Yannick Cherel

Olivier Goffard

Mark Gem

Marta González Pérez

Financial crime compliance principles in the securities custody business

Yannick Cherel,* Olivier Goffard, Mark Gem† and Marta González Pérez‡**

Received (in revised form) 1st June, 2018

*Standard Chartered Bank, Marina Bay Financial Centre (Tower 1), 8 Marina Boulevard, Level 28, Singapore 018981
Tel: +65 65 96 8166; E-mail: yannick.cherel@sc.com

**Euroclear SA/NV, Boulevard du roi Albert II, 1, 1210 Brussels, Belgium
Tel: +32 2 326 1027; E-mail: olivier.goffard@euroclear.com

†Clearstream Banking SA, 42 Avenue JF Kennedy, L-1855 Luxembourg
Tel: +352 243 36761

‡Euroclear SA/NV, Boulevard du roi Albert II, 1, 1210 Brussels, Belgium
Tel: +32 326 2960; E-mail: marta.gonzalezperez@euroclear.com

Yannick Cherel *is the Group Product Head of Financial Crime Compliance for Standard Chartered focusing on Cash, Securities Services, Digitisation and Client Access products. Over the past 20 years, Yannick has built his international risk management career, through his experience as an external auditor (PwC), then as Operational Risk & Compliance Head (BNP Paribas Securities Services). As part of his role, Yannick is an active representative at the International Securities Services Association (ISSA) focusing on the implementation of the financial crime compliance principles. Yannick holds a Masters in Finance and Audit completed at the Burgundy School of business. He is also a Certified Anti-Money Laundering Specialist (CAMS).*

Olivier Goffard *is Head of Compliance and Ethics for Euroclear Group and Chief Compliance Officer for Euroclear Bank. Olivier manages a team of professionals providing a wide range of compliance and ethics services around domains such as anti-money laundering (AML)/ counter terrorist financing (CTF), personal data protection and anti-fraud. Olivier has worked as a company lawyer, internal auditor and internal consultant before taking over the Compliance and Ethics Department. Olivier is a Certified Anti-Money Laundering Specialist (CAMS).*

Mark Gem *is a member of the executive board at Clearstream and one of the leading product specialists in the industry. Beyond looking at financial crime risk issues in securities as its chief compliance officer, Mark has run Clearstream's product and strategy areas, its network management department, its new issues business and risk management. He holds an honours degree in Modern History from Oxford University.*

Marta González Pérez *is a Senior Advisor in Financial Crime for Euroclear SA/NV, with a key focus in compliance with anti-money laundering (AML), counter terrorist financing (CTF) and international sanctions laws and regulations. She provides subject matter expertise on AML/CTF and sanctions to the Euroclear Group entities. Marta has more than 17 years of experience in the securities industry both as a compliance advisor and as an in-house legal counsel. Marta is an active member of the International Securities Services Association Financial Crime Compliance Principles Implementation Working Group. She holds a Master's in Law from Universidad Complutense in Madrid, an MBA from Antwerp University Management School and the Association of Certified Anti-Money Laundering Specialists (ACAMS) certification.*

Journal of Financial Compliance
Vol. 2, No. 1 2018, pp. 22–36

2398-8053

Abstract

This paper aims to introduce the reader to the purpose and content of the International Securities Services Association (ISSA) Financial Crime Compliance Principles (FCCP). The FCCP aim to become the standard in financial crime prevention across the securities industry. The Principles particularly address the risks resulting from the many layers of intermediation between the issuer and final beneficial owners, taking into account the cross-border nature of the industry. The FCCP provide guidance to custodians on how to implement adequate controls on assets holdings, and not only on the execution of transactions. Recognising that different account structures are used for holding securities interests, the FCCP propose that the due diligence performed at the account level is proportionate to the risk of the account structure used and make the distinction between proprietary accounts, segregated third party accounts and omnibus accounts. A significant aspect of the FCCP is that they foresee that custodians communicate their due diligence standards to its clients (account holders in ISSA terminology) and has to obtain contractual commitment that they will be complied with. The Principles go even further and require the custodian to compel the account holders to apply the FCCP to their clients, thereby creating a virtuous circle and increasing transparency along the custody chain.

Keywords: securities industry, due diligence, financial crime, guidance, custody

INTRODUCTION

We met with a new breed of compliance professionals seeking to establish common and effective standards for financial crime compliance across the cross-border securities custody industry. The International Securities Services Association (ISSA) has published Financial Crime Compliance Principles for Securities Custody and Settlement (FCCP).

In this paper, representatives of three of the main securities custodians discuss the recent FCCP that aim at reinforcing the maturity and effectiveness of financial crime controls applied across the different layers of the custody chain.

WHY DID ISSA FEEL THE NEED TO ISSUE SUCH PRINCIPLES?

Traditionally, most policy and regulatory efforts to combat financial crime have focused on trade and/or cash, not on securities.

The triggers for ISSA's work were a couple of enforcement actions against custodians in early 2014 relating to sanctions and to penny stock abuse. The global system under which securities are kept safe and settled is based largely on a clear distinction between beneficial and legal ownership. The practice of comingling fungible interests in omnibus and similar account structures brings benefits to the market and to end investors because it creates large economies of scale, enables competition between custodians and lowers transactional costs. It has also promoted a degree of liquidity and mobility of securities and collateral that has become a cornerstone of market stability.

In order to achieve that, the global system intermediates many players into securities custody chains and by its nature transforms the legal ownership of securities interests multiple times. The externality that this creates is to obscure the identity of those investing in and trading securities from the custodians and depository institutions. ISSA sought to tackle that issue.

Since we started work, we have come to appreciate that like most branches of financial services, the industry is vulnerable. The best way to explain it is to say that if you want to launder a very large amount of money, you have to use securities. The leading firms in the industry understand this and are committed to protecting the

industry and the market from the sort of abuse we have seen with cases such as 1MDB (1 Malaysia Development Berhad).

When we started this work, we realised that regulatory guidance covering securities custody was extremely limited and outdated.[1] In essence, the only guidance was, just check that participants are equivalently regulated. But what did that mean exactly? Were all anti-money laundering (AML) regulated institutions supposed to have the same standards and the same compliance objectives? The question was relevant because the authorities have not been shy to enforce against institutions servicing account holding banks in whose books the violations actually occurred.

There was also a school of thought at that time among payments specialists that custodians needed to invent a cover message, a securities equivalent of the MT202COV. Other less than helpful suggestions from outside the industry were to hold securities only in the name of the ultimate investor. These views misunderstood the structure of the industry. Securities processing is not like payments only with securities instead of cash; it is a lot more complex than that. Intermediation and the use of pooled or omnibus accounts brings enormous benefits of scale, which we wanted to preserve.

ISSA was in a unique position to address the challenge. Its one hundred institutional members are collectively responsible for the vast majority of the global securities transactions volume. It also represented a cross-section of the specialist roles that underpin the industry: wealth managers, dealers, prime brokers, global custodians, sub-custodians, clearing houses, International Central Securities Depository (ICSDs) and domestic securities depositories. In 2014, the association decided to set up a working group composed of securities professionals to come up with principles that would serve as industry standards to improve the execution of financial crimes controls in the securities industry.

The work undertaken by ISSA came to fruition on 27th August, 2015 with the first version of the 'Financial Crime Compliance Principles for Securities Custody and Settlement', or 'the Principles'.[2] Those Principles were revised in May 2017.

The main objective of the Principles, once implemented across the securities and funds distribution industry,[3] is to strengthen the control framework in place to prevent, detect and remediate financial crime-related risks. In order to do that effectively, the Principles address the particular product features associated with cross-border custody, settlement and distribution of securities or funds. The Working Group considered thoroughly various use cases of how to launder money, violate sanctions, abuse markets or evade tax by using securities. The Principles aim to guide securities custodians in the implementation of controls to manage the risks resulting from the many layers of intermediation between the securities issuer and the ultimate beneficial owner or investor. To support financial institutions in implementing the Principles, on 6th October, 2015, ISSA issued a background and overview guide providing additional operational guidance.[4]

The Principles mainly address the establishment and maintenance of cross-border securities custody relationships. We define cross-border securities as those in which the account holder is foreign or that concerns the deposit of foreign or international securities.[5] These do not specifically target domestic securities custody accounts, but in many cases, domestic markets will benefit from thinking about and potentially implementing the Principles.

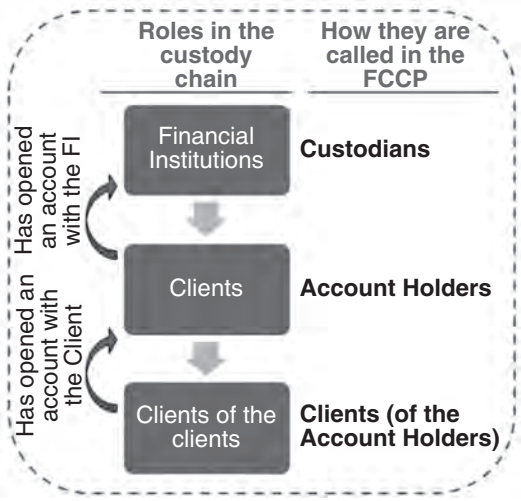

Figure 1 Financial Crime Compliance Principles (FCCP) naming convention for stakeholders of the securities custody chain

The security industry has its own specificities and vocabulary that might be opaque to the lay reader. Which kind of organisations are you targeting with the Principles?

Investors deposit securities with asset managers, wealth managers or hold them via collective investment vehicles, or mutual funds. The securities underpinning these investments are issued either through central securities depositories (CSD) that are organised on a national basis or through the international securities depositories that have a global reach. Investment funds are issued through transfer agents with banks acting as distributors to reach final investors. Securities are also immobilised to support the issuance of a wide variety of derivative instruments. Typically, the prudential, securities and property law obligations that bind holders under national law are transmitted by custodians to their foreign customers contractually.

Let us then clarify the terminology to avoid divergent interpretations (Figure 1).

The Principles are applicable to what they call custodians and their account holders (hereafter 'account holders').

(a) For the purposes of the Principles, we define custodians as the upstream, regulated financial institution holding securities and funds accounts and which provide accounts for the custody and safekeeping of securities. Custodians execute securities settlement instructions and deliver related services to their account holders, both other financial institutions,[6] and non-financial institutions.

Those related services include the settlement of trades cleared by a central counterparty and the related management of margins, the processing of payment obligations arising from clearing and settlement, funds distribution as well as related asset services (such as corporate action processing, tax and income services, securities lending and collateral management).

This definition is comprehensive, covering all actors in the securities and funds custody business including the global custodians and sub-custodians, the international central securities depositaries, central securities depositaries, the trustee and depositary banks, (prime) brokers and the fund distributors.

(b) We define account holders as regulated financial institutions that hold securities accounts directly with the custodian. This typically includes institutional, collective and private investors, investment managers, and broker dealers. It also includes custody and depository banks when they deposit securities cross-border.

Our definition of account holder expressly excludes the notion of direct end investor records at the level of the CSD, which is the arrangement in place in some markets such as Finland, Greece or Malta.[7,8]

The Principles do not seek to regulate relationships between custodians and non-regulated account holders; however, some custodians have chosen to extend

their application to this category of client as well.

(c) Account holders might be using the services of custodians to manage their own assets in proprietary accounts or to sub-deposit assets of their own clients (individuals or institutional) in client account. The Principles refer to those downstream holders as 'clients of the account holder/clients'.

How is the concept of beneficial owner, as referred to in the recent fourth AML Directive,[9] translated into the securities services industry?

There is a degree of confusion around this term, which the securities industry has traditionally used to describe the end investor in a security. To clarify the definition of beneficial owner, the Principles stipulate that this term relates to the natural person(s) who ultimately owns (shareholders) or controls (directors, executive committee members) an entity (the 'entity beneficial owner') as well as to the natural person(s) on whose behalf a transaction is being conducted, the 'assets beneficial owner', or end investor.

In some non-AML legal contexts, the account holder or its immediate client is deemed to be the beneficial owner. For the purposes of the Principles, the asset beneficial owner is always defined as the ultimate owner or controller of the asset. In other words, the Principles use the term to describe the end investor, even if the property law governing the holding defines it differently.

One of the key elements of the FCCP is the very prescriptive due diligence framework to be implemented by custodians when opening business relationships with account holders. What are the main pillars underlying this framework?

Actually, the due diligence framework is not intended to be prescriptive at all. It merely seeks to ensure that the account holder undertakes due diligence that covers the requirements of the custodian as well as its own. The Principles seek to harmonise the level of due diligence to be performed by a custodian before onboarding a new account holder or when performing a regular risk review of the relationship. The Principles foresee two criteria to be considered when conducting this due diligence:[10]

(a) The risk profile of the account holder.

The following criteria will have to be assessed by the custodian:

- Its geographic risk: verification that the account holder is established in a jurisdiction that has a strong framework for the prevention of financial crimes. In order to define this, the custodian will look at relevant publications, such as, for example, the Financial Action Task Force (FATF),[11] the US Department of State International Narcotics Control Strategy Report,[12] the Basel AML Index[13] and the Transparency International Corruption Index.[14]
- Its ownership and management structure: domicile, source of wealth and reputation (adverse media checks) of the account holder and also of the end investor owning a significant interest in the account holder, transparency of the ownership structure, publicly held shares, shares traded on an exchange in a FATF-compliant jurisdiction, structure and experience of the executive management, presence of politically exposed persons (PEPs) among the ownership or management structure[15] and effectiveness of the account holder's AML/CFT and sanctions programme.

(b) The nature of the business relationship between the custodians and the account holder.

> The custodian will obtain information about which products and segments are supported by the account provided to the account holder. This involves the verification of which divisions, branches, subsidiaries and affiliates are involved in distributing securities-related products.

In addition, it is recommended for the custodian to take steps to ensure that all downstream intermediaries up to and including the end investor have been name screened in accordance with the custodian's compliance objectives.

It seems ISSA has introduced its own securities business-focused due diligence questionnaire; what can you tell us about it?

When dealing with regulated firms who are acting for the accounts of third parties, it is generally the case that enhanced due diligence must be performed. What the Wolfsberg Group recognised quite early on is that the due diligence process must go beyond simply identifying the firm (account holder in ISSA terminology) and confirming its regulatory status. Wolfsberg looked at how participating firms use payment services and the controls installed to mitigate not only their own risks but by extension those of their correspondents. We have tried to do the same for securities.

By utilising the Wolfsberg questionnaire,[16] widely in use in the correspondent banking industry, ISSA has indeed created a due diligence questionnaire to guide custodians on particular specific securities industry risks that need to be addressed. This questionnaire includes additional questions to ensure it satisfies the requirements of the Principles and the provisions of Office of Foreign Assets Control (OFAC)[17] FAQ 335[18] that mentions that firms operating in the securities industry as custodians and securities intermediaries should:

- make customers aware of the firm's US sanctions compliance obligations and having customers agree in writing not to use their account(s) with the firm in a manner that could cause a violation of OFAC sanctions …
- conduct due diligence, including through the use of questionnaires and certifications, to identify customers who do business in or with countries or persons subject to US sanctions.

ISSA recommends that custodians require their Account Holders to complete the questionnaire before starting a new business relationship and at each recertification of this information as part of the periodic review conducted by the Custodian.

Our vision of how this should evolve is that for each type of product that is common in correspondent relationships, product-specific assessment frameworks should emerge. Wolfsberg for payments, ISSA for securities. The SWIFT know your customer (KYC) Registry or other KYC utilities that target the financial institution market will allow us to digitise and add to those frameworks over time.

Besides the due diligence to be performed on account holders, are the Principles prescriptive on the type of securities accounts that can be offered by custodians? There have been some discussions about the perceived lack of transparency of the so-called omnibus accounts. Are the FCCP prescribing their usage?

One concept underlying the Principles is that they should be technologically-neutral to avoid IT-costs being a showstopper in an industry that is already now under a huge pressure to review its IT infrastructure to comply with the likes of T2S,[19] AIFMD[20] and CSDR.[21] This explains why the Principles do not promote one type of account versus another but

adjust the level of due diligence to the account risk profile.

In order to ensure that due diligence adequately addresses the underlying risks, the Principles now recommend that the custodian ensure that all accounts opened by an account holder are clearly labelled as proprietary or for client assets. Client accounts must then be designated as segregated[22] or omnibus[23,24] depending on whether the account is held for a single client or for many whose interests are commingled.

What are these different account structures and the level of due diligence expected for each of them?

In the case of proprietary accounts, the due diligence is tailored to the risk profile of the account holder and the due diligence will actually bear directly on this account holder. For segregated client accounts, the due diligence conditions are obviously different:[25]

- The account holder must be regulated and authorised to accept client assets and money and must have adequate compliance and control functions that fulfil the demands of safekeeping client assets.
- The segregated client account must be associated with the name of the client of the account holder. This does not mean that the naming convention of the custodian must include the mandatory mention of the name of the client in the custody account denomination. This might indeed be in contravention with certain bank secrecy or other similar legal, contractual or technical requirements. The account holder should, however, provide this information to the custodian so that it has this information at its disposal on file at all times and is in a position to perform adequate due diligence on those names,
- Finally, the account holder should disclose the asset's beneficial owners, that is, the end investor of the assets so deposited.

In the case that a segregated client account is held for a downstream custodian, then the principles for omnibus client accounts will be applicable. To illustrate this rather complex point, a bank may open an account with a custodian for the benefit of another bank, and in that sense, the account in the custodian's books is segregated; however, in the books of the account holder the account is an omnibus account. Consequently, the risks that the custodian faces with this type of segregated account are similar to those that it faces when opening an omnibus account for another financial institution.

Let us now speak about omnibus accounts. Has special care been taken to provide the custodian sufficient assurance that its omnibus account will not be used for illegal activities?

Yes. More stringent conditions are indeed imposed by the Principles before the opening by the custodian of an omnibus account.[26] The objective of those conditions is to ensure that their omnibus account holders apply compliance and due diligence principles that are aligned with its own principles and verify that those principles are indeed effectively applied:[27]

The account holder should:

- be regulated and authorised to accept client assets and money;
- have adequate compliance and control functions that fulfil the demands of safekeeping client assets;
- represent that they have applied the due diligence requirements as communicated by the custodian and that risk-based steps are taken to verify compliance with those requirements by their clients;

- screen transactions and holdings against relevant sanctions or other relevant lists (eg politically exposed persons or adverse media lists). It is interesting to note that during the 2016 Swift International Banking Operations Seminar (SIBOS) session on securities transparency it appears that screening securities transactions is not yet common practice; from the audience participating in this session only 52 per cent were already screening this type of transaction whereas 22 per cent had plans to do it as from 2016 and 25 per cent had no plan to do so yet; and
- disclose to the custodian the geography, segments and products which the account will support and they must inform the custodian of any material change in the way they use its account.

ISSA also recommend that in the event a client's account holder hold a material portion of the omnibus account, a self-disclosure by the account holder to the custodian is made based on which the custodian may recommend to set a segregated account for this client's account holder. This is to participate in the transparency approach as set out in the Principles.

As described so far, is it fair to say that to ensure a successful implementation, existing contractual arrangements between the custodian and its account holders and then down the custody chain need to be revisited?

In contrast to the payments industry, controls should focus on asset holdings and not only on the execution of transactions by asset holders. The securities custody chain indeed might be composed of a significant number of intermediation levels between the securities issuers and the ultimate assets beneficial owner. An account holder may indeed hold assets for its clients at the custodian, themselves holding securities for their own clients and so on.

In order to ensure that the custodian is assured that its account holder will comply with the FCCP and also that the clients of the account holders and underlying intermediaries also comply, the Principles include a significant difference with the Wolfsberg principles for cash. The FCCP foresee that it is the responsibility of the custodian to communicate its due diligence requirements to its account holders. They also have to obtain from their account holders a contractual commitment that they will comply with those requirements, and will request similar standards from their own clients.[28]

The Principles recommend that custodians communicate any due diligence requirements or standards that go beyond the general FATF principles or beyond existing due diligence obligations that apply in both the jurisdiction of the custodian and the account holder.

Examples of such standards to be communicated are:

- any requirements in regard to sanctions, in particular the exclusion of individuals or entities subject to sanctions imposed by the authorities of a jurisdiction other than the custodian and/or account holder's jurisdiction;
- the exclusion of entities from specific sectors such as cluster munitions manufacturers; and
- policies applicable to specific assets classes such as penny stocks.[29]

The ISSA background and overview note further explains that ISSA will not play any role in publishing a library of due diligence standards and that the contractual commitment mentioned above has to be bilateral without ISSA maintaining a list of those institutions that have agreed or declined to comply with the FCCP.[30]

The FCCP rely mainly on the performance of adequate due diligence at account holder, assets and transactional level. The need to review the contractual documentation is an extra step to give assurance to the custodian that its own due diligence standards will be met. Do the FCCP go one step further, allowing the custodian to receive some more insights from the account holder on how they respect those due diligence standards?

The FCCP indeed mandate the account holder to ensure a risk-based approach and that its direct clients have undertaken the appropriate level of due diligence to ascertain the identity of the assets beneficial owners. This means that the account holder should be entitled to receive positive confirmation about the compliance of its own clients with the Principles, themselves depositing securities for their own clients.[31]

The Principles go a step further by foreseeing the right of the custodian to verify that its compliance and due diligence standards have been met and to ask its account holders for two different types of disclosures:

(a) Assets beneficial ownership disclosure:

The custodian is entitled to ask the account holder to disclose the assets beneficial ownership of assets held on the omnibus account should the custodian be faced with the following circumstances:[32]

- Detection of a red flag concerning the misuse of the account. This might be the case if the financial crime monitoring tool used by the custodian flags suspicious names of individuals or entities listed by relevant authorities that remain unexplained or in case of material adverse media news affecting the account holder. Another example is if the use of the account by the account holder is not in line with the representations it has provided on the geography (markets), segments and products that the account holder supports with an omnibus account and that cannot be resolved in a timely fashion.
- Enquiry by a regulatory or judicial authority.
- Enquiry by the issuer of the assets, provided this enquiry relies on sufficient legal basis.

(b) Disclosure of buyers and sellers to a transaction:

Should the red flag affect a transaction — and not an account — then the custodian is granted the right to ask the account holder to disclose the identities of the ultimate buyer/seller of a security transaction.[33]

The Principles do not require an upfront agreement on how the custodian should trigger a request and how the account holder should address it, principally because we expect the volume of such disclosures to be rare. Custodians should establish policies in this respect that are proportionate to the volume and complexity of the activities of the account holder.

Having said that, a current discussion in the industry following the introduction of the 'smart', Russia, Ukraine and Venezuela-related sanctions regimes is whether the volume of disclosures might not be sufficient to justify a degree of technological and standards investment.

When issuing a disclosure request, the custodian should seek to be as precise as possible and include the following information: the originator of the request (it might be the custodian, a sub-custodian, the regulator or an issuer, for example), details of the account or transaction at stake, the justification for the request and the timing for answering. The later should be reasonable and should recognise that the account holder does not necessarily hold the information itself and might be required to transfer this request to its own clients.

When answering to such a disclosure request, the account holder should give all relevant information to provide the necessary assurance to the custodian and should advise the custodian in case of an intermediated custody chain and when they are themselves dependent on the disclosure request being transferred down the chain.

Finally, where communication protocols represent an efficient solution for the custodian, they should be agreed upfront and adjusted periodically as automation and market practices evolve.[34]

Now, let us suppose the custodian detects a positive or non-explained red flag linked to the usage by the account holders of its accounts or transactional system. What are the FCCP recommending in this case?

In this case, the custodian may face a dilemma, since the continuation of the holding may constitute a violation while any attempt to alienate the interest by, for example, transferring it to another custodian, may also constitute a violation.

ISSA has therefore acknowledged[35] that there is no one size-fits-all solution on what a custodian is expected to do in such circumstances. The actions to be taken should aim 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; and
- protecting its upstream custodians (sub-custodians/depositories/transfer agents) from breaching their own laws, policies or regulations.

Examples of such actions are disclosure to the regulators, refusal to contract, refusal to process a transaction, termination of a business relationship and blocking of activities. Each custodian should formalise in its internal policies and procedures the consequence of any observed non-adherence with the FCCP, including when such non-explained red flags occur.

As described earlier on, there is high likelihood that multiple stakeholders play a role in the custody chain between the account holder and the asset beneficial owner. How do the FCCP manage this additional complexity, as it is not enough for the account holder to comply with the custodian due diligence standards, it is also very important for the underlying participants to this custody chain to also respect them?

Most of the time, the custody chain is indeed composed of several layers and the effectiveness of the Principles lies in the possibility of ensuring compliance with the Principles across the whole chain, and not only at the level of the account holder or its client. Therefore, a third significant aspect of the Principles is that they focus not only on the relationship between custodians and account holders, but also on third party client business. The aim of the Principles is indeed to ensure that the custodian's compliance standards can be imposed on the end investor who may be several steps removed from them in the custody chain.[36]

That is why the Principles clearly state that the custodian should:[37]

- require its account holders to apply the Principles to their clients;
- be entitled to require its account holders to be able to identify the assets beneficial ownership and the identity of the buyers and sellers to a transaction in a similar way as that explained above; and
- require that its account holders perform their due diligence on omnibus client accounts in compliance with the provisions of the Principles.

This means that if the account holder holds assets for clients who themselves act as custodians for third party client securities, they also will have to comply with the Principles and get a similar contractual arrangement with their own clients. They will have to notify their clients that by holding securities cross-border they will be subject to the requirements of the jurisdictions in which the securities are held, including the due diligence standards as communicated by the custodian.[38]

Are there any other points worth mentioning to give the reader a good understanding about the scope and strength of these very important Principles?

There are four elements to mention:

(1) Need for a jurisdictional link to apply the Principles:

To prevent abuse of the rights granted to the custodians in the Principles, an additional condition has been added before being able to effectively exercise those rights. A custodian will indeed only be granted the prerogatives foreseen in the Principles if there is a clear link between, on the one hand the jurisdiction of the security at stake, and the jurisdiction of the custodian and account holder on the other hand.[39]

For example, a custodian will only be able to rely on the obligations arising from the German legal system if (a) the custodian and/or its account holder fall under the remit of German law or (b) the securities at stake have been issued, deposited or traded in Germany.

(2) Adequate governance and controls at the level of the custodian:[40]

Besides the rights and obligations elaborated above in this paper, the Principles also foresee for some more organisational requirements:

- The custodians will have to draft the relevant policies and procedures to describe how they intend to comply with the Principles.
- They will have to set up adequate compliance (second line of defence) and control (first line of defence) functions that will be tailored to the business of safekeeping, clearing, settling and administering securities. This involves, among others, having personnel specifically responsible for ensuring the compliance of the custodian with the FCCP and for reviewing the opening of new relationships with account holders, as well as periodically re-assessing them, including in terms of compliance with the standards communicated by the custodian.

(3) Conflict of laws:

The FCCP have a global reach and will apply across jurisdictions with different legal regimes. This means that certain provisions of the Principles might be in contradiction with domestic requirements (eg, the disclosure of assets beneficial ownership or buyers/sellers might be in contradiction with personal data protection or banking secrecy rules).

The FCCP are cognisant of this difficulty and of the fact that solving those issues require more than the issuance of industry principles but rather an intervention from the legislator.

To solve this issue, the Principles indicate that the account holder shall use reasonable endeavours to obtain the appropriate consent from its clients should such a consent/waiver allow mitigation of this conflict of laws.

The account holder shall in any case inform the custodian:

- whether such a consent has not been provided by some of its clients;
- of cases when obtaining such a consent is not a solution to resolve the conflict.[41] Here again, it will be up to the custodian to

define in its policies what to do should they face such circumstances.

(4) Importance of the contractual commitment:

Requiring a contractual agreement is a key element of the Principles and aims at providing the custodians with the assurance that the account holder will comply with the compliance and due diligence standards as communicated by the custodian. This means that each custodian will have to review its contractual documentation with its clients, which also explains why the implementation date for the Principles has been set at January 2020 as reviewing those contracts will take some time.

We are of the opinion that the following subjects should at minimum be covered within the contractual provisions:

- Commitment by the account holder that it will make reasonable efforts and put in place adequate controls to comply with the compliance and due diligence requirements as communicated by the custodian.
- Agreement to provide the custodian with the information necessary for the custodian to verify the account holder's compliance with Principles.
- Agreement to provide any relevant information to satisfy the disclosure requests issued in line with what is explained above.
- Communication to the custodian of any underlying clients who have not provided the required waivers to mitigate the potential conflicts of laws.

Where do you stand on the implementation process of the FCCP?

Very solid foundations have been built to achieve our original objective of increasing the robustness of the financial crime compliance control framework in the security industry. The Principles and related guidance have received buy-in from most of the main custodians in the industry. The cross-border custody industry is actually quite concentrated and the vast majority of cross-border holdings globally are intermediated by at least one, and usually by several, ISSA member firms. Once the Principles are in force, we expect a virtuous circle to appear by which their clients will start applying the FCCP on their own.

We are now busy providing guidance to custodians on the practicality of implementation. We should keep the focus on the long-term objective mentioned above, that is, utilising the positive experiences of the Wolfsberg Group in issuing similar types of standards and guidelines.[42]

To do so, ISSA has set up an ad hoc FCCP Implementation Working Group to ensure the implementation takes place smoothly and to provide guidance on how to apply the most difficult provisions of the Principles.

In addition, since 2015, ISSA has positively engaged in discussions with the main regulators worldwide regarding the Principles.

In terms of concrete deliverables, we see the ISSA due diligence questionnaire being implemented by several custodians. It is also part of the baseline of the SWIFT KYC Registry, alongside the Wolfsberg one. Another area where we see changes is in contractual repapering, where some custodians are well advanced at integrating the Principles in their contractual documentation.

These are all positive signs, but the momentum must continue to ensure a broad enough adoption of the FCCP by the time of their entry into force in January 2020.

Are there any specific hurdles you are anticipating in the implementation process?

Aligning the main custodians in the ISSA working group occurred relatively smoothly. A challenge will certainly be to create a virtuous circle of institutions implementing the FCCP to 'encourage' other financial institutions, which were not part of this effort, to play the game. But

with the institutions sitting around the ISSA table, we do already have a fairly important representation of the whole securities transactions globally.

Another challenge we will have to consider is the potential conflict of legislations between what we propose to implement in the FCCP and domestic privacy or banking secrecy requirements. This one will be more difficult to address in isolation and will probably require some intervention by an authority. But we see a movement towards more transparency worldwide as shown by the recent discussions on the creation of a beneficial ownership register in the British Virgin Islands (BVIs).

Finally, the repapering, that is the new requirement to insert the recommended provisions in the contracts between the custodians and the account holders, will take some time. Nevertheless, we have already observed changes in the market that indicate things are moving in a positive direction, with several custodians having already adapted their contractual framework to make it closer to the FCCP.

To conclude, what are your key messages?

It is very important that existing business models are preserved, protected and left free to develop. There is a temptation to believe that changes in account structures or transparency rules will mitigate those risks. ISSA believes that could not be further from the truth. Changes such as these have myriad regulatory and legislative dependencies that could not reasonably be resolved in the span of a single generation. Different markets have evolved different models that are optimised to their particular needs. What ISSA must do is to articulate principles, which when properly applied, will protect all these different models and allow them to continue to develop.

The securities services industry is facing developing financial crime risks, which need to be well understood in order to implement an adequate control framework. ISSA believes that through the Principles and the associated implementation guidance, the industry will reinforce its maturity and the strength of the control framework to adequately detect and respond to financial crimes attempts.

It is also important to note that current geopolitical tensions lead to regular additional and complex sanction measures that directly affect the clearing, custody and settlement industry. Owing to the particularity of multiple layers in the intermediation level, the industry is facing challenges to detect potential sanction circumvention and may unwittingly facilitate the clearing and settlement of a sanctioned asset and/or for the benefit of a sanctioned asset beneficial owner. Therefore, it is crucial to reinforce and streamline how key controls are performed across the custody chain and this involves key items such as clients, assets and transactions due diligence.

The journey ahead is long, but ISSA believes that key foundations have been defined to help the industry embarking on this journey with greater awareness and the adequate toolbox.

Disclaimer

The opinions and judgments expressed by the author's in this paper are personal and do not necessarily reflect the position of the companies they work for. Any mistakes and misinterpretations are entirely the author's responsibility.

Notes and References

(1) FATF/GAFI (2009) 'Money laundering and terrorist financing in the securities sector', available at: http://www.fatf-gafi.org/media/fatf/documents/reports/ML%20and%20TF%20in%20the%20Securities%20Sector.pdf (accessed 9th July, 2018) note that at the date of publication of this article, FATF just published a consultation regarding the risk-based approach guidance in the securities sector, available at http://www.fatf-gafi.org/publications/fatfgeneral/documents/public-consultation-guidance-securities.html.

(2) ISSA (2017) 'Financial crime compliance principles for securities custody and settlement', available at: http://www.issanet.org/pdf/2015_08_27_ISSA_Financial_Crime_Compliance_Principles_final.pdf (accessed 9th July, 2018).
(3) January 2020 is the expected implementation date and when financial institutions will be expected to comply with the FCCP.
(4) ISSA (2015) 'Financial crime compliance principles for securities custody and settlement background & overview', available at: http://www.issanet.org/pdf/2015-10-05_ISSA_Background_Overview_Final.pdf (accessed 9th July, 2018).
(5) ISSA FCCP, 27th August, 2015, p. 5.
(6) ISSA FCCP, 27th August, 2015, pp. 3 & 4.
(7) European Central Securities Depositories Association (ECSDA) (2015) 'Account segregation practices at European CSDs', 13th October, available at: http://ecsda.eu/wp-content/uploads/2015_10_13_ECSDA_Segregation_Report.pdf (accessed 9th July, 2018).
(8) ISSA FCCP, 27th August, 2015, p. 4.
(9) Directive (EU) 2015/849 of the European Parliament and of the Council of 20th May, 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No. 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC.
(10) ISSA FCCP August 27th, 2015, pp. 7 & 8.
(11) Financial Action Task Force, an international body that has issued a set of Recommendations setting out a comprehensive and consistent framework, which countries should implement in order to combat money laundering and terrorist financing, as well as the financing of proliferation of weapons of mass destruction. FATF/GAFI (2018) 'International standards on combating money laundering and the financing of terrorism & proliferation: The FATF recommendations', available at: http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf (accessed 9th July, 2018).
(12) United States Department of State, Bureau for International Narcotics and Law Enforcement Affairs (2017) 'International Narcotics Control Strategy Report. Volume II. Money Laundering and Financial Crimes', available at: https://www.state.gov/j/inl/rls/nrcrpt/2017/ (accessed 9th July, 2018).
(13) International Center for Asset Recovery (2017) '2017 Basel AML Index', available at: https://index.baselgovernance.org (accessed 9th July, 2018).
(14) Transparency International (2017) 'Corruption Perception Index', available at: https://www.transparency.org/news/feature/corruption_perceptions_index_2017 (accessed 9th July, 2018).
(15) ISSA FCCP, 27th August, 2015, B1.
(16) The Wolfsberg Group (2018) 'Correspondent Banking Due Diligence Questionnaire (CBDDQ)', available at: https://www.wolfsberg-principles.com/wolfsbergcb (accessed 9th July, 2018).
(17) OFAC is the US Office of Foreign Assets Control (OFAC) of the US Department of the Treasury, which administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers.
(18) US Department of the Treasury (2018) 'OFAC FAQs: Sanctions compliance', available at: https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_compliance.aspx (accessed 9th July, 2018).
(19) T2S, for Target 2 for Securities, is a large infrastructure programme launched by the European Central Bank T2S, which will consolidate settlement across all countries in Europe. See: European Central Bank (2018) 'T2S', available at: http://www.ecb.europa.eu/paym/t2s/html/index.en.html (accessed 9th July, 2018)
(20) Directive 2011/61/EU of the European Parliament and of the Council of 8th June, 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010.
(21) Regulation (EU) No. 909/2014 of the European Parliament and of the Council of 23rd July, 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No. 236/2012.
(22) Defined as any client account containing securities interests that are legally owned by a single party other than the account holder. ISSA (2015) 'FCCP background & overview for ISSA members', 30th September, p. 13.
(23) Defined as any account containing securities interests that are beneficially owned by multiple parties. ISSA (2015) 'FCCP background & overview for ISSA members', 30th September, p. 13.
(24) ISSA FCCP, 27th August, 2015, Principle 5.
(25) ISSA FCCP, 27th August, 2015, Principles 6–8.
(26) ISSA FCCP, 27th August, 2015, Principles 9–16.
(27) ISSA (2015) 'FCCP background & overview for ISSA members', 30th September, p. 11.
(28) ISSA FCCP, 27th August, 2015, Principles 1 and 2.
(29) ISSA (2015) 'FCCP background & overview for ISSA members', 30th September, p. 17.
(30) ISSA (2015) 'FCCP background & overview for ISSA members', 30th September, p. 16.
(31) ISSA FCCP, 27th August, 2015, Principle 4.
(32) ISSA FCCP, 27th August, 2015, Principle 13.
(33) ISSA FCCP, 27th August, 2015, Principle 17.
(34) ISSA (2015) 'FCCP background & overview for ISSA members', 30th September, p. 18.
(35) ISSA (2015) 'FCCP background & overview for ISSA members', 30th September, p. 19.
(36) ISSA (2015) 'FCCP background & overview for ISSA members', 30th September, p. 10.

(37) ISSA FCCP, 27th August, 2015, Principle 14.
(38) ISSA FCCP, 27th August, 2015, Principle 3.
(39) ISSA FCCP, 27th August, 2015, p. 5.
(40) ISSA FCCP, 27th August, 2015, p. 7.
(41) ISSA FCCP, 27th August, 2015, p. 13.
(42) The Wolfsberg Group (2018) 'Wolfsberg Group Payment Transparency Standards', available at: https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/wolfsberg-standards/1.%20Wolfsberg-Payment-Transparency-Standards-October-2017.pdf (accessed 9th July, 2018). The Wolfsberg Group, ICC and BAFT (2017) 'Trade Finance Principles', available at: http://www.baft.org/docs/default-source/policy-department-documents/final-clean-trade-finance-principles-final.pdf?sfvrsn=2 (accessed 9th July, 2018).