



JUNE 2009

ADVANCED GLOBAL SECURITIES OPERATIONS

MARK SCHEME

Answer ALL questions in this section

1 Under the FSA, regulations exist to ensure that firms apply a standard process in the opening of client accounts. Identify THREE of the areas contained within this process. (3 marks)

- *Client classification*
- *Client agreements*
- *Client asset protection*
- *Anti money laundering laws*

2 In the UK and mainland Europe, funds such as OEIC's, Unit Trusts and SICAVs are subject to various charges. Identify any THREE of the charges that the fund will likely have to pay. (3 marks)

- *Custody Fees*
- *Auditor Fees*
- *Administration Fees*
- *Trustee Fees*
- *Legal, Regulatory and Government Fees*
- *Dealing Fees and commissions*
- *Registration Fees*
- *Translation and Publishing Fees*

3 Whenever an investor places an order to buy or sell equity securities, the investor has to eventually settle the transaction. Identify THREE of the main reasons why a transaction might fail to settle on time. (3 marks)

- *Insufficient securities available for delivery*
- *There is insufficient cash*
- *Trade instructions are unmatched*
- *Securities are unavailable for delivery*

4 Sub-Custodians form a vital part of the business known as global custody. Identify the THREE main criteria that you would consider to be of the highest importance to your firm from a high level business point of view. (3 marks)

- *Credit Rating*
- *Local Regulatory approval*
- *Reputation*
- *Overall product offering*
- *Fees charged*
- *Demonstrated Management controls and procedures*
- *Audit Reports*

5 Securities lending is a very popular business activity. Within this business activity there is something known as *discretionary* or *managed lending*. Identify THREE of the high level business tasks that are undertaken by any entity that decides to supply this service to its clients. (3 marks)

- *Broadcast of Positions*
- *Management of securities Loaned*
- *Management of collateral*
- *Acceptance of Credit Risk*
- *Apportionment of lending fees*

6 In Cash Management parlance *sweeping* is commonly used terminology. Briefly describe what you understand sweeping to be. (3 marks)

- *Sweeping is a product that might be provided by Global Custodians to its client base.* (1 mark)
- *It provides a client with an automatic movement of cash from non, or low interest bearing accounts to a vehicle that will generate a higher rates of interest. This will typically be placed into the overnight market or STIF's.* (1 mark)
- *It is therefore a "cash management" tool, which allows the client (or the agent) to better manage their cash.* (1 mark)

7 Corporate actions and their associated terminology are a critical part of global securities operations. A company in the UK has announced a 1-for-2 capitalisation issue. Answer the following questions:

- (a) On what day should you change the client's holding?
- (b) If the client held 1000 shares, what would their new holding be?
- (c) If the client's holding was valued at £1000.00 prior to the event, what would you expect the value to be immediately after the event?

(3 marks)

- *The Day the issue went "ex capitalisation".*
- *The new holding would be 1500 shares*
- *The new value would be £1000 as the price would change to compensate for the new shares issued.*

- 8 Straight-Through Processing (STP) is an increasingly important part of the financial services industry. Identify THREE different operational areas within the industry that could benefit from deployment of a STP environment. (3 marks)
- *Cash payment and receipts*
 - *Reconciliations*
 - *Trading and associated Settlement (Securities, Bonds ,FX, Funds,)*
 - *Corporate Actions*
 - *Management Information*
 - *Compliance*
- 9 Service Level Agreements (SLA) are a familiar industry component. Outline THREE of the principles underpinning the use of SLAs. (3 marks)
- *To help mitigate the operational risk associated with the outsourcing of services*
 - *To provide clarity of obligations between the contracting parties of what service(s) is being provided*
 - *To define the quality, timeliness and content of the service*
 - *To help the parties monitor the performance of the service provider*
 - *To support the necessary legal agreements that have to be in place*
- 10 Transition management is a critical industry innovation. Outline the strategic reasons why an institutional investor might choose to appoint a transition manager. (3 marks)
- *Changing their asset allocation*
 - *Changing their investment manager(s)*
 - *Changing their underlying investment aims (e.g. capital growth to income)*

SECTION B

TOTAL 30 MARKS

- 11 You are the manager of a global custody firm's transition area. Your senior management has asked you to prepare a presentation for a customer who has appointed a transition manager and is particularly interested in knowing how your firm manages their part in the transition process. Your presentation must outline:
- (a) the primary tasks undertaken by your firm in pre transition; (5 marks)
- (b) the primary tasks undertaken by your firm in post transition. (5 marks)
- (a) *Tasks should include;*
- *Creating an effective Transition plan that will include;*
 - *Reconciliation and agreement of starting asset positions*
 - *Communication with the Transition Manager to understand their strategy*
 - *Exchanging settlement instructions for asset types and markets in their strategy*

- *Agree policy for ongoing Corporate Action and Income*
- *Determine staffing required*
- *Amend internal system STP rules to allow for new incoming messages*
- *Ongoing reconciliation process*
- *Notify back office of timing of trades*

(b) *Tasks should include;*

- *Reconcile final asset holdings with Transition Manager*
- *Agree anomalies and resolution*
- *Request feedback from client / Transition manager*
- *What could have been better executed*
- *Sign off from Client / Transition Manager*

12 A junior member of your staff has asked you for an explanation of what the term *underwriting* means. Prepare an answer to this question so that the junior member of staff is fully aware of:

- (a) the principle of underwriting; (2 marks)
- (b) how underwriting benefits the issuer; (2 marks)
- (c) how underwriting benefits those institutions that participate; (2 marks)
- (d) the risks associated with underwriting; (2 marks)
- (e) the level of commissions normally paid. (2 marks)

(a) *Underwriting is the mechanism that allows an issuer of new shares or debt to come to the market and have certainty that they will receive the full monetary value of their issue.*

(b) *The “Issuer” benefits from Underwriting because issuer receives the full monetary value of the issue and is therefore able to fulfil their strategic plans.*

(c) *The Sub-underwriters and their client’s benefit because they receive fees for their risk taking and increase their revenues. They often benefit by receiving discounted shares.*

(d) *The risks associated with underwriting are usually financial in nature and relate to the fall in value of the shares being issued.*

(e) *Underwriting commissions are normally between 1-to-3%.*

13 It is important for our industry that those who aspire to become the future managers should understand the significance of maintaining accurate client records. The FSA provide firms with general guidelines to ensure the accuracy of client records. What are these guidelines? (10 marks)

- *A firm must take the utmost care in recording information obtained from the client.*
- *Data should be obtained from clients in a uniform manor and the data requested must meet that as laid down by the regulators, this being a readable format or in a manner that is capable of being reproduced in a readable format.*
- *A firm should not open accounts or allow any transaction to take place unless the correct information and forms have been signed by the client and the appropriate documents such as passports have been seen by the firm.*

- *The firm should have appropriate procedures in place to ensure that the data obtained is transposed into their systems accurately.*
- *Documentation must be archived by the firm in a manner that meets the statute of limitations for such data as outlined by the FSA.*
- *Records must be kept to reflect that the firm has diligently kept their database up to date and confirmed their client's data on a regular basis.*

SECTION C

TOTAL 20 MARKS

Answer ONE question in this section

- 14 You have just joined a global custodian. You have been appointed as the manager of your new firm's reconciliations section. You are responsible for the timely reconciliation of the securities and cash positions that your firm hold on behalf of its clients. In the interview process you had been advised by your new employer that there are "some difficulties within the area that the internal audit team were concerned with that need sorting out" hence your appointment.

Describe what your first 10 days on the job might entail. (20 marks)

- *Obtain from the appropriate sources an organogram of the department that shows all the team members and their responsibilities.*
- *Attend any company Induction process.*
- *Introduce yourself to all the staff in the Reconciliation department en mass. State that you will need to familiarise yourself with the departments circumstances.*
- *Explain what your long term vision might be and what you would hope to achieve within the area.*
- ✓ *This should include stating the minimum statutory levels required.*
- ✓ *That the department will be a star performer in the organisation.*
- ✓ *The fact that you will be seeking help in this quest from everybody.*
- ✓ *That you will be holding individual meetings in the coming weeks with each individual.*
- *Identify from the organogram who is the 2 IC in the department.*
- *Request a list of the sub-custodians that you deal with together with any other institutions which hold assets on behalf of your clients.*
- *Request a schedule of the current and latest reconciliation reports from your staff giving details of the outstanding positions.*
- *Analyse the quality of data supplied e.g. are the recs automated or manual, are they time stamped, is there narrative as to follow ups, is there evidence of distribution internally to other departments, is there any stats on clear up rates etc.*
- *Analyse the amount of work versus the number of staff employed.*
- *Arrange a meeting with your 2 IC and the internal audit team and ascertain what the perceived difficulties are.*
- *Organise the 1-2-1 with the staff to ascertain their views.*

- *Within the first two weeks prepare an interim report for your senior management and the Head of internal audit as to what your initial reactions are and share with them your thoughts on what needs to be done.*

15 You are currently employed by a custodian and are the manager of your firm's data processing area. It has been brought to your attention that some time ago data regarding a client was incorrectly coded and input into your system. The data concerns the classification of the client type. The client has been classified and recorded as being a Charitable Fund whereas they should have been classified as a Pension Fund.

- (a) Discuss the ramifications of this error and how it could affect your firm and the client.
- (b) Outline the actions you would immediately take in such a circumstance.
- (c) Outline the potential remedial actions you will likely have to take in such a circumstance.
- (d) Outline what you would do to prevent this from happening again.

(20 marks)

(a) Impacts

- *As a Custodian the most likely area of concern will be that of the level of Withholding Tax applied to the income. In some countries tax exemptions or reduced levels of withholding tax will be levied on pension funds.*
- *This would also be an issue if the Fund was lending their securities. This misclassification could impact the value of loans to the borrower and therefore the revenue created by the loans due to the fact that a different calculus for the manufacture of dividends could have been applied.*
- *This could lead to the potential for serious capital loss to the Custodian firm depending upon how the Custodian chose to deal with the matter.*
- *There could be ramifications for the Custodian with the tax authorities of various countries if they attempted to retrospectively apply for a different tax rate.*
- *Potential Reputation costs*
- *Cost of remedial action*
- *Potential issues with Regulators*

NOTE: Some candidates might say there could be stamp duty issues or issues with the commissions applied in the UK, but I do not think that this would be the Custodians issue.

(b) Immediate Actions

- *Identify the client and their fund manager.*
- *Identify the countries in which they had been investing.*
- *Identify whether they were a lending client.*
- *Identify whether there was a withholding tax issue in the countries they were investing.*
- *Identify whether the investments were being held in the correct sub-account with the sub-custodian. (e.g. 15%, 30%, Zero rate, etc.)*
- *Evaluate the value of the inappropriate taxation applied on investment income and manufactured dividends.*

- *Identify what had caused the misclassification.*
- *Inform Senior Management (includes Compliance) of the circumstances and the facts and your proposed action.*

(c) Potential remedial action

- *Depending upon the outcome of the above investigation there would need to be a “management” decision as to whether to inform the client’s Fund Manager of the circumstances.*
- *If there was a zero impact on the client, borrowers, the sub-custodian and overseas tax authorities, there is no ethical reason why any one should be informed of the misclassification.*
- *In these circumstances the action would simply be to amend the records within your firm.*
- *If there was an impact on the client we would need to explain to the client’s Fund Manager the circumstances, and the value of the cost of the misclassification.*
- *We would need to explain to the Fund Manager what action we needed to take.*
- *We might need to get the client to complete new tax forms and explain to the client what had happened to make us take the action.*
- *The Custodian firm should be ready to take the capital loss of making client whole, if there was a difference in the withholding tax applied.*
- *Evaluate whether it would be possible to retrospectively obtain the differential in withholding tax from the overseas authorities.*
- *Ensure staff training is appropriate.*
- *Take disciplinary action if it is felt appropriate and justified.*

(d) Outline Prevention

- *Ensure that the firm’s procedures are robust.*
- *Make any necessary changes.*
- *Retrain staff if required.*

SECTION D

TOTAL 20 MARKS

Answer ONE question in this section

- 16 You are the Senior Network Operations Manager of a global custodian institution. You have been tasked with the preparation of a document for your board of directors that outlines the overarching business principles that should be applied in the creation of an effective sub-custodian network. *(20 marks)*

Discuss what you believe to be:

- (a) the overarching business principles that should be applied;
- (b) the definition of an effective sub-custodian network;
- (c) the best way to gauge the performance of the network;
- (d) the risks associated with the creation of a network.

(20 marks)

(a) The business Principles applied:

- *The name of the entity with whom we would contract.*
- *The level of products provided, versus the minimum product requirements.*
- *The credit worthiness and rating of the sub-custodian.*
- *The regulatory status of the sub-custodian and identifying known breaches.*
- *The cost of the services provided and the ability of the sub-custodian to recognise reciprocity potentials.*

(b) The definition of an effective sub-custodian network:

- *A network that provides us with the correct level of services.*
- *A network that helps us to be cost effective in our own product offering.*
- *A network that uses our own branches wherever possible.*
- *A network that will provide and adhere to SLA's.*
- *A network that allows regular Due Diligence visits.*

(c) The best way to monitor the performance:

- *Create an SLA that outlines the service performance standards required*
- *The SLA will focus on what your firm believes to be the most important*
- *You will create an internal scoring system*
- *You will have regular internal meetings*
- *You will have regular conference calls with the network*

(d) The risks associated with creating a network:

- *Credit*
- *Political*
- *Regulatory*
- *Reputation*
- *Systemic*

17 You are the manager of your client data service team. Your company is trying to win a fund management contract from a very important new client. As the client is extremely keen on knowing how your firm's client records are kept accurate and up to date, your sales team want you to discuss the regulatory framework that exists so as to demonstrate the overall management applied to client data. They want you to demonstrate:

- (a) the essential elements within the UK investment industry that a firm has to gather in order that client records are accurate and up-to-date;
- (b) FIVE examples of the effects that incorrect or incomplete client records could have on a firm;
- (c) the regulatory guidelines and recommendations for ensuring that client records are maintained

(20 marks)

(A)

- *Money Laundering regulations are mandatory and if not conducted thoroughly could lead to censure and fines for the firm.*
- *Know Your Client (KYC) rules are mandatory and if not conducted thoroughly could lead to censure and fines for the firm.*
- *Investment criteria and asset allocations are vital to make the correct investment decisions.*
- *Standing instructions for varying items of administration are crucially important.*
- *Correspondence, Fee billing.*
- *Client Assets must be recorded accurately and segregated from the firm's own assets.*
- *Reporting of activity and portfolio content both internally and externally*
(1 mark each, max 5 marks)

(B)

- *Allowing inappropriate assets to be acquired / held in the client's portfolio leading to serious consequences such as official complaints to the regulators, censure and fines and losing the client account and revenues.*
- *Incorrectly recording a standing instruction leading to an incorrect action to be taken / not taken leading to financial loss.*
- *Sending confidential data to an inappropriate recipient leading to the firm's reputation being damaged plus potential financial consequences.*
- *Erroneous action being taken on a corporate action leading to financial loss.*
- *Incomplete or incorrect KYC and Money Laundering processes leading to the firms censure and fine by the regulator.*
(1 mark each, max 5 marks)

(C)

- *A firm must take the utmost care in recording information obtained from the client.*
- *Data should be obtained from clients in a uniform manor and the data requested must meet that as laid down by the regulators this being in a readable format or in a manner that is capable being reproduced in a readable format.*
- *A firm should not open accounts or allow any transaction to take place unless the correct information and forms have been signed by the client and the appropriate documents such as passports seen by the firm.*
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- *Records must be kept to reflect that the firm has diligently kept their database up to date and confirmed theory holders name and address on a regular basis.*