



International Securities Services Association

ISSA Thought Leadership Working Lunch

Capital Market Developments and Financial Crime Compliance Principles

Welcome and Introduction

Josef Landolt, ISSA CEO, Singapore, November 4, 2016



International Securities Services Association

ISSA Thought Leadership Working Lunch - Program

11:30 – 11:50	Welcome and Introduction / ISSA in a Nutshell Josef Landolt, <i>ISSA CEO</i>
11:50 – 13:00	Financial Crime Compliance Principles Mark Gem, Member of the Executive Board Clearstream International <i>Chairman of the ISSA Working Group on Financial Crime Compliance</i>
13:00 – 13:30	Business and Practical Implications – Moderated Discussion Alan Naughton, Managing Director, Head Securities Services and Corporate Agency & Trust, Standard Chartered Bank <i>ISSA Board Member</i>

ISSA

International Securities Services Association

ISSA in a Nutshell

History

Mission

Sponsoring Institutions / Board Members

Members

Current Working Groups

Recent Publications



International Securities Services Association

ISSA's History

Need and Idea

The idea of an association of securities services providers from all over the world was conceived in 1975 by the heads of Securities Services Citibank, New York, and Union Bank of Switzerland, Zurich.

Foundation

In 1979, Citibank, Deutsche Bank and Union Bank of Switzerland, by jointly organizing a first meeting of senior securities services executives in Switzerland, laid the foundation of ISSA.



International Securities Services Association

ISSA's Mission

Drive Solutions

Actively contribute to developing and promoting forward-thinking solutions that create efficiencies and mitigate risk within the global securities services industry.

Strengthen Collaboration

Bring together influential securities services leaders, regulators, and other industry stakeholders to foster international coordination and collaboration across the securities services industry.

Facilitate Communication

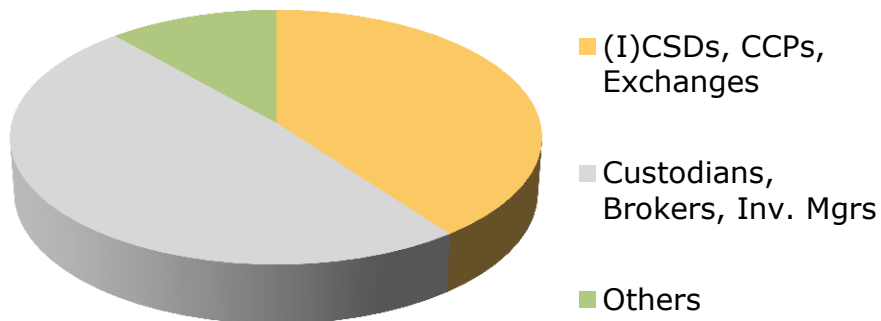
Facilitate and stimulate active communication among all industry stakeholders.

ISSA's Sponsoring Institutions and Board Members (18)

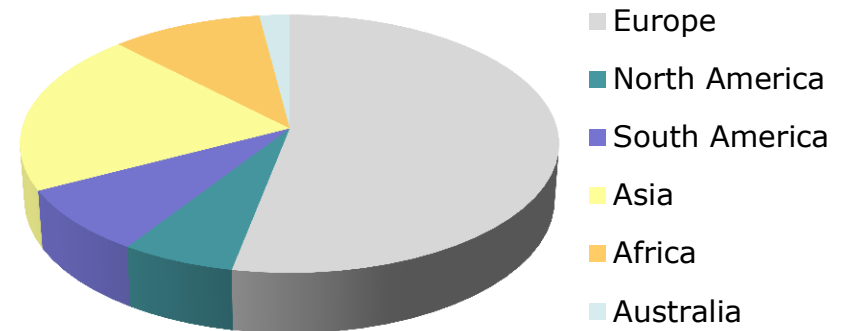
	Charles Cock		John Van Verre
	Tom Casteleyn		Matthew Bax
	Lee R. Waite		Anita Leung
	Ulrich Stritzke		Thomas Zeeb
	Phil Brown		Alan Naughton
	Stephen Lomas		Javier Perez-Tasso
	Andrew Gray		Vicky Kyproglou
	Luc Vantomme	Additional Board Members: Josef Landolt (ISSA CEO) Irene Mermigidis (Chair Operating Committee) Urs Stähli (ISSA Secretary)	

113 ISSA Members from 49 Countries

Membership Types



Country Representation





International Securities Services Association

ISSA's Current Working Groups

Distributed Ledger Technology (Blockchain) – Principles for Industry-wide Acceptance

ISSA Risk Guide – Inherent Risks within the Custody Chain

Collateral Management Best Practices

Corporate Actions and Proxy Voting

Regulatory Impact on the Securities Services Chain

Financial Crime Compliance Principles for Securities Custody & Settlement FCCP

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Recent Publications on www.issanet.org

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

27 August, 2015

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**TRANSPARENCY IN SECURITIES
TRANSACTIONS AND CUSTODY
CHAINS**

**Study on the Benefits and Costs of Securities
Accounting Systems**

Research Paper, 20 August 2015

Coventry University, Faculty of Business,
Environment & Society

Professor Stuart Weinstein
Head, Coventry Law School
Dr Sina Yekini
Senior Lecturer, Economics Finance and Accounting

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Report on Collateral Management

Cross Border Mobilisation of
Collateral

July 2016

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Features of our Current System

The current system is a mixed system in which investors' assets are commingled and segregated for a wide variety of reasons.

Irrespective of the degree of segregation, cross-border custody is always based on contractual claims on entitlements to securities assets. The beneficial owner is always substituted by a financial institution or trustee as the legal owner.

Benefits

Cost

Mobility

Competition

Collateralization

Efficiency

Problems

Transparency

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
23 January 2014**

“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**

1MDB

1Malaysia Development Berhad

Forging Partnerships
Advancing Growth

FOR A GREATER



Reuters

1D

1M

1Y

5Y

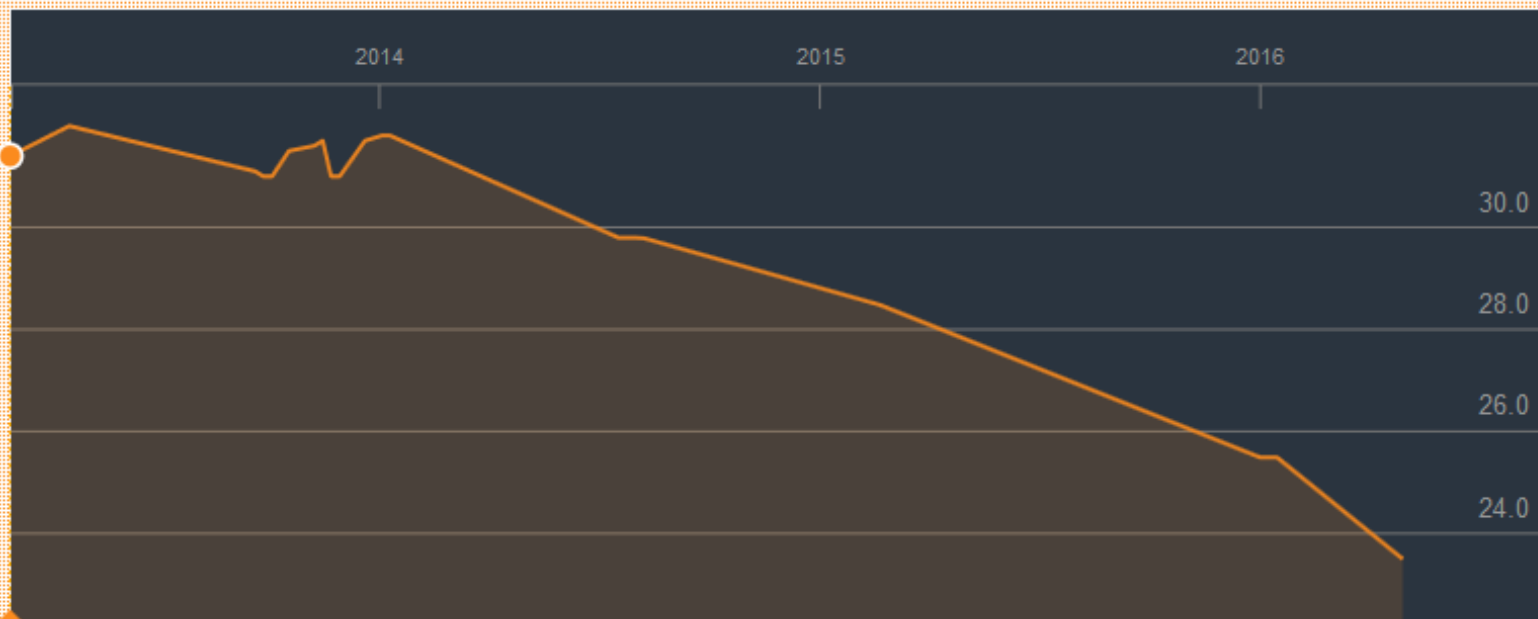
Time Frame

Add Comparison



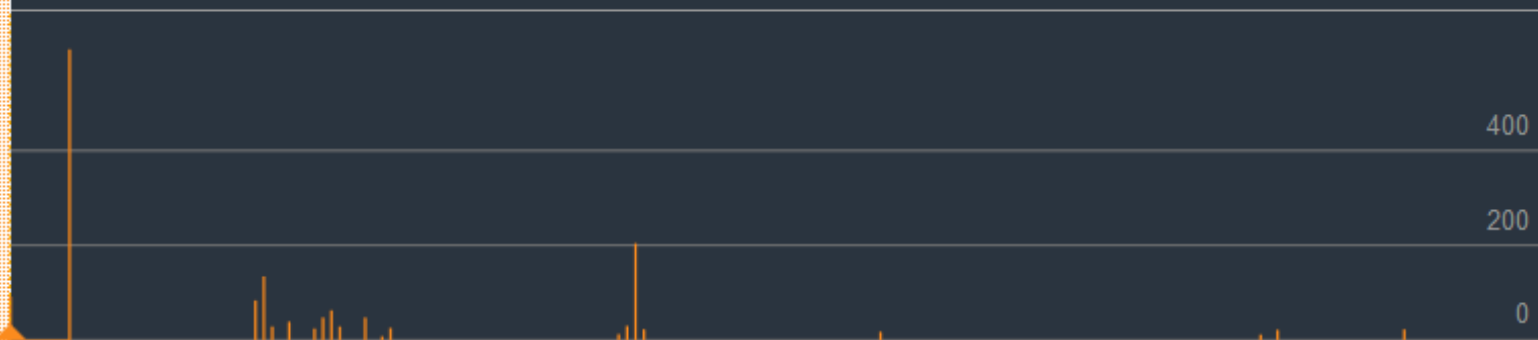
Indicators ▼

ABCD:XY

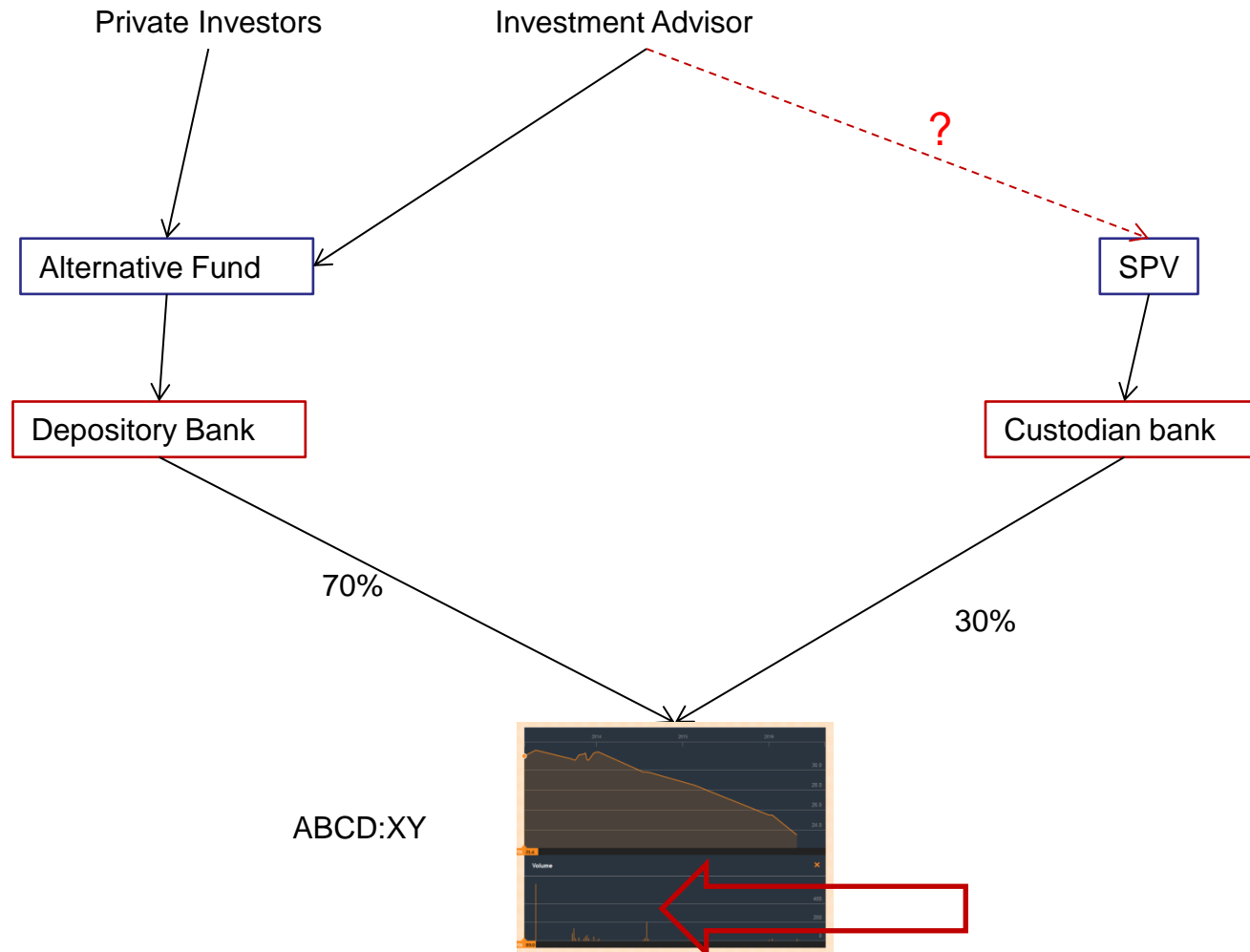


03/01 31.4

Volume



03/01 89.0



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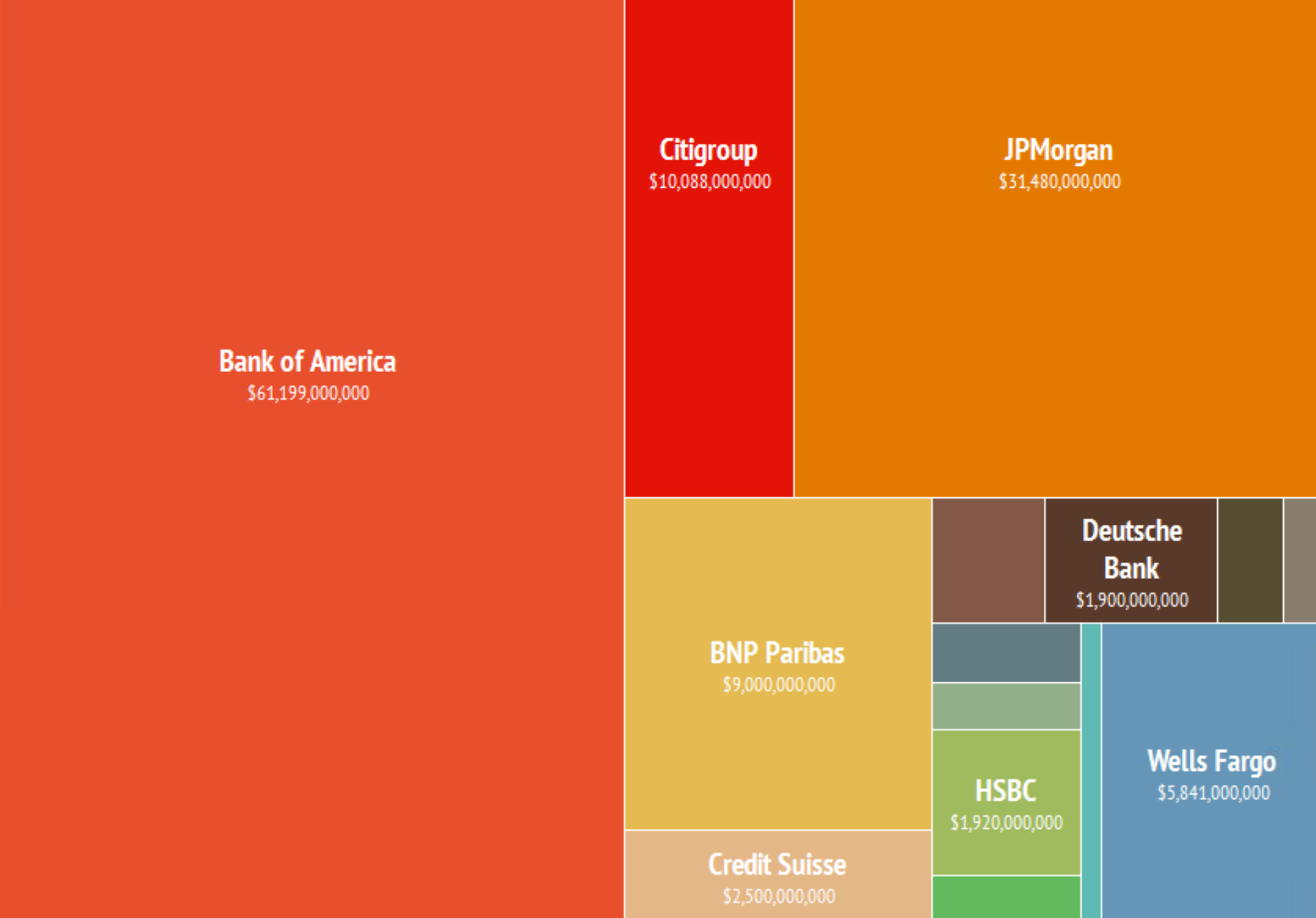
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Trading with my Mum and Other Crimes



Yellow Flags - Securities and Funds Processing

- Significant positions in unregulated instruments, including private placements and alternative funds, especially those with protected cells or compartments;
- Securities issued by offshore companies where the identity of the principal or the beneficiary of the capital is not identified;
- Securities positions, including investment funds, which are closely held by a single customer or by a group of customers who may each be acting for a single underlying client;
- Investment funds with a constant NAV or a NAV which is changed only in round increments;
- Investments funds, especially alternative funds, where the general investment strategy is unclear or obscured;
- Equities issued where the number of shares in issuance is high relative to the material value of the issuer;
- Debt securities issued where the amount issued is both significantly higher than subscriptions received and high relative to the capacity of the issuer;
- Debt securities issued where the business purpose of the financing does not make sense.



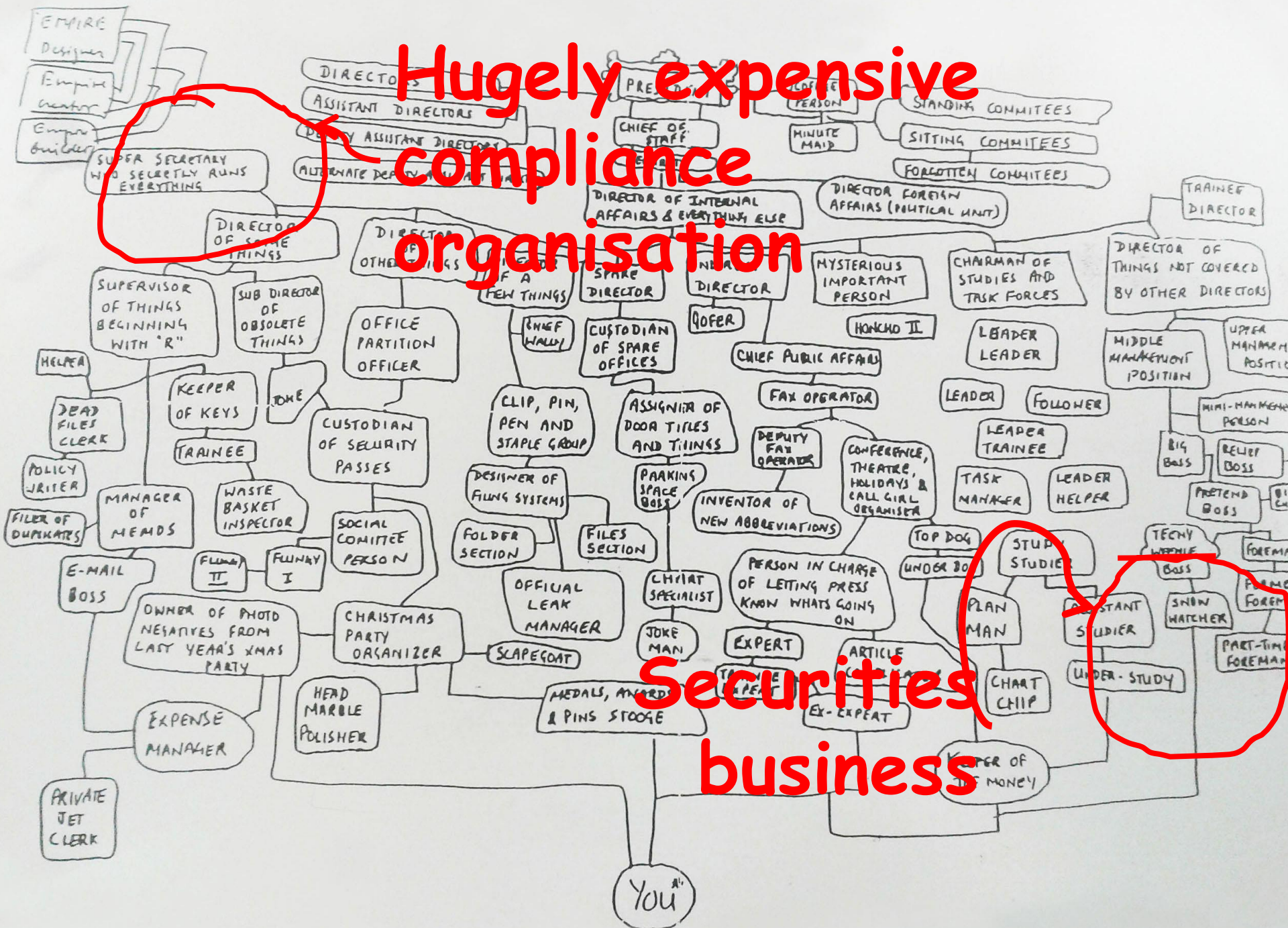
Source: Huffington Post

Enterprise Compliance – The Prevailing Wisdom



An enterprise-wide approach is essential and should leverage new analytical software tools.

Insight on financial crime: Challenges facing financial institutions
Deloitte, 2014

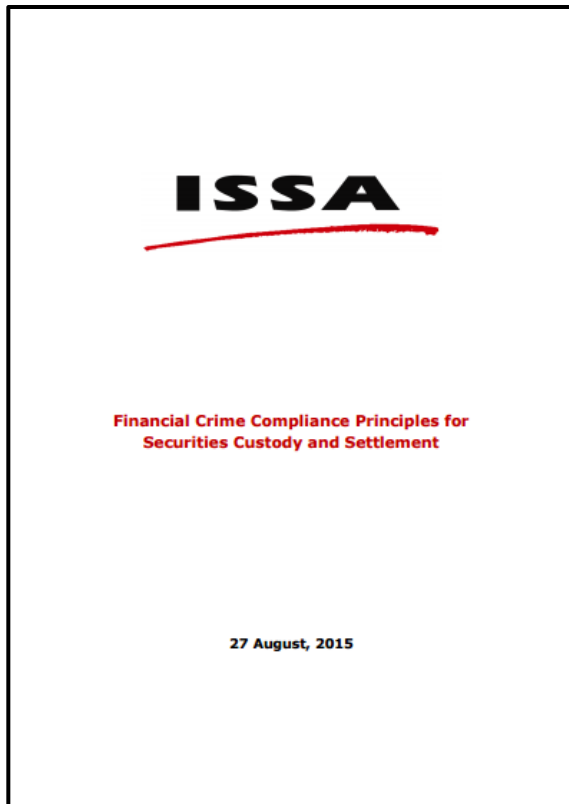


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The Principles (FCCP)

The Compliance Working Group has Developed Principles to Govern Industry Practice



The principles are designed to become the securities equivalent of the Wolfsberg Correspondent Banking Principles.

The Compliance Principles are intended to cover conduct risks in general, including measures to counter money laundering, terrorist financing, market abuse, corruption, fraud and the evasion of sanctions.

The Principles provide market participants with practical guidance on the question of transparency of ownership and control in intermediated securities custody arrangements.

What do we Aim to Achieve?

Practical yet Effective Standards

- To mitigate effectively the risk that the global system under which securities are safekept and settled is abused in the areas of sanctions, money laundering, corruption, fraud, capital flight and market manipulation;
- To implement standards in a reasonable and achievable time frame;
- To avoid the significant technical investment and operational disruption to the capital markets that could flow from the systematic disclosure of the identities of underlying asset owners and the burden of continuously screening those names;
- To avoid undue geographic de-risking;
- To work with existing account structures, preserving the efficiency, policy and safety benefits they provide whilst avoiding any dependency on legislative or statutory change.

Compliance Principles for Securities - Key Features

A Broad Scope

The Principles should apply globally to financial institutions active in the intermediation of securities.

Addressing Transparency

The Principles aim to address the question of transparency of ownership interests because this is what distinguishes securities from other branches of financial services.

A Focus on Cross-Border Settlement and Custody

The Principles focus on cross-border custody. However, the compliance principles that govern cross-border custody cannot be fully dissociated from purely domestic arrangements involving domestic investors holding domestic instruments denominated in the national currency.

Driven by Standards

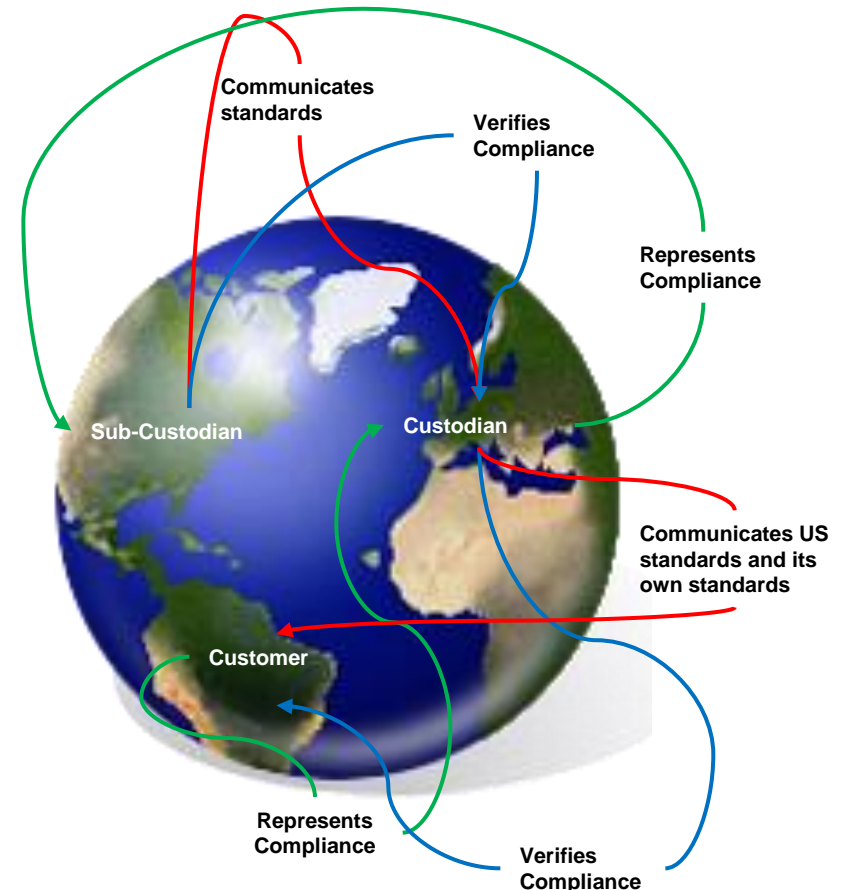
The Principles are driven by standards rather than information. Information is used to verify compliance with standards.

Retaining the Benefits of Current Practice

The Principles do not question or influence the validity or fitness for purpose of the different legal mechanisms for vesting ownership interests. The aim is to future-proof the legal structures that we have.

Standards Drive the Principles

1. It is the responsibility of the Custodian to **communicate** its KYC standards and other requirements to its Account Holders.
2. It is the responsibility of the Custodian's Account Holder to **comply** with those requirements.
3. Where the Account Holder has clients who themselves accept deposits of third party client securities, the Account Holder should notify those 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).
4. It is the responsibility of the Account Holder to sub-deposit securities with the Custodian only when **the Assets 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.



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Implementation

Contractual Arrangements

It is envisaged that an adjustment of Contractual Terms will be required between the Custodian and its Institutional Account Holder. ISSA does not recommend a standard template contract side letter, since the existing agreements and local regulatory provisions are diverse and it is impractical to cover these in a standard letter. Key themes that should be included in any side letter or side agreement include:

- The specific Requirements of the Custodian;
- Representations by the Account Holder that it will make reasonable endeavors to comply with the requirements of the Custodian;
- Representations that controls are in place that are reasonably designed to ensure that the Account Holder can ensure compliance with the Custodian's requirements;
- Agreement to provide the Custodian with the information necessary to assess the Account Holder's compliance with the ISSA FCC Principles;
- Agreement to disclose any underlying Client / ultimate beneficial owner in the event of an entitled request or in the presence of aggravated risk factors within an agreed period;
- Notification of any underlying Clients who have not provided any necessary waivers to bank secrecy or data protection provisions and of any circumstances in which waivers that are held may prove ineffective;
- Custodians should also independently validate whether regulations in their Account Holder's jurisdiction conflict with the intended Principles and operating practices in a manner that could make performance of these unreliable. Where this is the case, Custodians should re-consider whether offering an omnibus account is appropriate and instead whether a segregated account would more practical.

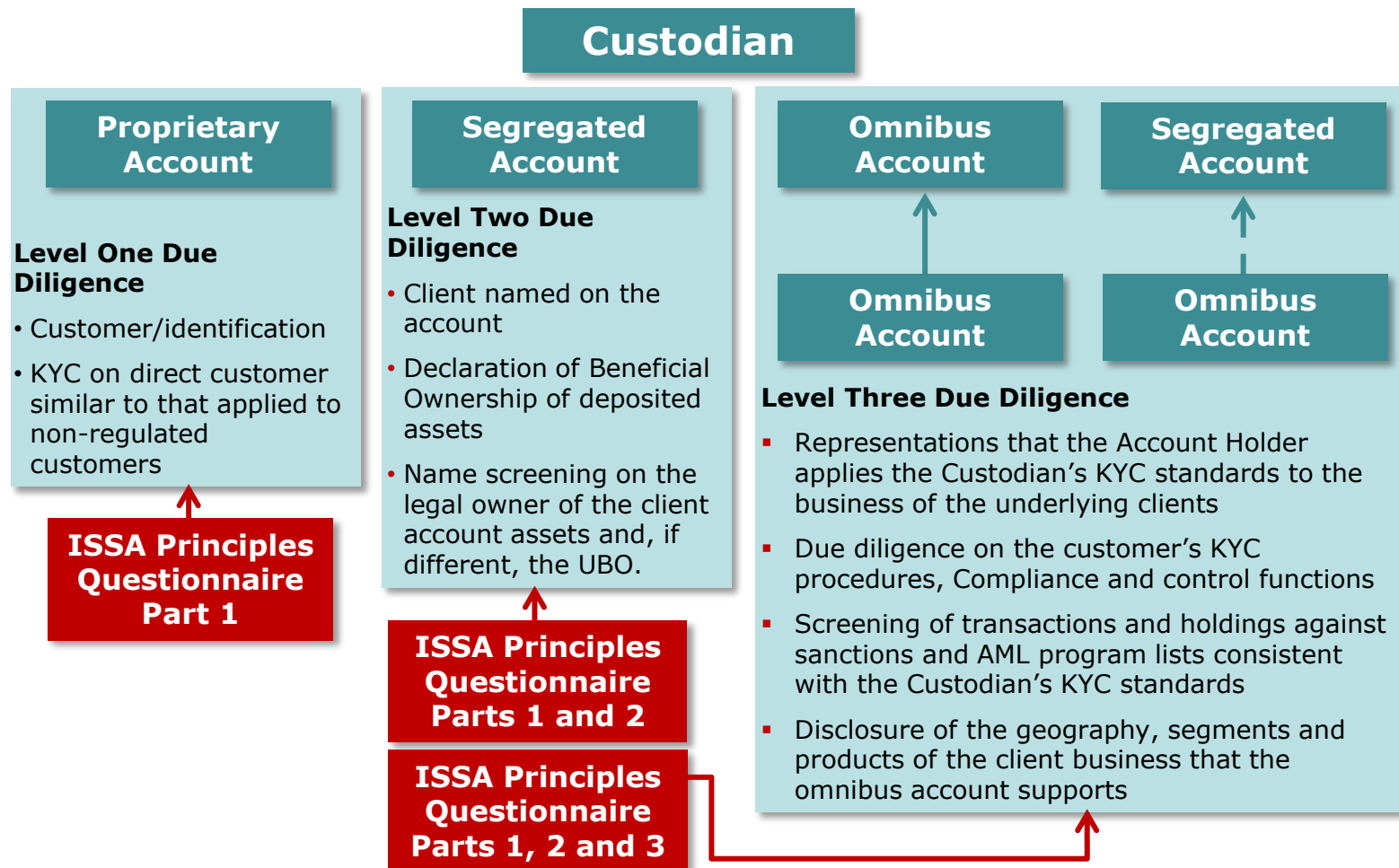
Bank Secrecy and Data Protection

Where secrecy and data protection could disrupt the application of the Principles, Custodians should seek specific waivers from their Account Holders. The Custodian must be advised upfront if any of the Account Holder's Clients have not granted the necessary waivers or of any circumstances in which waivers given may be ineffective.

However, the decision to explicitly address possible challenges flowing from secrecy regimes may not be sufficient to mitigate the risk in full, particularly where non-bank intermediaries are concerned.

Therefore, ISSA proposes to encourage regulators to adjust secrecy and data protection regimes to facilitate the adoption of harmonized standards for transparency and disclosure. This would include lobbying for new/ amended laws/rules which impose requisite disclosure obligations on Account Holders (without them being in breach of data protection/ confidentiality obligations) and advocating principles to which a wider constituency (including non-bank institutional account holders) would adhere.

Due Diligence Framework



Communication of Standards Downstream; Intermediated Holding Chains

The Account Holders of a Custodian are expected to communicate the standards of the Custodian as well as their own standards to their own (institutional) account holders. Custodians are therefore expected:

- To share the Principles and to advise or educate Account Holders of the relevant aspects;
- To determine the ownership status of each account maintained by the Account Holder, whether proprietary in nature or held for third party clients and if so, whether in segregated or omnibus form;
- To provide a Legal Side-letter or Revised Contractual Terms (for example, market guides) to their Account Holders for agreement in line with the adjusted operating conditions of the impacted accounts;
- To agree the communication protocols, procedures and timelines for any requests for information and associated responses;
- To provide the Account Holder with a reasonable period to adjust to the revised terms. It is expected that a period of 12 months should be a benchmark.

Client Accounts – Segregated Accounts

The aim of the Principles is to ensure that the Institutional 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. Custodians should assess their Account Holders with the Level 2 ISSA Principles Questionnaire or equivalent annually to determine the appropriateness of maintaining client accounts for the Account Holder.

- 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.
- Unless otherwise required by the Custodian's jurisdiction, Segregated Accounts should reflect the name of the party holding the account at the level of the Customer: *ABC Bank Plc / XYZ Global Growth Fund* or *ABC Bank Plc Re. XYZ Global Growth Fund*. Where the underlying client is a private person, an account name protecting the privacy of the client may alternatively be used provided that it clearly indicates that the client is a private person; *ABC Bank Plc Re. Private Client 123*. The identity must, however, be declared to the Custodian.
- Custodians should take affirmative steps to determine the ultimate beneficial ownership of the assets deposited on the Segregated Account by obtaining a declaration from the Account Holder.
- Custodians should screen both the underlying clients holding Segregated Accounts with the Customer and (if different) the underlying beneficial owner(s) against lists that include the targets of their own sanctions and other compliance-related programs.

A High Level of Scrutiny of Omnibus Accounts is Targeted

In considering whether to open an omnibus client account, 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.

The Custodian should undertake **periodic review** on a risk basis of its omnibus client accounts to ensure that these requirements are continuously observed.

The omnibus account holder must disclose to the Custodian **the geography, segments and products** that the omnibus account supports.

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

The omnibus account holder must **represent** that it maintains no securities interests on the omnibus account which would violate the requirements communicated by the Custodian.

Omnibus Client Accounts

Custodians should assess their Institutional Account Holders using amongst other tools the Level 3 ISSA Principles Questionnaire or equivalent periodically to determine the appropriateness maintaining Client Omnibus Accounts for the Account Holder. The Custodian should confirm that the Account Holder:

- Has the appropriate regulatory, statutory and operational capacity to commingle third party securities interests. In the limited case of countries that do not regulate safekeeping, the Custodian should confirm that the Account Holder has taken appropriate steps to ensure that the securities held are suitable for the clients and that appropriate consents to commingle are held;
- Has 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;
- Makes representations (via the Questionnaire and / or other tools) on the geography (markets), segments and products that it supports with the omnibus account in order to provide a baseline for forming an expectation of how the account will behave.

Disclosure of Beneficial Ownership in Omnibus Accounts

Unless the Custodian's local regulation requires it systematically, disclosure of the underlying holders of securities interests in an omnibus account is a tool to be used in verifying the Account Holder's representations that it has put in place measures reasonably designed to ensure compliance with the Custodian's standards in the presence of aggravating risk factors, such as:

- Suspicious Transaction Flags that cannot be resolved in due diligence;
- Sanctions and AML 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 may be 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 effected.

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 the underlying trade. Risk factors or Suspicious Transaction Flags that might give rise to a need to identify the ultimate buyer or seller might include:

- Transactions that trigger the Custodian's own screening programmes and which cannot be resolved;
- Subscriptions that apparently violate or cannot be shown to comply with the terms of a Fund;
- Settlements at a trade price which is off market;
- Instructions to receive positions in a security that would result in its being closely held;
- Significant activity in low priced stocks;
- Settlement of OTC (voice) trading in high volumes of liquid securities that are ordinarily traded on-exchange;
- Short selling;
- Short entitlements over compensation dates.

Resolution Guidelines

Breaches of the ISSA FCCP requirements may – if not resolved within a reasonable timeframe - occur in the following ways:

Breach of Guidelines

- Behavior on an account that conflicts with the representations made to the Custodian by its Account Holder as to its use.
- Objective breaches of the representations made to the Custodian by its Account Holder, for example in relation to sanctions screening.
- The use of omnibus accounts to mask specific interests which would otherwise have been declared to the Custodian.
- Deficiencies in the Account Holder's control and compliance frameworks.

Breach of Information Requirements

- Refusal by a broker acting for a transferor or transferee which is not in the custody supply chain to provide necessary client / ultimate beneficial owner data in a timely fashion to the downstream intermediary in the custody supply chain.
- Identification of client or ultimate beneficial owner information in relation to any proposed transferor/transferee which raises a red flag.
- Refusal / inability of broker / downstream intermediary to provide further / better details promptly upon request.

Resolution – Practical Considerations

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.

Remedies

Whilst a payment bank can simply refuse to execute a transaction and move on, resolving an apparent violation is more fraught with complexity and risk for a custodian.

We have come to the conclusion that the enforcement authorities have provided virtually no practical guidance on what a custodian is expected to do in such circumstances. ISSA has identified no universal silver bullet but has determined a matrix of possible actions which depending on the legal tools available to the custodian and the nature of the apparent violation may be more or less practicable.

Resolution Guidelines – Possible Remedies for Breaches of the ISSA FCC Principles and Apparent Violations

- Disclosure of the breach to upstream custodians and / or regulators (including foreign regulators);
- Refusal to contract with the party;
- Termination of contractual relationships with the party;
- Suspension of dealings with or on behalf of the party;
- Suspending activity in relation to a particular account or holding;
- Blocking all activities on an account;
- Rejecting any trades for an account;
- Transferring securities in an account to a blocked sundry account;
- Escheating securities in an account;
- Selling securities in the market and delivering proceeds of sale to client, using an agreed sales / pricing methodology applicable on a violation – de facto close out of position;
- Disclosing the violation to regulators local to the party causing the apparent violation.

Phased Approach to Engagement

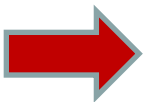
Phase I – Membership and Regulators

Raising awareness of the Principles across the broad ISSA membership
Adjusting the Principles to reflect member feedback
Informing relevant financial regulators

Phase II – Public Industry Engagement

Public announcement at the SIBOS conference in Singapore in October 2015
Dedicated SIBOS community session on *ISSA - Financial Crime Compliance Principles: Creating Industry Standards* moderated by Dominic Hobson
First publication of Principles on the ISSA website
Launch of raising awareness of the Principles across the broader financial industry

Organization of the FCCP Working Group as a standing team



Phase III – Implementation

FCCP to provide contractual guidance and advocate supportive measures with global regulators

The Principles are expected to be in place across intermediated cross-border custody chains from 2019.

Phased Approach to Engagement

“If you prosecute a CEO or other senior executive and send him or her to jail for committing a crime, the deterrent effect in my view vastly outweighs even the best compliance program you can put in place.”

Jed S Rakoff, District Judge, NY
Southern District

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