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THE CUSTODIAN

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Introduction

A warm welcome to the sixth edition of *The Custodian*. Starting a publication is relatively easy – there is usually a good variety of stories to choose from for the first couple of editions. The difficult part is maintaining the momentum, ensuring there is a continuing flow of relevant and interesting articles for inclusion.

Fortunately, with coverage of 40 markets across Africa, Middle East and Asia, as well as new regulations originating from Europe and the US, there are always plenty of interesting topics competing to be included and this edition is no exception. Communication and exchanging views with clients are key elements of what we do at Standard Chartered Securities Services. This issue goes to press just after the latest iteration of our Securities Services Think Tank, which was held in London, and at which senior client representatives actively participated in discussions concerning important issues facing our industry.

Topics from this latest Securities Services Think Tank included how we expect the industry to shape up over the coming years, how the roles we all occupy in the investment chain are likely to change and what we need to do to keep ourselves relevant in this rapidly evolving world. China also figured prominently – Madam Jin Mei, Chief Representative for the People's Bank of China in Europe gave her thoughts on the likely development of "the Connects", leading into a lively panel conversation covering China access channels. The discussion covered recent changes to the QFII and RQFII regimes, which now allow clients to appoint more than one custodian in China.

Continuing the theme of exchanging views, The Network Forum taking place in Greece during the second week of June is fast approaching. Links to downloadable versions of this issue will be available at the Standard Chartered stand, which we invite you to visit. The Bank is proud to be a founder member of The Network Forum as well as a long-time supporter of its predecessor, NeMa. We have always sought to encourage frank debate and discussion within the industry and will continue to do so, in order to inform market developments.

Communication and exchanging views with clients are key elements of what we do at Standard Chartered Securities Services.

Hoping to see you in Athens!

Margaret Harwood-Jones
Global Head
Securities Services
Transaction Banking

Awards and accolades

Global Finance World's Best Sub-custodian Bank Award 2019

Region – Middle East

Countries – Bahrain, Ghana, Hong Kong, India, Indonesia, Malaysia, Mauritius, Oman, Pakistan, Philippines, Vietnam

Global Custodian Agent Banks in Frontier Markets 2019

WON 30 ACCREDITATIONS
Category Outperformance in 11 markets
Market Outperformance in 10 markets
Global Outperformance in 9 markets

DOUBLED ACCREDITATIONS SINCE 2017

Symphony Hackathon 2019

Most Cutting-Edge Technical Development Award

Global Custodian Legend 2019

Colin Brooks,
Vice Chairman of
Securities Services

Asset Servicing, Institutional Investor and Insurance Awards 2019

19 awards wins in 13 markets – Bahrain, Bangladesh, China, Indonesia, Jordan, Korea, Malaysia, Oman, Pakistan, Philippines, Singapore, Sri Lanka, Vietnam

Best Custody Specialist – Africa and Fund Managers

Mandates of the Year – Best Custody Mandate and Best Sub-custodian Mandate

Highly commended in 4 categories

Global Custodian's Leaders in Custody Awards 2019

Emerging Markets Continued Excellence for MENA

Best Bank Network Team

The Asset Triple A Asset Servicing, Institutional Investor and Insurance Awards 2019

CUSTODIAN BANKER OF THE YEAR

Somruthai Srikanchana,
Head of Securities Services,
Transaction Banking, Thailand

Positioning the largest offshore banking centre for "VCC"

The Monetary Authority of Singapore (MAS) has recently released what could possibly be the last consultation paper and set of documentation on the new Open Ended Investment Company (OEIC) legal and regulatory framework that will launch soon in Singapore. The structure will be called Singapore Variable Capital Company (VCC) and the Singapore parliament has already legislated on the act. We anticipate that this structure will be available to new funds in Q4 2019.

The new framework will give Asset Managers more flexibility as compared to the current unit trust structures and will reposition Singapore as an international fund development centre alongside other financial centres like Luxembourg, Dublin and Cayman Islands.

VCC will provide managers another option besides the current Unit Trust model that tends to be domestic in nature. The new framework will provide:

- Greater tax efficiency as VCC can access double tax treaties. As a domicile country, Singapore is uniquely placed on this front, compared to any other competitor
- Efficient and flexible structure which will allow for quicker and more innovative setup of funds
- Asia-centric – the Asset Manager can deal with the same time zone
- Access to passporting schemes like ASEAN Collective Investment Scheme (CIS) and Asian Fund Passport
- Economies of scale – VCC will allow the Asset Manager to have sub-funds with segregated P&L, providing them economies of scale on administrative functions

From Standard Chartered's perspective, this is ground zero as the changes will result in new managers coming into Singapore to disrupt the local ecosystem.

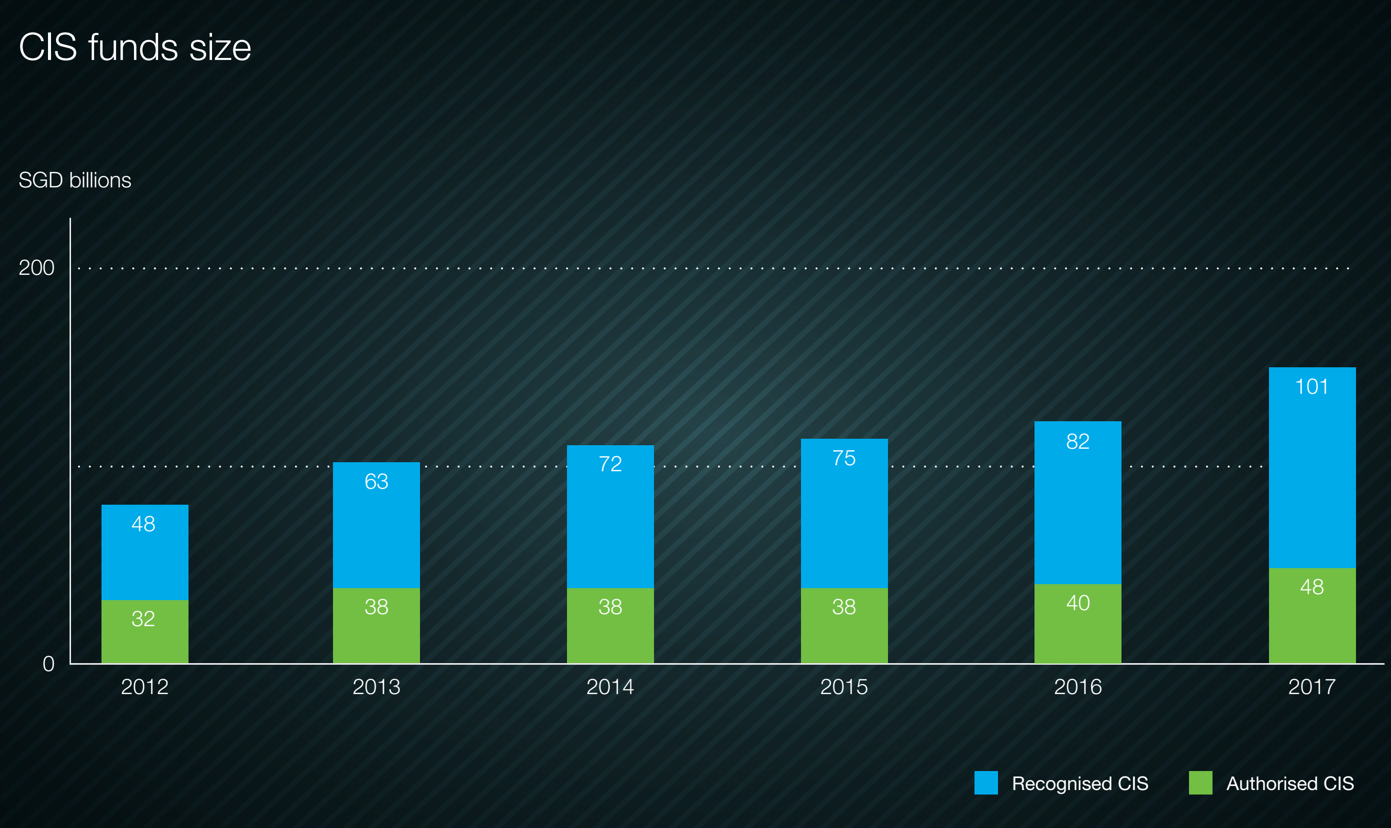
Current situation

The Singapore retail fund ecosystem is domestic-focused with a mixture of Singapore domiciled Unit Trusts and recognised offshore funds such as the Undertakings for Collective Investment in Transferable Securities (UCITS) funds. Though CIS AUM has grown from under USD40 billion in 2009 to over USD145 billion in 2017, much of the growth has been in UCITS (USD101 billion) as opposed to locally domiciled funds. The domestic funds industry is lagging in growth when compared to the overall investment fund market.

Focus from the government has led to Singapore becoming the biggest wealth management centre in Asia, managing a total of USD2.5 trillion currently and this is growing at a rate of more than 20% per annum.

However, domestic domicile funds are experiencing slower growth and are being overshadowed by offshore funds necessitating a fresh wave of ideas and structures for fund managers to setup shop in Singapore.

Singapore has all the key ingredients for a successful domestic funds centre. However, it has lagged from other successful centres in providing variable legal vehicles while setting up funds. The new consultation paper from MAS recommending the VCC structure in Singapore is addressing these gaps.



What is “VCC”?

VCC is a collective investment vehicle established as a company. VCC is designed to allow individual and institutional investors to invest in a well-diversified and professionally managed portfolio in a relatively cost-effective and tax-efficient manner. Conventionally VCC are only for open-ended funds. However, MAS is proposing VCC for both open and closed-ended funds.

Investor profile

- VCC allows for pooling of assets, or as MAS calls it, a cellular structure
- As an open-ended investment vehicle, investors can freely purchase and sell shares of the VCC and the value of the shares owned reflects the net asset value of the underlying assets

Regulatory reporting requirements*

- The prospectus, instrument of incorporation, key investor information, annual and periodic reports must be filed with the ACRA as defined in the companies act. ACRA will also act as a registrar. AML regulations will be under the purview of MAS
- Segregation of assets and liabilities at a sub-fund level

Open-ended and closed-ended funds*

- MAS will allow both open and closed structure for a VCC. However, redemption rights need not be set out in the constitution

Residency requirements*

- A VCC will need a presence in Singapore.
  - A registered office needs to be in Singapore
  - At least one director needs to be a resident of Singapore
  - The company secretary needs to be based in Singapore

Fund operational organisation structure*

- Governed by ACRA, VCC will be setup as an umbrella structure with several sub-funds comprising various share classes (which can be hedged). Flexibility on switching will be permitted
- Sub-funds will not have separate legal personality, but can be separately managed, charged and accounted for, and assessed for tax

Taxation*

- VCC will be exempt from capital gains taxes but income is taxable

Approved custodian

- VCC will need to be an “approved trustee” and will be accountable to MAS for safeguarding rights of shareholders

VCC is designed to allow individual and institutional investors to invest in a well-diversified and professionally managed portfolio in a relatively cost-effective and tax-efficient manner.

Ingredients for a funds centre

Investors
- HNWIs
- Retail
- Institutional
- Sovereign

Asset Managers
- Investment teams
- Labour force

Service providers
- Legal
- Regulatory advisors
- Fund administrators
- Custodians

Products
- Investment vehicles
- Unit trust
- Partnerships

What happens in Singapore with VCC?

- This will give Singapore a competitive edge
- There will be impetus to re-domicile funds from offshore locations to Singapore
- VCC simplifies the fund setup process, bypassing the onerous “Trustee” structure
- It might be a precursor to Singapore joining the Asian Funds Passport as this will provide a level playing field for funds setup between Australia and Singapore

Bigger pie of Asset Management manufacturing

- With the new VCC structure, Asset Managers in Singapore will have an option to setup locally as opposed to the European or Cayman route
- It may also attract other Asian, smaller European and US Fund Managers to setup in Singapore as well
- With numerous tax treaties, world-class infrastructure and a stable environment, Singapore now offers a compelling proposition as a funds domicile in the region and Asia in general
- As part of ASEAN which has around 9% growth of funds, VCC makes Singapore even more attractive
- With upcoming Asian Fund Passport, there is also potential for these funds to be distributed throughout Asia

Asset Managers reaction to VCC

Based on our discussions with local and foreign Asset Managers there is a positive reaction to this new VCC structure. In the short and medium term, we expect the launch of a few funds – firstly from local managers then from regional players. Key services which an Asset Management company will require to setup a VCC structure in Singapore will include custodial services, fund administration services, FX, cash and other advisory services. As an approved custodian, Standard Chartered will work with partners in Singapore to provide an end-to-end service to Asset Managers keen to setup a VCC structure in Singapore.

ISSA Financial Crime Compliance Principles for Securities Custody and Settlement

Traditionally, most policy and regulatory efforts to combat financial crime have focused on trade and/or cash and not on securities. Following several enforcement actions against custodians in early 2014 that related to sanctions and penny stocks abuse, the International Securities Services Association (the ISSA) recognised that the regulatory guidance covering securities business was limited and outdated.

ISSA started its work on drafting the "Financial Crime Compliance Principles for Securities Custody and Settlement" (the Principles), with the objective that once implemented across the securities and funds distribution industry, it would strengthen the control framework in place to prevent, detect and remediate financial crime related risks. The first version of the Principles was issued in August 2015, and subsequently revised in May 2017 and April 2019. Notably, the regulatory landscape continues to evolve over time and most recently in October 2018, The Financial Action Task Force (FATF) issued a guidance for a risk-based approach for the securities sector.

With the objective of protecting the global securities custody and settlement infrastructure and its participants from criminal activity, the Principles provide guidance to securities custodians (''Custodians") on how best to manage the risks that arise from the layers of intermediation between securities issuers and the ultimate beneficial owners. Custodians define the policies and procedures by which they will ensure compliance with these Principles, which apply to Custodians and account holders (Account Holders).

The 17 Principles cover policies and standards, Account Holder's assets – segregated versus omnibus accounts and disclosure of buyers and sellers. They provide practical guidance to Custodians on the appropriate due diligence measures to fulfil one of the recommendations set out in the Principles of client identification and beneficial ownership for the securities industry that were published by the International Organisation of Securities Commissions (IOSCO) in 2004. Particularly, the guidance under the Principles is focused on the question of transparency of ownership and control in intermediated securities custody arrangements.

Due diligence framework

All Account Holders of the Custodian shall be subject to the appropriate due diligence, the aim of which is to satisfy the Custodian that it is comfortable conducting business with the Account Holder, in the light of that Account Holder's risk profile and the nature of the business relationship that it will have with the Custodian.

In relation to the risk profile of the Account Holder, the Custodian has to assess its geographic risk, and its ownership and management structures. The Custodian will also obtain information on the products and segments supported by the account provided to the Account Holder (including relevant verification) to establish the nature of the business relationship that it will have with the Custodian.

Account Holder's assets – segregated versus omnibus

To ensure that due diligence adequately addresses the underlying risks, the Principles recommend that the Custodian ensure that all accounts opened by an Account Holder are clearly categorised as proprietary or for client assets. Client accounts must then be designated as segregated or omnibus, depending on whether the account is held for a single client or for many whose interests are commingled.

For proprietary accounts, the due diligence is tailored to the risk profile of the Account Holder.

For segregated client accounts, the due diligence conditions would include:

1. The Account Holder must be regulated and authorised to accept client assets and money; and must have adequate compliance and control functions to fulfil the obligations of safekeeping client assets.
2. The segregated client account must be associated with the name of the client of the Account Holder.
3. The Account Holder should disclose the asset's beneficial owners, that is, the end investor of the assets deposited.

In the case of an omnibus account, more stringent conditions are imposed by the Principles, whereby the Account Holder should:

1. Be regulated and authorised to accept client assets and money; and must have adequate compliance and control functions to fulfil the obligations of safekeeping client assets.
2. Represent that they have applied the due diligence requirements as communicated by the Custodian and taken risk-based steps to verify compliance with those requirements by their clients.
3. Screen transactions and holdings against relevant sanctions or other relevant lists.
4. Disclose to the Custodian the geography, segments and products which the account will support and inform the Custodian of any material change in the use of its account.

The Custodian should be entitled to require its Account Holder to disclose the identities of the ultimate buyer and/or seller of a security in response to a specific request predicated on risk factors within a reasonable period.

ISSA has created a due diligence questionnaire to guide Custodians on the specific industry risks that need to be addressed. The due diligence questionnaire, the Principles, the background and overview of the Principles and the examples of draft contractual terms to support the implementation of the Principles, are available on the ISSA website.

Standard Chartered Bank is represented as a board member in ISSA and actively participates in the ISSA FCC working group.

References

[1] ISSA Financial Crime Compliance Principles for Securities Custody and Settlement (April 2019) (https://www.issanet.org/e/pdf/2017-05-04_ISSA_Financial_Crime_Compliance_Principles_First_Revision_Final.pdf)

[2] Publication on 'Financial Crime Compliance Principles in the Securities Custody Business' (https://www.issanet.org/e/1/news/247-publication-financial-crime-compliance.html)

Understanding China

With a late start in the 1980's, China's capital market has been experiencing rapid growth in the context of the country's economic reforms and market liberalisation. Like many other industries and components of the economy, China's capital market also has multi-layered attributes with, for example, advanced infrastructure with scale and efficiency, underdeveloped derivative market, inadequately diversified asset management products, high direct participation of retailing investors, strong regulation from various regulators and inconsistent development across segments and industries.

In 1992, China started to open up its capital market to foreign investment through B Shares. At present, the major inbound channels include the Qualified Foreign Institutional Investor (QFII) programme, the China Interbank Bond Market (CIBM) and northbound Connect schemes for Stocks and Bonds. The Qualified Domestic Institutional Investor (QDII) programme remains the major outbound channel for local institutional investors, while the southbound Stock Connect is also developing well.

Further reforms and opening up is the ongoing direction set by the country's top leadership. The regulators are enforcing a series of rules to standardise the operations of the market players to be aligned with international standards, e.g. the new accounting rules, the new asset management rules, the establishment of the Sci-Tech Innovation Board. On the other hand, more measures are being taken to attract participation of foreign investors by relaxing cross-border fund transfers, simplifying entry requirements, streamlining the application process, dispelling tax ambiguities, expanding the investment scope, and allowing for Wholly Foreign-Owned Enterprise (WFOE) asset management business.

China market in numbers

2nd largest economy

USD13.12 tn

GDP as of Dec 2018

2nd largest equity market

CNY43.49 tn

total market value
as of Dec 2018

Source: PBOC

3rd largest bond market

CNY85.98 tn

total outstanding
as of Dec 2018

Source: PBOC

8th largest mutual fund market

USD1.78 tn

market value
as of Dec 2018

Source: IIFA

Fastest growing ABS market

USD413.61bn

total outstanding
as of Dec 2018

Source: cn-abs

Top derivative market

>3 bn

futures and options
traded in 2018

Source: FIA

Foreign capital

2%

equity market

2.9%

bond market

China Access

USD300 bn

QFII investment quota

USD255 bn

RQFII investment quota

CNY52 bn

Stock Connect daily investment quota

No restriction

CIBM Direct/Bond Connect quota

Our view – current highs and lows

Highs:
The investment environment will be further improved by a series of regulations implemented to instil discipline in participants' behaviour, mitigate risks, synchronise standards, and improve transparency.

Index inclusion of China's equities and bonds proves there is wide recognition of China's capital market by overseas institutional investors. In respect of equities, three major global equity indices (MSCI, FTSE and S&P Dow Jones) will start to include A-shares, or increase weighting of A-shares in 2019. The expected passive inflow will be around USD21 billion (data source: SC research). With respect to bonds, the Bloomberg-Barclays' Global Aggregate bond index (Global Agg) officially started the 20-month inclusion of China onshore government bonds (CGBs) and policy financial bonds (PFBs) on 1 April 2019. The expected passive inflows will reach to be around USD120 billion. The total expected inflow for both equity and bond markets is set to inject new vitality into China's capital market.

Further relaxation of foreign investment in financial sector and capital market has been announced in succession. In August 2018, the China Securities Regulatory Commission (CSRC) issued the Administrative Measures for Foreign-invested Futures Companies; this was understood as a breakthrough for the opening of China's futures market. In January 2019, the regulator in China doubled its QFII quota and further deregulated its capital market for overseas investors to expand investment in China. Most recently in March 2019, China's congress passed a massive revamp of its Foreign Investment Law to put foreign companies that invest in China on an equal footing with local firms.

Lows:
The continuous impact and uncertainty created by the China-US trade tension is casting a shadow on China's economic growth as well as foreign capital access. China's economy will suffer in the short term as a result of this. However, from a long-term perspective, the conflict will push China to face and remedy its shorts in economic structure which could lead to a further boost for China.

USD-CNY/CNH currency fluctuation is influenced by the China-US trade tensions as well. China has shown clear signals that it has a firm stance to keep USD-CNY under 7.0 in the foreseeable future. The People's Bank of China bill issuance is one of the easiest ways to define CNY at a relatively low cost. The previous three issuances were viewed as some of the most powerful tools to stabilise FX expectations. In order to protect the interest of investors, China has relaxed FX regulation, which allows investors to utilise FX derivatives onshore to mitigate FX loss.

Supporting clients in China

Even in the context of the trade war, China remains too big a prospective market to be overlooked or ignored. Currently, it is more important than ever for interested foreign investors to access the Chinese market with the support from viable partners who speak a common international language, and have a proven track record in the Chinese market.

From the custody of B shares as early as in 1992, Standard Chartered has been among the first select batch of foreign banks that provided Securities Services in each cross-border scheme as it was opened up by the local regulators. The Bank has also forged unique competitive edges in QDII with above 60% market share in trust companies and 15% in insurance sector. In October 2018, Standard Chartered was the first foreign bank granted a local fund custody license, and remains the only fully licensed foreign custodian in China.

The future of custody: work in progress

Does blockchain represent an existential challenge to custody or the next stage in its evolution? The potential for distributed ledger technology to collapse the post-trade securities value chain has intrigued and unsettled custodians in equal measure since blockchain first emerged as the supporting infrastructure for pioneering cryptocurrency Bitcoin.

Despite delays to certain high-profile blockchain-based initiatives, the topic continues to hold our attention. But, as experts pointed out at the recent Securities Services Think Tank event in London, the future of custody is not necessarily entwined with the development of one particular technology.

Indeed, a discussion on the future of securities was preceded by a Q&A session between Margaret Harwood-Jones, Global Head of Securities Services, and Nivaura's Head of Strategy and General Counsel, Richard Cohen, in which the latter said blockchain was important but not essential to the firm's end-to-end automated platform for securities issuance and lifecycle management. "Blockchain is just one part of our technology stack; ultimately, we're about automation," he said.

Nivaura, a London-based fintech automation startup, recently secured USD20 million funding to develop its services, and believes it can cut T+10 settlement times for debt issues to T+1, and eventually T+0, by automating and integrating data flows more efficiently. The firm is working on multiple projects globally but a core focus is supplying white-labelled platforms to market infrastructure operators and banks, including custodians. "Greater automation in the securities processing chain will cause disruption. Business models will have to evolve, but incumbent firms will still perform the same core functions," said Cohen.

The challenges to the status quo posed by firms such as Nivaura provided an apt appetiser for the main session, moderated by John Ho, Standard Chartered's Head of Legal, Financial Markets, under Chatham House rules.

While panellists acknowledged the need to rise to new expectations and the potential for disruption, they were quick to note that custodians, central securities depositories (CSDs) and other post-trade service providers had adapted nimbly and regularly over time. As new technologies offer opportunities to improve processes and services further, custodians may relinquish some of the tasks they currently perform. But there may be little overall change in the responsibilities expected by clients. In short, the 'how' of custody, may change much more than the 'what' over time. As one expert noted, custodians will still be required to serve as a sponsor of customer assets, but they may have a less intimate involvement in settlement processes.

Panellists cited diverse examples of projects leveraging blockchain and other innovations in technology to improve existing post-trade processes, from internal bookkeeping to proxy voting, and corporate actions. But they also flagged more transformative applications, such as the tokenisation of otherwise illiquid analogue assets, and the development of custody services to support digital assets, whether crypto-currencies, assets denominated in crypto-currencies or tokenised instruments.

In this respect, the future of custody looks similar to its past, with service providers focused on giving secure access to (and information on) a new generation of digitised assets within an evolving regulatory and technological framework. Panellists observed that once initial security reservations were overcome, it would be important to secure the end-points of nodes on a blockchain to support holdings of digitised assets – for example, via private keys – as they drew parallels with public internet-based data transfers between financial institutions.

Many high-volume sectors of the securities market are already highly efficient. As such, panellists suggested that future applications of new technology be best directed where existing processes and platforms had not delivered value. In view of this, candidates for greater automation, with or without blockchain, might include tokenisation of illiquid instruments, such as SME loans, accelerated issuance to meet urgent funding needs, and other areas where technology can reduce friction,

As new technologies offer opportunities to improve processes and services further, custodians may relinquish some of the tasks they currently perform.

risk and timelines or improve transparency and mobility of assets.

Although some have regarded blockchain as a solution in search of a problem, panellists noted that viable use cases are far from the only barrier to its deployment to deliver new efficiencies and new services.

Concerns over security, interoperability, resilience, standardisation and regulatory clarity can all provide a reality check, reminding innovators and disruptors of the need to consider existing obligations to customers. Panellists also noted the need to move at a pace consistent with wider market developments: real-time settlement processes have liquidity management implications.

These considerations may slow change, but will not halt it. Whether driven by competition, client expectations, or regulatory requirements, the custody landscape is increasingly marked by exploration, innovation and collaboration. Panellists attested to the range of pilots and proofs of concept being developed – and even postponed, with failure and revision being accepted as a part of the process.

In many respects, the biggest change being witnessed is one of mindset. Custody increasingly belies its popular image as resistant to change. Trust remains central to the custody relationship, but timeless principles can evolve as technology supports new ways to bring value. To illustrate the speed and agility now possible, one panellist cited the rapid establishment of a market infrastructure to support niche commercial paper issuance needs in competition with a slow, expensive service from the incumbent CSD. Whether or not blockchain proves to be the most disruptive technology, the pace of change will ultimately depend on the ability to meet customer demand.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