
Domestic-CSD-Due Diligence

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DOMESTIC CSD DUE DILIGENCE PROCESSES



Welcome to the third paper of a series of publications created by the Domestic CSD Working Group (WG) which comprises multiple CSD organizations. The aim of this paper is to raise awareness and foment industry discussion and change around due diligence (DD) processes as they pertain to a Central Securities Depository (CSD). This paper is written from the perspective of the CSDs. The senders of the DD questionnaires may well have views on what the CSDs can do to improve the process and the WG is happy to understand any suggestions to improve the processes.

INTRODUCTION

CSD DD processes have grown more arduous, complex and duplicative over time. The WG participants recognize that DD questionnaires are a critical tool in ensuring that organizations can assess and manage CSD risk effectively. However, as new risk factors are identified, for example in areas such as Cyber and Operational Risks, DD processes have grown increasingly more complex and arduous to answer. As a result, the WG participants believe that the industry is at a juncture where it needs to consider whether changes to the methodology and/or the timing of DD processes could reduce the burden on the domestic CSDs while still achieving the objectives of the questionnaire owners.

The WG believes that there are opportunities to automate, digitize and mutualize important aspects of the industry's DD approach, particularly as it relates to domestic CSDs. The CSDs do not see that there can be a material competitive advantage from asking risk management questions in different formats. If there is an advantage the CSDs believe that this is eroded rapidly so a single standard should be achievable.

PROBLEM STATEMENT

Domestic CSDs have a number of DD processes that they engage with, including completion of multiple questionnaires. Examples of Questionnaires that CSDs are expected to complete include:

- Association of Financial Markets in Europe (AFME) DD Questionnaire - 110 pages of generic questions before any requesting firm-specific add-ons. This questionnaire is focused on assessing the risks that might exist through using a particular CSD (generally based on binary questions).
- Association of Global Custodians (AGC) DD Questionnaire - The genesis of this questionnaire is to ensure compliance with the US's Investment Company Act of 1940 rule 17 (generally based on open ended questions).
- International Organization of Securities Commissions and the Committee on Payments and Market Infrastructures (CPMI-IOSCO) Principles for Financial Market Infrastructures (PFMI) call on FMIs to complete and publish a self-assessment of their adherence to the PFMI. This questionnaire is a detailed and time-consuming exercise that is required to be repeated at regular intervals and should provide interested parties with a significant amount of the static information that is traditionally requested under DD processes (generally based on open ended narrative questions that require documentary evidence including audit reports, financial statements, regulatory approvals, licenses and authorizations).
- Global Custodian assessments – These are annual or bi-annual assessments of the depository infrastructure as part of market monitoring and management by the custodial intermediaries of foreign investors. These assessments are usually performed in two parts: (i) a written questionnaire completed and submitted on a 4-to-6-week schedule (generally based on open ended narrative questions that require documentary evidence including audit reports, financial statements, regulatory approvals, licenses and authorizations) and (ii) a follow up scheduled meeting that has, historically, been conducted in person but is now, increasingly, held via video conference.
- The ISSA FCC Securities questionnaire – This questionnaire focuses on Financial Crime through the securities value chain, and is increasingly being used, although not in all jurisdictions. However, completion is only required if the CSD is an “accountable institution” (generally based on binary questions).
- The WG participants also note that some of these questionnaires such as the Wolfsberg questionnaire, are actually aimed at credit institutions and banks and not the CSD community. It is often the case that a custodian receives the questionnaire and then send it on for the CSD to answer the detailed questions.
- Thomas Murray – This is a risk rating organization that undertakes independent risk assessment of individual CSDs and other market infrastructures using its own proprietary assessment methodology. The FMIs and various support organizations are required to complete/review the Thomas Murray assessment on an annual basis. This leads to the Capital Market Infrastructure Risk Rating which is available on a subscription basis. Additionally, CSDs are able to commission Thomas Murray to perform a formal ratings exercise should they so wish.

In addition to the need to complete multitude questionnaires, the CSDs find there are many challenges with the processes around DD:

1. There is little consistency or coordination in the timing of information requests. Completion of questionnaires can be initiated at any time of the year, meaning that a CSD may receive requests for information from January to December from different Local or Global Custodians.

2. The questionnaires are often followed by DD visits by the different custodians. This is time consuming and inefficient for CSDs as they deliver the same material and discuss the same matters during each visit.
3. The different structures of the questions determine a variety of answers – data rich or free format – which do not easily enable responses to be used in multiple questionnaires. CSDs have to answer the same question from various perspectives and at various levels of detail.
4. Industry standard questionnaires have not been effective in reducing the effort for CSDs. Information requestors frequently provide a supplemental questionnaire in addition to the standard questionnaire.
5. Certain questions, (for example on Cyber policies and procedures) are requested but the information may not be freely available or could be considered confidential to the CSD. The provision of these documents may increase the risk to a CSD. Additionally there is concern that the requestors may not have the ability to interrogate the data provided on specialist technical questions in a meaningful manner.
6. The lack of digitization of the DD forms, the different structure of questions asked as well as answers provided do not allow for the easy automation of the process of uploading and maintaining responses over multiple years. These differences can be generated due to a change in the CSD’s market or because the questionnaire itself has changed (e.g. where question numbers are not kept consistent).
7. Delivery of the answers to the questionnaires are via a variety of different portals which require manual entry, dedicated staff and time.

POTENTIAL SOLUTIONS

The WG believes that 60-70% of all information requests could be standardized as they are aimed at the same topics but have variety in the approach to extracting the answer. The remaining approximately 30% of the information asked varies from the standard and need additional documents to be provided as support to the request.

There have been historic approaches to helping solve the problem such as the World Forum of CSDs “Standard Disclosure Tool” but take up has been limited by the CSDs. There are additionally commercial services which could perform the DD activities for the CSDs’ users but again take up is not sufficient to alleviate the problems that CSDs face.

The WG are proposing a number of improvements for the CSDs’ processes of DD. The WG do not believe that there is a “silver bullet” but that a combination of the following improvements will increase the risk transparency, improve the process for all involved parties and help to create a virtuous circle of better data and responsiveness. In addition, adoption will reduce the environmental damage of multiple DD visits and resources consumed to produce and upload/send responses.

1. AGC and AFME

AGC and AFME should collaborate with the following objectives:

- a. To start work to combine the questionnaires into a single one. The emphasis will be on creating as many binary questions as possible to facilitate comparison and automation. It is recognized that this is a substantial task but convergence by risk theme will incrementally bring benefit without making the effort too large to embark on. If improvements and/or changes are subsequently made to the questionnaires, they are transparently identified both by CSDs and CSDs’ assessors.

- b. To reduce the number of questions substantially. This can be achieved either by deleting questions or nesting questions so that a binary answer leads to further sub-questions or to the next section.
 - c. To logically group questions into thematic sections to facilitate the responses.
2. The custodian and CSD community should collaborate with the following objectives:
 - a. To agree the areas of the combined questionnaire which are "push rather than pull". For example the CSDs can publish much of the static data on their websites (push) and the custodians use that at their source of information (e.g. financial, regulatory etc).
 - b. To automate the process (see solution 4 below) and the questionnaire "pull" for areas where it is needed and there is potential ambiguity.
3. The solution providers for the industry should aim to create and make available a single system solution – be that an improvement upon a utility such as WFC's Single Disclosure tool or a commercial solution – where the static data for all questionnaires could be loaded on an annual basis as a core reference data site. The solution will cover all requirements of AGC, PFMI, AFME, Thomas Murray and ISSA's FCC Questionnaire. This will be queried using an API to allow easy access to Network Managers.
 - a. The industry will need to agree an annual date when this should be completed by the CSDs. The market practice recommends that 30 April each year initially be selected as the date for all data to be current. In need, a second date (say 31 October) can be added to accommodate those entities that have a June FYE.
 - b. If data updates are needed more frequently, there is a clear business justification articulating why the data periodicity is less than annual.
 - c. Normalization of data such as financial statements is created via use of XBRL or other recognized formats.
 - d. The system is built as a first step to a full audit-tech or reg-tech solution for the DD assessment
 - e. This system solution would need both authorization and authentication built in.
 - f. The WG members would welcome engagement with the providers to more granularly define the requirements.
4. Global Custodians should:
 - a. Justify any additional questions and related responses they want to receive as extensions to any standardized questionnaire
 - b. Present to the AFME/AGC Committee the rationale for the need for new questions and answers to the standard questionnaires
 - c. Compare their additional questionnaires to the AFME and AGC questionnaires (currently widely used) to ensure that questions are not repeated with slightly different wording, but asking for the same topic, and eradicate those which are duplicates.
 - d. Use their local custodians (if used) as the entry point into the local CSD as they already have deep knowledge of the market mechanics.

- e. Pool DD physical visits where they are necessary to be performed. A number of improvements could be made here, possibly under the governance of a trade association such as the AGC :
 - i. Physically join a DD visit with other GCs and share the relevant information create a mutual report
 - ii. Agree that, as member of AGC, the GC performing the visit to report back to all GCs
 - iii. Use their local custodian as in d. above
 - iv. Pay a commercial organization to attend the DD visits for them on a utility basis.
5. If new risks are identified, such as sustainability, the industry should come together and agree a set of questions to be added to the new singular standardized questionnaire.



SUMMARY AND CONCLUSION

Due Diligence is not a differentiating factor for custodians. It is inefficient for all parties involved. Collaboration in non-competitive areas benefits the whole industry.

As an industry we talk about transformation and this is an area which can be transformed by some hard work to agree the correct framework and the application of existing technology.

It is the WG hope that ISSA can engage AFME and AGC **to execute meaningful convergence of questionnaires over a three year period and that a commercial provider can create the correct technology and processes to support the needed DD efficiently for all parties.**

ACTIONS:

1. Syndicate the paper with AGC, AFME and IOSOC.
2. Agree between CSDs and Custodians the push and pull data
3. Ask technology service providers to response to a RFI on possible technological solutions
4. Agree with GC members of ISSA that it is possible to:
 - a. Justify any additional questions
 - b. Present to the AFME/AGC Committee the rationale
 - c. Compare their additional questionnaires to the AFME and AGC questionnaires
 - d. Use their local custodians (if used) as the entry point into the local CSD
 - e. Pool DD physical visits where they are necessary to be performed.
5. Embed new risks areas into the questionnaire in a standard manner as the new way of working.