-risking may occur as a result of the adoption of the Principles, the contractual framework will, ISSA believes, tend to minimise the degree to which it occurs.

## 4.5 Segregated and Client Accounts

The aim of the Principles is to ensure that the Account Holder has the processes and policies in place to provide the Custodian with a reasonable level of assurance that the business conducted is consistent with its own standards and policy objectives.

The Ownership status of each account should be validated with each Account Holder and tracked clearly to ensure that Proprietary, Segregated and Omnibus Client Accounts can be easily distinguished.

Custodians should screen both the underlying Clients holding Segregated Accounts with the Account Holder and (if different) the Ultimate Assets Beneficial Owner(s) against lists that include the targets of sanctions and other compliance-related programs.

Custodians should take affirmative steps to determine the Ultimate Assets Beneficial Ownership of the assets deposited on the Segregated Account.

## 4.6 Omnibus Accounts

Custodians have the right to assess their Account Holders periodically to determine the appropriateness of maintaining Client Omnibus Accounts for the Account Holder. The Custodian should take appropriate steps to assess the degree to which the Account Holder:

- Has the appropriate regulatory and statutory capacity to commingle third party securities interests;
- Maintains control and compliance functions which are dedicated or specific to the business division within the Account Holder's organization;

- Screens transactions and holdings against lists of designated persons under sanctions and other relevant programs consistent with the requirements communicated by the Custodian;
- In line with the Custodian's onboarding process, provides information on the geography (markets), segments and products that the Account Holder supports with the Omnibus Account in order to provide a baseline for forming an expectation of how the Custodian expects the account to behave;
- Agrees to communicate to its underlying Clients any restrictions of the types mentioned in "Communication of Requirements to Downstream Clients and Distributors" (refer to point 4.3 above).

#### **4.7 Disclosure of Holdings**

In the presence of certain aggravating risk factors Custodians should require Account Holders to provide information on underlying security holders. Such risk factors could include *inter alia*:

- Suspicious transaction flags that cannot be resolved in due diligence;
- Sanctions and adverse media screening triggers that cannot be resolved in a timely fashion where disclosure is necessary to protect the Custodian's interests;
- Activities on or use of the account(s) of the Account Holder which are inconsistent with its representations on the geography (markets), segments and products that the Account Holder supports with the Omnibus Account and that cannot be resolved in a timely fashion;
- Breaches of law or the contract with the Custodian where disclosure would be a reasonable precaution to ensure that termination can safely be effected.

#### **4.8 Disclosure of Holdings – Communication Protocols**

The Custodian and its Account Holder may establish a set of communication protocols for notices and responses between the two parties. The Principles do not require that Custodians do so, and ISSA believes that Custodians should establish policies in this respect that take account of the volume and complexity of the client business. Where communication protocols represent an efficient solution for the Custodian, they should be agreed upfront and adjusted periodically as automation and market practices evolve.

#### **4.9 Data Collation and Aggregation**

Custodians should consider options to leverage existing beneficiary data sources to meet the disclosure processing requirements. Use of LEIs could be considered as a standard for all institutional clients in the chain.

Existing tax driven requirements, including FATCA disclosures, could be leveraged to avoid the duplicate maintenance of databases, and reporting requirements. ISSA believes that Custodians' tax databases (Certificates of Residence and so forth) could be reconciled to information obtained on the legal and beneficial ownership of securities and investment funds deposited.

#### **4.10 Transactions – Disclosure of Buyers and Sellers**

The Principles focus on the ultimate ownership of securities holdings which, from the Custodian's perspective is a continuing exposure. Nonetheless, Principle 17 covers the situation where the transaction itself triggers the need to identify the principal(s) to an underlying trade. Risk factors or suspicious transaction flags might give rise to a need to identify the ultimate Buyer or Seller. Industry protocols in this particular space are evolving and, as such, Custodians should keep themselves apprised.

## 5. Problem Resolution

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### 5.1 The Custodian's Dilemma

One of the key differences between the situation of a securities intermediary and a payments bank on detection of suspicious activity is that the Custodian's exposure is continuous because property interests are involved whilst a payment bank's exposure is momentary and resistible.

In the worst case, the continuation of the holding may constitute a violation whilst any attempt to alienate the interest by, for example, transferring it to another Custodian may also constitute a violation.

### 5.2 Remedies

Whilst a payment bank can in many cases simply refuse to execute a transaction and move on, efforts to resolve an apparent violation can often be fraught with complexity, cost and risk for a Custodian.

ISSA has come to the conclusion that there is little practical guidance on what a Custodian is expected to do in such circumstances. ISSA has identified no universal silver bullet but will engage with relevant regulatory authorities to gain further guidance. An appropriate response of a Custodian to breaches of the Principles and / or other concerning activity that are not resolved within a reasonable period of time can involve remedies which are aimed at:

- Encouraging the Account Holder and / or the recalcitrant Downstream party to comply;
- Protecting itself from breach of its own laws, policies, regulations or foreign regulations arising from the securities and funds positions deposited by the Account Holder;
- Protecting its Upstream Custodians (sub-custodians / depositories / transfer agents) from breaching their own laws, policies or regulations.

## 6. Cost of Adoption

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There may be financial costs associated with the adoption of the Principles:

- Documentation of bilateral arrangements with respect to the Custodian's requirements;
- Mobilizing Custodians' KYC teams to address the due diligence requirements of the Principles to the extent that the effort may be incremental to existing KYC costs;
- Implementation of systematic ledgers to record legal and beneficial ownerships and the tools to reconcile this data to other data held by the Custodian (for example, in its tax reclaims databases);
- Development of communication protocols associated with the handling of disclosure requests where anticipated volumes are such that a scaled process may be beneficial;
- The implementation of transaction and name screening solutions by any (smaller) firms who do not yet employ such secondary controls.

While each institution must individually evaluate its costs of implementation, ISSA believes that on balance the Principles represent an efficient set of measures to meet the expectations of regulators and enforcement authorities for the industry as a whole.

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