



DECEMBER 2007

ADVANCED GLOBAL SECURITIES OPERATIONS

MARK SCHEME

Answer ALL questions in this section

SECTION A

- 1 Under the FSA rules, ordinarily firms are required to enter into an agreement with a private customer. When is it allowable for a firm not to do this? (3 marks)

When the private customer is ordinarily resident outside of the UK and the firm has reason to believe that the client does not wish to enter into an agreement.

- 2 The Panel on Takeovers and Mergers (PTM) levy is imposed on certain securities transactions. When should a firm ensure that this levy is imposed?

(3 marks)

On any equity transaction in securities of companies incorporated in the UK, or on a register in the UK, the Channel Islands or the Isle of Man that is in excess of £10,000.00 in value.

- 3 Settlement of securities transactions in all of the leading markets is primarily achieved electronically. This is achievable because of what is known as *Dematerialisation* or *Immobilisation*. Explain what these terms generally mean.

(3 marks)

Dematerialisation = No paper record of share / security legal ownership is produced.

Immobilisation = Certificates of legal ownership of holdings are produced but are held at a physical Location / depository.

- 4 Sub-Custodians form a vital integral part of the business known as *Global Custody*. Explain why this is the case.

(3 marks)

They are the Global Custodians agent in a particular market place. They will conduct all of the vitally important functions in the settlement and servicing of the assets held in that market place.

- 5 Securities Lending is a very popular business activity. However, within this business activity there is something known as *Daylight Exposure*. Explain fully what *Daylight Exposure* is.

(3 marks)

Daylight Exposure is said to be the intra-day risk between the delivery of loaned assets and the delivery of the collateral that secures the loan. For example if the borrower of assets defaults (goes broke) before the exchange of assets and collateral has been completed there is the possibility that the lender could find

themselves without the assets they have loaned and the collateral. The borrower of course is faced with the same exposure when trying to repatriate the borrowed assets.

- 6 In Cash Management parlance “Sweeping” is common terminology. Describe what Sweeping is and how it benefits all the parties involved in sweeping. (3 marks)

Sweeping is the process whereby cash balances (in any currency) held on behalf of clients in cash accounts that might not be earning any interest or a low rate of interest are transferred to another account or another asset that does produce a better rate of interest. (1 mark)

- *Clients get a better return on their surplus cash.* (1 mark)
- *Provides the supplier of the service the opportunity to generate additional revenue.* (1 mark)

- 7 Corporate Actions are a critical part of a company’s corporate strategy. Explain the reasons why a company might decide to announce a Rights Issue and what the benefit to a company is of taking this action. (3 marks)

The primary purpose of a Rights issue is to raise additional cash by selling additional shares to the existing shareholders. The company directors will explain to shareholders at the time of the issue how they intend to use the additional cash raised. However it could be used to build a new factory, to pay down debt, or to finance other growth strategies. (1 mark)

The reasons why the company would raise capital by selling shares is to produce funds with a lower base cost than would otherwise be the case if they had to raise the funds in the open credit market. (2 marks)

- 8 Straight Through Processing is becoming an increasingly important part of the Financial Service industry. What are three key business drivers for the introduction of STP into any business process? (3 marks)

Any three of the following;

- Reducing costs
- Reducing operational risk
- Reducing errors and process delays
- Improving customer satisfaction
- Enabling business growth without increasing costs / volume insensitive

- 9 When entering into any ongoing business relationship with another firm to provide certain services, how would you recommend that both firms are able to manage the ongoing relationship? (3 marks)

By the creation of a Service Level Agreement (SLA) between the two that identifies the services to be provided and the Key Performance Indicators (KPI's) against which the service will be measured.

- 10 There have been several important global markets developments in the last 2 years. Name two of these developments. (3 marks)

Eg MiFID. Credit will be given for any valid answer.

SECTION B

- 11 You are the manager of your firms Trade Settlement area. The management of *Risk* is becoming increasingly important to both clients and the institutions that serve those clients. Your senior management have asked you to prepare a presentation for a prospective new customer. Your presentation must outline:

- (a) The fundamental primary risk or risks involved in Trade Settlement. (5 marks)
- (b) The measures that you and your firm takes to mitigate such risk(s). (5 marks)

This question is designed to test the candidate's ability to determine between Cause and Effect. E.g. Cause being the items that need mitigation and the Effect being the Risk being run.

(a) *Risk(s) should include;*

- *Counterparty default*
- *Delays in Settlement (uncertainty of finality)*
- *One sided settlement (client being without either cash or stock after settlement)*
- *Regulatory / market actions (e.g Buy-in or Sell-out procedures)*
- *Reputation*

(b) *Mitigation should include;*

- *Ongoing process to validate Counterparty Creditworthiness (completed by either the Client, Clients dealing agent, or Settlement Firm)*
- *Processes to ensure trades are correctly matched both at market level and custodian level*
- *Pre-Settlement communications between all parties to the trade and settlement agents to ensure integrity of intention to settle*
- *Processes to ensure Certainty of Settlement (should include settlement advice and reconciliation processes of stock and cash positions)*
- *Measurement of the firms settlement performance*

- 12 Your in-house portfolio accounting system has generated an ex-capitalisation position in ABC Co Ltd. This position differs to that which your Sub-Custodian reports to

you. Explain how this could be the case and describe the action you would take to determine the correct position on which you should act. (10 marks)

1. *My in-house system will likely be working on a “traded” basis, whereas the sub-custodian system could be working on a “settled” basis. This would have the effect of making a difference in the area of unsettled trades.*

1(a) *I would therefore look at any trades that fall into this category.*

2. *My in-house system may retain any “securities out on loan” in the portfolio, whereas the sub-custodian system will likely have their position reduced by the amount of “securities out on loan”.*

2(a) *I would therefore look at any trades that fall into this category.*

3. *There could be a previous unsettled Corporate Action position.*

3(a) *I would review reconciliation reports as they should appear on this and/or investigate any previous unsettled CA positions.*

4. *It is possible that securities have been delivered into or out of the sub-custodian for our account and these securities not to have been updated on my system. It is possible that these would appear on reconciliation report. I would investigate this.*

5. *Failing any of the above being readily identifiable I would liaise with my reconciliations area who deals with the sub-custodian to ascertain a recent securities movement statement and to resolve the difference.*

13 The fulfilment of regulatory requirements is of paramount importance to any institution conducting business in the investment industry.

(a) Discuss what your personal commitment is to uphold the Anti-Money Laundering regulations. (7 marks)

➤ *To ensure that I report any suspicious activity to my immediate manager or my Compliance unit and (2 marks)*

➤ *To ensure I do not discuss my concerns with any other colleague or indeed the client. (2 marks)*

➤ *To ensure I get a satisfactory reply. (2 marks)*

➤ *To ensure that my training in such matters is current. (1 mark)*

(b) List **THREE** ways in the securities and investment business which criminals could use to launder money.

➤ *Introduction of frequent large amounts of cash into and out of the multi-currency accounts.*

➤ *Securities deposited and then sold and cash proceeds transferred out.*

➤ *Bearer bonds deposited and then sold and cash proceeds transferred out.*

SECTION C

Answer ONE question in this section

14 You are the manager of your firm's Corporate Actions department. A situation has arisen and been brought to your attention whereby there is a dispute between your staff and the administration staff of a fund management institution that you serve, with regards to the outcome of a particular rights issue. Your staff has notes to suggest that a verbal instruction was received to take up all of the fund manager's clients rights entitlement; whereas the fund manager's staff say they did not issue any verbal instruction, as they wanted to lapse the rights and want the position removed from their clients' portfolio. The value of the shares involved has since dropped by 20%.

- (a) Describe the actions you would take to clarify this situation
- (b) Explain the key drivers that will influence the action you will take
- (c) Itemise the action you would take to remedy the situation.
- (d) Outline the actions you would take to prevent this from recurring.

(20 marks)

This question examines the candidates on several fronts e.g. their business acumen, their sense of what is right for their firm and for their clients and their resolve to manage the situation to an equitable outcome.

The anticipated answers are as follows:

(a)

- *Review the value of the current loss. This will have a bearing on the future action taken. If the current value (including any potential "lapse" value) is over the threshold of my discretionary loss write off authority I would inform my senior management of the situation. If not, I would not report at this time.*
- *Review the documentary notes that my staff have taken to ascertain any dates, times, names of contacts recorded.*
- *Review any taped phone calls in conjunction with my compliance unit to ascertain recorded evidence of conversations with the fund management staff.*
- *Contact my counterpart at the fund manager to review what tape recording facilities they have.*
- *Review the value of the business (fee revenue) generated by the fund management company.*
- *Review what action we request from our fund management clients with regards to verbal instructions, in particular the lapsing of rights.*

(b)

- *To minimise the financial impact on my firm taking into account the overall value of the loss and the potential loss of goodwill.*
- *To have a fair resolution to all parties based on the evidence presented.*

(c)

- *Assuming that the documentary evidence, the request to have written instruction to lapse rights and phone recorded evidence are compatible and support my staff, I would present such evidence to my counterpart and resist their request to change the portfolio position, whatever the value of the loss. If the loss was over my discretionary authority I would report the incident and my action to senior management and Compliance.*
- *I would anticipate that the claim against my firm would be removed. If it was not I would report all the facts to and escalate to senior management.*
- *Assuming that there is documentary evidence but no phone recording evidence to support my staff, but there is a standard request given to fund managers for written instructions to take any action, I would present such evidence to my counterpart and resist their request to change the portfolio position, whatever the value of the loss. If the loss was over my discretionary authority I would report the incident and my action to senior management and Compliance.*
- *I would anticipate that the value of the loss would come into play. I would anticipate that if the value of the loss was not significant that the claim against my firm to be dropped. If the value was significant I would anticipate that there was potential for a secondary claim. If this resulted I would escalate the matter to senior management.*
- *Assuming that there is documentary evidence but no phone recording evidence to support my staff, and there is no standard request given to fund managers for written instructions to take any action, I would contact my counterpart and request that they examine their own phone records to see if there is evidence, whilst resisting their request to change the portfolio position, whatever the value of the loss. If the loss was over my discretionary authority I would report the incident and my actions to senior management and Compliance.*
- *Assuming that they concur with this request and confirm no recorded evidence exists, depending on the current value of the loss as opposed to my discretionary write-off authority I would;*

Discretionary Action

- (1) *Arrange for the fund manager to confirm in writing that they did not issue instruction to take up the rights and request removal from the portfolio.*
- (2) *Remove the shares from the client portfolio into the firms "holding account" and issue instructions to the firms broker to sell the shares.*
- (3) *Arrange for the clients cash account to be credited with the value of the subscription costs.*
- (4) *Arrange for the value of any "Lapsed" value to be credited to the clients account.*
- (5) *Document the action taken and the total loss incurred and send to both finance and the Compliance department.*

Non-Discretionary Action

- (1) Report the incident and circumstances to senior management and Compliance.
- (2) Recommend a course of action based on the evidence available.

(d)

- Ensure that phone recording facilities are available to my staff.
- Ensure that our procedures insist on written instructions to support verbal requests are in place and that no action is taken without written instruction.
- Ensure all my staff are made aware of the procedures.
- Ensure that our “Terms and Conditions” of business are clear on our minimum requirements re CA events.

15 You are the manager of your firm’s Cash Management section. Your firm offers contractual settlement in certain markets. However, you have noticed that your firm’s accounts at some of your various sub-custodians regularly go into overdraft.

- (a) Discuss the impacts that this has on your firm.
- (b) Identify what you think the probable main causes would be.
- (c) Outline the actions you would take to prevent this from continuing.

(20 marks)

Impacts

- Funding the cost of overdrafts
- Reputation costs
- Cost of remedial action
- Compliance issues with FSA

Probable Main Causes

- Late funding of accounts due to late value F/X deals.
- Repatriation of funds prior to actual settlement date.
- Incorrect internal projection positioning reports.

Action to stop continuance

- Identify commonality of problem markets.
- Review Cash Management Terms and Conditions under which the Fund Managers are acting as there may be anomalies due to error or redundant T&C timeframes.
- Review current T&C is in accord with your STP requirements for each market.
- Ensure internal F/X staff acting under current T&C arrangements.
- Determine problems and rectify by system change, procedural change or....
- Request Client Service managers to liaise with F/M to resolve issue if outside your firms control.

- *Request Client Service managers to liaise with F/M to resolve issue if outside your firms control.*
- *Set up monitoring process to ensure compliance with changes.*
- *Ensure T&C process is kept up to date based on countries rules.*

SECTION D

- 16 You are the Senior Operations manager of a Fund Management institution. It has been brought to your attention that some of the important client details concerning the country of residence of one of your wealthy private clients have been recorded incorrectly by your firm. These details have been incorrect since the client was taken on some years ago. Explain what action you need to take and what the ramifications for your client and your firm might be. (20 marks)

Need to corroborate the facts:

- *Examine the original account opening details completed and signed by the client.*
 - *Examine the proof of residency documentation on your files.*
 - *Review the copies of the client's passport.*
 - *Determine how the error was made and by whom.*
 - *Examine the sign-off procedures and who signed off the system data as correct.*
 - *Need to identify the ramifications:*
 - *What is the consequence of the change of residency on the client's dividend / interest income, withholding tax liability, and securities lending income?*
 - *Is the withholding tax liability significant enough to inform any UK or overseas tax authorities?*
 - *Do you need to inform the client of the error due to the fact that you need to make a repatriation of tax, the redress of any tax liabilities, the completion of new tax documentation?*
 - *Should your firm inform the client anyway?*
 - *Do you need to inform your compliance unit or the regulatory authorities?*
 - *Is there a likelihood that you will lose the client?*
 - *Is there any action to be taken against your staff?*
 - *Are the internal procedures strong enough?*
 - *Is there potential for any other incident?*
- 17 You are the Manager of the Transition Section in your firm's securities operations department. Your Board of Directors has decided to review the firm's costs as part of a drive to generate a better profit margin for the whole firm. You have been asked to produce a report which identifies the possibilities for cutting costs.

What would be the significant items that you would include in your report to your Board of Directors? (20 marks)

This is a fairly open question. The only qualifiers given in the question is the fact that the candidate looks after Transitions and that the board is looking for cost reductions. There are no clues as to the state of automation currently employed or the number of transitions being dealt with. This will test the candidate's business acumen and their ability to answer the question from a very high level business point of view.

- *Identifying the significant cost areas in the section*
- *Outlining the number of transitions completed over the last 6 /12 months.*
- *Produce a graph of sales completed and the anticipated transition activity over the next 6 month period to show trends.*
- *Report on the state of the technology currently employed (level of STP employed) in your area. Hence the ability to cut staffing levels or not to increase staffing levels.*
- *Description of the level of manual intervention required.*
- *Report on the number of staff employed in your area.*
- *Report on the overtime levels currently required.*
- *Report on current error rates / settlement rates (KPI's give firm's cost implications).*
- *Give a current "cost per transition" analysis.*
- *Attempt to give industry comparison of your areas cost effectiveness versus competitors (say whether it has been possible or not).*
- *Draw conclusions based on current workload, current technology support and future sales wins converted.*