

ISSA



Financial Crime Compliance Principles for Securities Custody and Settlement

Examples of Draft Contractual Terms to Support the Implementation of the Principles

May 2019

Disclaimer

None of the products, services, practices or standards referenced or set out in this document are intended to be prescriptive for market participants. Therefore they should not be viewed as express or implied required market practice. Instead they are meant to be informative reference points which may help market participants manage the challenges in today's securities services environment.

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

ISSA does not warrant the accuracy or completeness of the information or analysis contained in this paper.

International Securities Services Association ISSA
c/o SIX Group Services AG
Hardturmstrasse 201
P.O. Box
CH-8021 Zurich, Switzerland

Contact + 41 58 399 2368
issa@issanet.org
www.issanet.org

Table of Contents

1. Introduction.....	3
2. Terms and Definitions	4
3. Contractual Guidance – Suggested Draft Language	6
3.1 Policies and Standards	6
3.2 Account Holder’s Assets – Segregated versus Omnibus Accounts....	9
3.3 Segregated Client Accounts	9
3.4 Omnibus Client and Commingled Accounts	11
3.5 Disclosure of Buyers and Sellers.....	15
3.6 Management of Conflict of Laws	15

1. Introduction

The aim of this document is to provide those financial institutions that require it with initial guidance on the drafting of contractual terms between Custodians and their regulated Account Holders governing the application of the ISSA Financial Crime Compliance Principles (“the Principles”) to cross-border securities custody relationships. Clearly, conditions governing account relations between Custodians and Account Holders are extremely diverse. They are governed by many jurisdictions, usually that of the Custodian, which require not only different drafting but also must meet a wide variety of statutory and regulatory requirements that go well beyond the scope of the Principles. This document does not aspire to provide specimen language, but to inspire approaches that might serve as a starting point for in-house legal teams seeking to amend contractual terms of account to facilitate an application of the Principles.

Those Principles which may - depending on the situation of the Custodian and the existing terms governing the relation between the Custodian and its regulated Account Holders - benefit from contractual force, have been identified. In each case, different drafting approaches have been provided in the form of various examples. Typically, these examples contrast more and less onerous approaches.

Only the Custodian can determine which of these options, if any, may strengthen its capacity to apply the Principles. In some cases, it may not be necessary or even feasible to enforce some of the Principles contractually. In other cases, Custodians may already have provisions substantially similar to those contained in this document included in the terms governing their account relations with regulated financial institution Account Holders.

2. Terms and Definitions

The terms and definitions in the Agreement between the Custodian and its regulated Account Holders may have the following meaning:

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.

Commingled Account: A securities account opened by the Account Holder with the Custodian in which securities are deposited on behalf of several Ultimate Assets Beneficial Owners, irrespective of whether the account is a Segregated Client Account or an Omnibus Client Account.

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.

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.

Law and Regulations: A set of national, foreign or international laws or national or foreign decrees, regulations, judicial or governmental orders, including, but not limited to, any sanction rules and any orders, writs, judgements, injunctions, stipulations, determinations, recommendations or other acts entered or actions taken by national or foreign government, authority court, (self-) regulatory organization, government agency or instrumentality of government, administrative practices or any relevant market practice applicable to all citizens in a society and to the financial sector.

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.

Policies and Procedures: A set of policies and procedures, rules and guidelines formulated and adopted by the Custodian to reach its long-term goals and possibly published in a form accessible by its customers. Procedures are the specific methods employed by the Custodian in order to maintain its policy objectives in day-to-day operations.

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.

Standards: Laws and regulations and policies and procedures, taken together. Standards embrace both statutory obligations of the Custodian and the policies and procedures that it chooses to apply.

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.

3. Contractual Guidance – Suggested Draft Language

For each Principle contained in the ISSA Financial Crime Compliance Principles, suggested examples have been drafted (with reference to no particular jurisdiction) that might give contractual force to a Principle depending on the requirements of the Custodian. In certain cases, more than one example has been provided, to illustrate different levels of obligation which the language might impose or how specific the obligation might be discharged which the Custodian might apply on a risk-led basis.

3.1 Policies and Standards

Principle 1

It is the responsibility of the Custodian to communicate to its Account Holders any relevant Know Your Customer (“KYC”) standards and other compliance and risk-based requirements that it expects them to follow.

Example 1.1: The Custodian shall communicate to the Account Holder the Policies and Procedures applicable to, implemented and applied by the Custodian to the Account Holder’s accounts with the Custodian from time to time.

Example 1.2: The Custodian shall communicate to the Account Holder the Policies and Procedures applicable to, implemented and applied by the Custodian to the Account Holder’s accounts with the Custodian from time to time. However, the Custodian does not warrant the completeness of such information and may not be liable for any loss, claim, liability, expense or damage arising from this action taken or omitted to be taken by the Custodian.

Example 1.3: The Custodian undertakes to inform the Account Holder of the Standards that it seeks to apply in addition to any other requirements. By receiving that information, the Account Holder tacitly accepts and agrees to apply the Standards.

Principle 2

It is the responsibility of the Account Holder to comply with those standards and requirements.

Example 2.1: The Account Holder understands and acknowledges its obligation to comply with the Policies and Procedures which are communicated from time to time by the Custodian, unless expressly agreed to the contrary in writing.

Example 2.2: The Account Holder has the obligation to take measures reasonably designed to ensure that the Policies and Procedures communicated from time to time by the Custodian are observed. Unless the Account Holder informs the Custodian in writing to the contrary within [the agreed number of] business days, the Policies and Procedures that the Custodian has communicated to the Account Holder are deemed to have been understood and accepted by the Account Holder.

Example 2.3: The Account Holder undertakes to comply with the Standards communicated by the Custodian from time to time. By receiving the information, the Account Holder acknowledges and warrants its intention to comply with those requirements.

Example 2.4: The Account Holder has the obligation to take measures reasonably designed to ensure that the Standards communicated from time to time by the Custodian are observed. Unless the Account Holder informs the Custodian in writing to the contrary within [the agreed number of] business days, the Policies and Procedures that the Custodian has communicated to the Account Holder are deemed to have been understood and accepted by the Account Holder.

Principle 3

Where the Account Holder has Direct Clients who themselves accept deposits of third party Client securities, it is the responsibility of the Account Holder to notify the Clients that by holding securities cross-border they will be subject to the requirements of the jurisdictions in which the securities entitlements are held, including the standards of the relevant Custodian(s).

Example 3.1: In the case of cross-border securities holdings sub-deposited by the Account Holder with the Custodian in the name and on behalf of Direct Clients which themselves accept deposits of securities of third party Clients, the Account Holder has the obligation to notify in writing those Direct Clients, as owners of the assets, of the law and regulations applicable in the relevant jurisdiction where the securities entitlements are held, together with the Custodian's Policies and Procedures that may be also applicable to these assets.

Example 3.2: The Custodian has the obligation under Examples 1.1 - 1.3 above to communicate to the Account Holder the Standards applicable to securities holdings of the Account Holder. The Account Holder has the obligation to transmit this information to any of its Direct Clients which themselves accept deposits of securities of third party Clients. By transmitting this information to the Account Holder, the Custodian shall consider that these Standards are satisfactorily communicated and that the Account Holder has undertaken reasonable efforts to ensure that it and its Direct Clients comply with those Standards. The Account Holder acknowledges that it may be liable for its failure or refusal to communicate such requirements to its Direct Clients.

Example 3.3: The Account Holder shall be solely responsible for providing the relevant information pertaining to the Standards communicated by the Custodian to any third party on whom it depends in order to provide the Custodian with a reasonable assurance that its Standards are observed. [By receiving that information, the Custodian assumes that the Standards that it has communicated to the Account Holder have been understood, approved and adopted by the Account Holder and any third parties to whom they have been communicated].

Principle 4

It is the responsibility of the Account Holder to sub-deposit securities with the Custodian only when the Ultimate Assets Beneficial Owners have been subjected to satisfactory due diligence. If the Ultimate Assets Beneficial Owners of the securities are not themselves directly Clients of the Account Holder, then it is the responsibility of the Account Holder to ensure that its Direct Clients have undertaken the appropriate level of due diligence. On a risk-led basis, the Custodian should be entitled to verify that its due diligence standards have been met. Third party agents or reports may be relied upon for this purpose.

Example 4.1: The Custodian has the right to perform a due diligence investigation to ensure that the Ultimate Assets Beneficial Owners of assets deposited by the Account Holder have been identified and that their identities are consistent with the Standards communicated by the Custodian.

Example 4.2: The Account Holder undertakes to deliver a due diligence program with respect to the assets deposited with the Custodian that is reasonably designed to ensure that the Ultimate Assets Beneficial Owners of those assets have been identified. If the Ultimate Assets Beneficial Owners are not Direct Clients of the Account Holder, the Account Holder shall require its Direct Clients to establish due diligence programs that are reasonably designed to ensure that the (Ultimate) Beneficial Owners of those assets have been identified. The Account Holder undertakes to provide the Custodian with information regarding its due diligence program and, if applicable, the due diligence programs that it has required its Direct Clients to perform, upon the request of the Custodian.

Example 5: The Custodian has the right to appoint a professional third party agent such as, inter alia, a legal adviser, consultant or accountant, to perform due diligence on the Account Holder to verify that reasonable measures have been taken to ensure that the Ultimate Assets Beneficial Owners of the securities deposited by the Account Holder with the Custodian have been identified.

Example 6: If the Ultimate Assets Beneficial Owners are not Direct Clients of the Account Holder, the Account Holder is responsible for the control of the due diligence program performed by its Direct Clients but has the right to use professional third party agents in order to verify that its Direct Clients have taken

reasonable measures to ensure that the Ultimate Assets Beneficial Owners have been identified.

3.2 Account Holder's Assets – Segregated versus Omnibus Accounts

Principle 5

The Custodian must ensure that all accounts are designated by the Account Holder as intended for the deposit of proprietary or Client interests in securities. Accounts designated as Client Accounts must be sub-classified as either segregated, holding securities for one single Client of the Account Holder or omnibus, commingling securities belonging to or held for several Clients of the Account Holder.

Example 7: The Account Holder undertakes to segregate in separate accounts at all times assets deposited with the Custodian and held by such Account Holder on a proprietary basis from assets deposited with the Custodian and held by such Account Holder on a non-proprietary basis. The nature of such non-proprietary account shall be subject to advance approval by the Custodian and to, at the discretion of the Custodian, the requirement by the Custodian to be provided by the Account Holder with additional information.

Example 8: In the case of any account held by the Account Holder on a non-proprietary basis, the Account Holder shall communicate to the Custodian in writing whether each such account is a Segregated Client Account or an Omnibus Client Account. In the case of Segregated Client Accounts, the Account Holder shall additionally advise the Custodian whether the account is a Commingled Account or not.

Example 9: The Custodian may request the Account Holder to provide information evidencing that it has taken reasonable steps to ensure that the information about its accounts provided pursuant to Examples 7 and 8 of this Agreement is accurate.

3.3 Segregated Client Accounts

Principle 6

Non-proprietary segregated accounts may be held only by Account Holders authorized to accept Client assets and monies that have adequate compliance and control functions fulfilling the demands of safekeeping Client assets.

Principle 7

When an Account Holder opens a Segregated Account for one of its Clients with the Custodian, it must disclose the identity of this Client to the Custodian.

Example 10.1: The Custodian shall ensure that any Segregated Client Account opened to hold the assets deposited with the Custodian on behalf of a single underlying Client of the Account Holder on a non-proprietary basis, is recorded in the Account Holder's name / denomination and associated with the underlying Client's name / denomination. The Account Holder shall ensure that sufficient information on the underlying Client is communicated in writing to the Custodian.

Example 10.2: The Custodian shall ensure that the Segregated Account opened to hold the assets deposited with the Custodian and held by one single underlying Client of the Account Holder on a non-proprietary basis, is recorded in the Account Holder's name / denomination and associated with the underlying Client's name / denomination. The Account Holder shall ensure that sufficient information on the underlying Client is communicated in writing to the Custodian. The Account Holder may require the Custodian not to include the name or denomination of the underlying Client in the title of the account, in which case the title of the account shall nonetheless make clear that the assets deposited in the account are not proprietary to the Account Holder.

Principle 8

In addition to the provision of Principle 7 above, if the Client of the Account Holder opens a Segregated Account for the benefit of one single party (i.e. the Ultimate Assets Beneficial Owner, which might be an individual or a moral person), the Account Holder is also expected to disclose the identity of this party to the Custodian. When the Segregated Account Holder's account is maintained on behalf of an underlying Client itself depositing securities with the Account Holder on an omnibus basis, the Custodian should apply, to the Account Holder, the Principles that govern the maintenance of Omnibus Client Accounts (Principles 9 and following).

Example 11: The Account Holder shall provide the Custodian in writing with the name, residence and date of birth of the party(ies) on whose behalf it holds any Segregated Client Account (that it has not declared to be a Commingled Account).

3.4 Omnibus Client and Commingled Accounts

Principle 9

Omnibus Client Accounts commingling securities held for several Clients of the Account Holder may be opened and maintained only by those Account Holders that:

- Are regulated and authorized to accept Client assets and monies;
 - Have compliance and control functions reasonably designed to ensure compliance with Client asset protection rules or, in the limited case of third countries that do not regulate safekeeping, have appropriate policies and procedures in place;
 - Represent that they have applied any specific requirements communicated by the Custodian to the business of the Clients of the Account Holder whose securities are sub-deposited with the Custodian and can demonstrate that reasonable steps are taken to verify compliance;
 - Screen transactions and holdings against lists of designated persons under sanctions and other relevant programs consistent with any requirements communicated by the Custodian.
-

Example 12.1: In order to maintain one or more Commingled Accounts with the Custodian, the Account Holder shall represent that:

- It is permitted by the terms of its regulation and jurisdiction regulated to commingle the assets of several Clients in single accounts;
- It has implemented compliance and control functions that guarantee compliance with any applicable Client asset protection rules;
- It has implemented controls reasonably designed to ensure that the Standards communicated by the Custodian are observed; [It has implemented controls reasonably designed to ensure that the Policies and Procedures communicated by the Custodian are observed].

In the case where one or more Direct Clients of the Account Holder have deposited securities with the Account Holder in Commingled Accounts that the Account Holder sub-deposits with the Custodian, the Account Holder shall represent that it is in possession of equivalent representations of those Direct Clients.

Example 12.2: In order to maintain one or more Commingled Accounts with the Custodian, the Account Holder shall represent that:

- It is permitted by the terms of its regulation and jurisdiction to commingle the assets of several Clients in single accounts;
- It has implemented compliance and control functions that guarantee compliance with any applicable Client assets protection rules.

The Account Holder shall put procedures in place that are reasonably designed to screen the legal and, if different, the names of the (Ultimate) Assets Beneficial Owners of securities before the latter are sub-deposited with the Custodian. The Account Holder shall also put procedures in place that are reasonably designed to screen the names of those counterparties and intermediaries with which their Clients transact before such transactions are instructed for settlement on its accounts with the Custodian or otherwise completed. The identities of these parties shall be screened against lists of persons that are designated under sanctions and other programs of restrictive measures that apply to the Account Holder, and as advised by the Custodian.

The Account Holder undertakes to make reasonable efforts to ensure that it does not sub-deposit with the Custodian or instruct the settlement of transactions in any securities position in which a party appearing on one or more such lists has an interest of any nature. Should despite these efforts, the Custodian become aware that such an interest has nonetheless been sub-deposited or instructed for settlement the Custodian shall be entitled to block the securities position(s) in question, to block any entitlement to it (them) and to report to the competent authorities charged with administering the applicable sanctions program(s) or applicable program(s) of restrictive measures.

In the case where one or more Direct Clients of the Account Holder has deposited securities with the Account Holder in Commingled Accounts that the Account Holder sub-deposits with the Custodian, the Account Holder shall represent that it is in possession of equivalent representations and undertakings of those Direct Clients.

Principle 10

In case the Account Holder opens an Omnibus Client Account with the Custodian, it must disclose to the Custodian the geography, segments and products which the Omnibus Client Account supports.

Example 13.1: Unless the Account Holder informs the Custodian in writing to the contrary within [the agreed number of] business days following the date of the receipt of the Custodian's written request, the Account Holder undertakes to disclose information related to the domiciliation and economic activity of its Direct Clients on whose behalf it has deposited or plans to deposit securities with the Custodian.

Example 13.2: The Account Holder undertakes to complete fully and accurately the Custodian's due diligence questionnaire [the ISSA FCCP Disclosure Framework] in relation to its securities holdings with the Custodian within 1 month of its receipt of the latter's written request.

Principle 11

In considering whether to open an Omnibus Client Account for an Account Holder, the Custodian should evaluate the risk factors present, including the reputation and jurisdiction of the Account Holder, the geographies, segments and products that the account is intended to support and the nature of the Account Holder's activity.

Principle 12

The Account Holder must inform the Custodian promptly of any intention to materially change its use of the Omnibus Client Account. The Custodian reserves the right to decline the use of the omnibus account to support any new business activity of the Account Holder.

Example 14: The Account Holder shall inform the Custodian of the business purpose of each Commingled Account that it has opened or that it plans to open with the Custodian including but not limited to information relating to the financial products the distribution of which the account is designed to support and the locations and market segments from which the Direct Clients whose securities will be sub-deposited in the Commingled Account are expected to be drawn.

Example 15.1: During the course of the contractual relationship, the Account Holder shall inform the Custodian without delay of any material change or intention to change materially the use of the Commingled Account.

Example 15.2: During the course of the contractual relationship, the Account Holder shall inform the Custodian without delay of any material change or intention to change materially the use of the Commingled Account. The Custodian reserves the right to decline such change and to decline to execute any operations that it considers to exceed the purpose of the Commingled Account.

Principle 13

The Custodian has the right to conduct activities to verify its Account Holder's compliance with the requirements including requesting that the Ultimate Assets Beneficial Ownership of assets deposited on Omnibus Client Accounts be disclosed to the Custodian via an agreed operational procedure based on predicated risk factors (i.e. red flags).

Example 16: The Custodian has the right to require the Account Holder to provide reasonable information or documentation to validate the Account Holder's compliance with the Principles. The Account Holder shall provide the Custodian upon request with information on Ultimate Assets Beneficial Ownership of assets deposited in Client Accounts based on predicated risk factors.

Principle 13 (continued)

Ultimate Assets Beneficial Owners of assets deposited on Omnibus Client Accounts shall be disclosed to the Custodian in case of an enquiry by a regulatory authority, judicial authority or the issuer of those assets provided there is sufficient legal basis (as determined by the Custodian) to justify the request.

Example 17: Unless otherwise provided for pursuant to Example 18 below, the Account Holder undertakes to provide the Custodian with all information that the Custodian may require concerning the ownership of the assets in order to allow the Custodian to comply with its legal obligations regarding the identity of the Ultimate Assets Beneficial Owners of the assets deposited on a Commingled Account with the Custodian. The Account Holder expressly agrees and authorizes the Custodian to transmit the information / documentation related to the identity of the Ultimate Assets Beneficial Owner of the assets deposited with the Custodian to any regulator or judicial authority or issuer who is entitled to receive it and who has required the Custodian to disclose it. [The Custodian shall not be liable for any damages suffered by the Customer and / or by the owner of the assets that may result from such disclosure.]

Principle 14

In the case of an Omnibus Client Account where Clients of the Account Holder have themselves deposited securities in this account on an omnibus basis, the Custodian should:

- Require its Account Holder to apply the standards to its Clients that the Custodian requires;
 - Be entitled to require that its Account Holder is in a position to identify the Ultimate Assets Beneficial Owners of the assets deposited and to disclose those identities in accordance with Principle 17;
 - Require that its Account Holder performs due diligence to ensure that its Clients meet the requirements of Principles 9 - 16.
-

This Principle is addressed by Example 12.

Principle 15

The Account Holder which has opened an Omnibus Client Account with the Custodian must ensure that it has an appropriate level of visibility over the business of its branches, subsidiaries, business divisions and affiliates that are entitled to also use this omnibus account.

This Principle is addressed by Example 12.

Principle 16

The Custodian should undertake periodic reviews on a risk basis of its Account Holders which have opened an Omnibus Client Account to ensure that these requirements are continuously observed.

3.5 Disclosure of Buyers and Sellers

Principle 17

The Custodian should be entitled to require its Account Holder to disclose the identities of the ultimate buyer and / or seller of a security in response to a specific request predicated on risk factors (i.e. red flags) within a reasonable period. Where the Client of the Account Holder is itself an intermediary, the Custodian should be required to ask its Account Holder to have its Client(s) disclose the identities of the ultimate buyer, seller and / or other related parties and communicate the data to the Custodian within a reasonable period of time.

This Principle is addressed by Example 16.

3.6 Management of Conflict of Laws

Account Holders may be subject to local legal or regulatory requirements that make compliance with the above Principles unlawful without appropriate consents or at all. If compliance with any Principle can be made lawful if the appropriate consents are provided, the Account Holder shall use reasonable endeavors to obtain such consents. The Account Holder shall inform the Custodian (a) whether it has Clients who have not granted such waivers or consents and (b) of any circumstances in which a contractual waiver would be ineffective to remove the legal impediment to compliance with the Principles.

Example 18: Any other provision of this Agreement notwithstanding, the Account Holder shall use reasonable endeavors to obtain any consent that may be necessary to ensure compliance with this Agreement and shall inform the Custodian without delay of any circumstances of which it becomes aware that might give rise to a legal impediment to its capacity to comply with one or more terms of this Agreement and, in particular, those of its terms that would otherwise require it to disclose the identity of its Direct Clients or the Ultimate Assets Beneficial Owners of assets deposited by the Account Holder with the Custodian.
