



DECEMBER 2008

ADVANCED GLOBAL SECURITIES OPERATIONS

MARK SCHEME

Answer ALL questions in this section

- 1 Under the FSA rules, it is important to segregate client assets from those of the firm. Under these rules, new cash monies received for the benefit of a client by automated transfer is governed by a timing expectation. What is this timing expectation?
(3 marks)

Cash received for a client by automated transfer should be placed into the client's account no later than the next business day.

- 2 Investors who buy and sell units in a Collective Investment Scheme such as a Unit Trust or OEIC will be faced with certain charges. Identify THREE of these typical charges.
(3 marks)

- *Initial Fee*
- *Management Fee*
- *Performance Fee*
- *Exit Fee*

- 3 *Cross Border Settlement* is terminology often used in the trading of international securities. What is *Cross Border Settlement*?
(3 marks)

Cross Border Settlement is the settlement of a transaction in securities that have their place of incorporation and registration in a jurisdiction other than that in which the transaction was conducted e.g. IBM have their book entry registration conducted in the US, but can be traded in Frankfurt, Germany. This in practicable terms means that the share ownership will be transferred in the US, but that the cash portion of the trade will transferred outside of the US in Europe.

- 4 Sub-Custodians form a vital integral part of the business known as *Global Custody*. Therefore it is very important that the performance of Sub-Custodians is regularly monitored. Give THREE examples of the components found in a good monitoring regime.
(3 marks)

- *Terms and Conditions of the relationship*
- *A Service Level Agreement*
- *Operational Performance Logs (to include Reconciliations, Settlement, Corporate Actions, Income, Withholding Tax, Market Updates)*
- *Schedule of future meetings / conference calls with the sub-custodian*

- 5 Securities Lending is a very popular business activity. Within this business activity there is something known as *Directed Lending*. Explain fully what *Directed Lending* is and name the TWO other types of lending programmes available to investors.
(3 marks)

Directed Lending is where the investor themselves takes total control of the lending process and negotiates loans, controls collateral and margins, initiates recalls, assumes counterparty risk, instructs delivery of securities and apportions fees to the underlying beneficial owners. The two other types of lending programmes are known as; Non-Discretionary and Discretionary (Managed)

- 6 In Corporate Finance Cash Management parlance *Asset Backed Securities* is common terminology. Describe what an *Asset Backed Security* is, why it is issued and what other strategic options might be available to a company instead. (3 marks)

- *An Asset Backed Security is a Corporate Finance mechanism for raising cash.* (1 mark)
- *They use existing assets of the Corporation to underpin the funding of another activity* (1 mark)
- *Other strategic options include a Rights Issue, or a Fixed or Variable rate bond issue.* (1 mark)

- 7 Corporate Actions are an important part of a company's corporate strategy. Explain THREE of the options a shareholder might have, should a company they hold shares in decide to announce and issue a Rights Issue. (3 marks)

Any three of the following;

- *Take up the rights*
- *Lapse the rights*
- *Buy more rights*
- *Sell part of the entitlement and take up / or lapse the balance*

- 8 Straight-Through Processing (STP) is becoming an increasingly important part of the Financial Services industry. Name any THREE of the key elements attributed to STP found within the definition of STP as described by the *European Central Bank* (ECB). (3 marks)

Any three of the following;

- *Automated end to end processing of trades / payment transfers*
- *Automated completion of confirmations*
- *Automated generation of clearing instructions*
- *Automated generation of settlement instructions*

- 9 When entering into any ongoing business relationship with another institution whereby a Service Provider provides certain services, most institutions would enter into a Service Level Agreement (SLA). Identify THREE of the consequences to each party to the SLA in the event that the Service Provider does not perform to the necessary standards as outlined by the SLA. (3 marks)

- *Financial loss incurred by the customer*

- *Regulatory breaches incurred by the customer*
- *Negative impact on the customer's performance*
- *Potential termination of the service contract*
- *Financial compensation required*

10 In some instances there is still a requirement to effect a *Certificated Settlement*. Identify THREE of the perceived risks that are associated with this practice.

(3 marks)

- *Potential fraud due to stolen / counterfeit certificates being used*
- *Certificates being lost in transit from shareholder to broker, registrar to shareholder, or broker to registrar (this encompasses all reasons for such communication)*
- *Cost of replacing lost certificates i.e. indemnities*
- *Capital requirements or insurance costs re outstanding indemnities*
- *Manual reconciliation of registered holdings vs certificated holdings*

SECTION B

TOTAL 30 MARKS

11 You are the manager of your firm's Securities Lending area. A client of your firm, who currently runs their own lending programme, is trying to decide whether to outsource this activity to your firm. Your senior management have asked you to prepare a presentation for the client which must outline:

(a) The fundamental tasks that your firm undertakes when lending securities;
(5 marks)

(b) The advantages to the client of outsourcing their lending programme.
(5 marks)

This question is designed to test the candidate's knowledge of the fundamental tasks when running a lending programme and to highlight the differences between Directed and Discretionary programmes.

Tasks should include;

- *Broadcasts Positions*
- *Negotiate Loans*
- *Delivers stock*
- *Manages Recalls*
- *Manages CA's and Income*
- *Manages receipt and delivery of collateral*
- *Manages Mark to Market of collateral*
- *Manages counterparty risk*

- *Apportion income equitably*

Advantages should include;

- *Becoming part of a much larger pool of assets*
- *Reducing cost base*
- *Reducing counterparty risk*
- *Reducing delays in Settlement due to outstanding loans*
- *Become part of the client base that enjoys CSDA*

- 12 A private client who is new to the global investment markets has asked you to describe to them what a CSD is and what an ICSD is. They have also asked you what the difference between them is. Draft a response to this question. (10 marks)

A CSD is an acronym for a Centralised Securities Depository. This is an organisation that exists within a single market infrastructure and whose purpose is to administer the safe transfer of ownership of securities either in an immobilised or dematerialised format. This nowadays can include Clearing and Settlement functions. In an immobilised format the transfer of securities from one beneficial owner to another, is completed in a book entry format. The name of the beneficial owner or their agent is held within the CSD. It is the CSD who is the registered legal owner of the securities. In a dematerialised format the CSD acts as a conduit to the share registrar who records the names of the shareholders in its system.

An ICSD is an acronym for an International Centralised Securities Depository. This is an organisation that is set up to allow the administration and safe transfer of the ownership of securities internationally in much the same way as a localised domestic CSD. It too can be used in certain circumstances as a Clearing and Settlement entity.

It can also be a conduit to other worldwide CSD's and will be act as an agent for those firms that use it. An ICSD will therefore interact with a CSD and will become an account owner within selected CSD's.

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

Discuss what you believe the fiduciary principles are that apply to holding a client's assets, together with the reasons for those principles. (10 marks)

- *To ensure that the firm will protect the client's assets at all times.*
- *This principle is based on the "Trustee" principles that a trustee should protect a client's assets "as if they were their own".*
- *This principle must be applied across all activities.*
- *It has to be applied to all activities because there are so many different ways in which a client's assets could be at risk.*

- *Firms (unless otherwise agreed) should segregate client assets from their own.*
- *This is to “ring fence” the client’s assets to ensure that the client assets are not used to bolster the firms own financial stability or soundness.*
- *Have those assets protected should the firm itself fails.*
- *This is to ensure that the client’s assets do not form part of the available funds to any receiver or administrator in the event of the firm’s financial failure.*
- *Do not use the client’s assets unless the firm has permission to do so.*
- *Again this is based on the fact that a firm should not be allowed to use any assets other than their own when running their own business.*

SECTION C

TOTAL 20 MARKS

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 have recorded notes to suggest that a verbal instruction to lapse all of the fund manager’s clients rights entitlement was given, whereas the fund manager’s staff say they did not issue any such verbal instruction, as they wanted to take up the rights and now want the position added to their clients’ portfolio. The value of the shares involved has since risen by 20%.
- Describe the actions you would take to clarify this situation.
 - Explain the key drivers that will influence the action you will take.
 - Itemise the action you would take to remedy the situation.
 - 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) Actions to clarify

- *Review the value of the current cost / loss to do what the fund managers wants to happen. 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 has 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, and in particular the taking up of rights.*
- *Review our policies as to what to do in the event of no written instructions being received.*
- *Review whether we were in compliance with our own policies in this regard.*

(B) Drivers

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

(C) Action to remedy

- *Assuming that the documented evidence shows that, the request to have written instruction to take up rights as a follow up to phone recorded evidence, our policies with regard to non instruction have all been adhered to and 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 cost / loss is over my discretionary authority I would report the incident and my action to date 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.*

In the event that there is evidence, that we did not fulfil all or any of our CA policies I would report the facts to my senior management for further guidance.

D Reoccurrence preventative action

- *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 that there is a policy to remind fund managers that there is a lack of 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 Within the investment industry as a whole it is accepted that each firm's records and *standing data* databases for clients are accurate and up-to-date. You have been asked to prepare a presentation to a prospective client to demonstrate where your firm will concentrate its efforts to ensure that the standing data is accurate and why.

Your presentation should:

- (a) Discuss why it is essential within the investment industry that each firm's client database records are accurate and up-to-date. (10 marks)

- *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.*
- *Residency accuracy is important to ensure that the correct withholding tax rates are applied.*
- *Client type status is important to ensure that taxes and regulatory issues are applied correctly.*
- *Residency accuracy is important to ensure that certain CA's are dealt with correctly.*
- *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 firms own assets.*
- *Reporting of activity and portfolio content both internally and externally*

- (b) Discuss the areas of operation within your firm that rely on these databases and illustrate, with examples, some of the effects that incorrect or incomplete database records could have on a firm. (10 marks)

- Settlements
Wrong data could result in;
 - *Settlement instructions sent to wrong Custodian / Sub Custodian / TPA.*
 - *Incorrect broker data sent on instructions.**Leading to failed settlement, potential buy-in issues, incorrect or late NAVs, with consequences for the firm's reputation.*
- Corporate Actions
Wrong data could result in;
 - *Wrong options being exercised.*
 - *Information being sent to wrong correspondents.*
 - *Inappropriate action being taken with regards to the CA (residency issues).*
 - *Incorrect accounting due to tax status.*

- *Assets could be placed into inappropriate tax buckets with Sub-Custodians effectively defrauding overseas governments of their rightful tax benefit. Leading to financial loss, incorrect or late NAV's, and remedial action being required with consequences for the firm's reputation.*
- Proxy Voting
Wrong data could result in;
 - *Wrong voting options being exercised.*
 - *Information being sent to wrong correspondents**Leading to incorrect voting or no voting with consequences for the firm's reputation, data protection issues and possible litigation.*
- Securities Lending
Wrong data could result in;
 - *Lending activity and rates unduly affected*
 - *Manufactured dividends incorrectly calculated*
- External Vendors
- *Wrong data could result in;*
 - *Information being sent to wrong correspondents.*
 - *Information being requested from wrong correspondents.**Leading to inefficiencies, data protection issues, with consequences for the firm's reputation.*
- Compliance
Wrong data could result in;
 - *Money laundering checks being breached or incorrectly carried out.*
 - *Know Your Client rules being compromised.*
 - *Incorrect portfolio building and performance issues.*
 - *Incorrect risks ratings being applied to the portfolio.**Leading to consequences for the firm's reputation and potential litigation.*
- Client Service
Wrong data could result in;
 - *Incorrect people being contacted.*
 - *Incorrect correspondence being generated.*
 - *Incorrect KPI performance.*
 - *Incorrect SLA performance.**Leading to consequences for the firm's reputation and potential litigation.*

SECTION D**TOTAL 20 MARKS**

- 16 You are a manager within your firm's audit team. Your firm has been the victim of several instances of *Buy-In* proceedings being instigated against it which has had a negative impact on the firm's Profit and Loss Account. Your senior management has asked you to review the situation and make recommendations as to what needs to be done to stop this worrying trend.

Describe what actions you would take to fulfil your senior management's request.

(20 marks)

- *Identify where the market rules allow a "Buy-in" to occur.*
 - *Identify the countries where this will be an automatic process that is generated after a set period of time initiated by the local Stock Exchange or Regulatory body.*
 - *Identify in which markets this period of time might be set at a zero tolerance level of "S+0" (S = Settlement date).*
 - *Alternatively the period might be set at "S+1" or any other period.*
 - *Identify the countries where the process is not automatic and has to be initiated by the "Buyer".*
 - *Review which markets currently have active "Buy-in" procedures.*
 - *Review your in-house processes and procedures to ensure that these are not compounding the problem.*
 - *Recommend that your firm ensures that the fund manager(s) are aware of the consequences and they only sell available stock.*
 - *Ensure that the fund managers are always made aware of the active "Buy-in" markets.*
 - *Review that the custodians / sub-custodians have good pre-settlement matching performance and policies that should alert settlement problems in those countries.*
 - *Review the custodians / sub-custodians "Availability reporting" in active buy-in markets to ascertain their ability to pre-empt problems.*
 - *Review the custodians / sub-custodians "Terms and Conditions" for the reporting of trades to them in the active markets so as to ensure that there is not a "timing" conflict that is helping to create the problem.*
 - *Recommend that an "early warning" mechanisms either by technology or manual means that warn of potential problems is created.*
 - *Ensure good communication exists with the local brokers either via the custodian / sub-custodian or by in-house methods.*
- 17 You are the Manager of the Reconciliation Department 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 in your own section.

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 Reconciliations 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 reconciliations being dealt with. Therefore I think this will test the candidate's business acumen and their ability to answer the question from a very high level business point of view.

- *Identify and report the significant cost areas in your section*
- *Outline what reconciliations are performed e.g. stock, cash, certificated holdings, dividend suspense etc.*
- *Outline the number and frequency of Reconciliations completed over the last 6 /12 months in each e.g. daily, weekly, monthly etc.*
- *Outline the recommended regulatory guidelines on the reconciliation requirements of each activity performed.*
- *Report on the state of the technology currently employed (level of STP employed) in your area. Hence the ability or not to cut staffing levels or not to increase staffing levels.*
- *Description of the level of manual intervention required to perform your activities.*
- *Report on the number of staff employed in your area.*
- *Report on the overtime levels currently required.*
- *Report on current error rates found within the firm's activities (KPI's give cost implications of these to your area re staffing).*
- *Give a current "cost per reconciliation" analysis.*
- *Draw conclusions based on current workload, current technology support.*
- *Recommendations on how to reduce the costs in your area e.g. how to reduce the reconciliation / staff cost ratios.*