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CLEAR ENOUGH?

FINDING THE BEST LEVEL OF TRANSPARENCY

A FUNDS EUROPE REPORT IN CONJUNCTION WITH CLEARSTREAM

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Funds Europe is the leading journal for the cross-border funds business. Each month you will find detailed coverage of the funds industry, spanning Ucits, alternative investment funds and ETFs. We are unique in covering the full life-cycle of funds, from investment strategy and economics, through to regulation, asset servicing and post-trade services.

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Introduction

THE BALANCE BETWEEN TRANSPARENCY AND EFFICIENCY

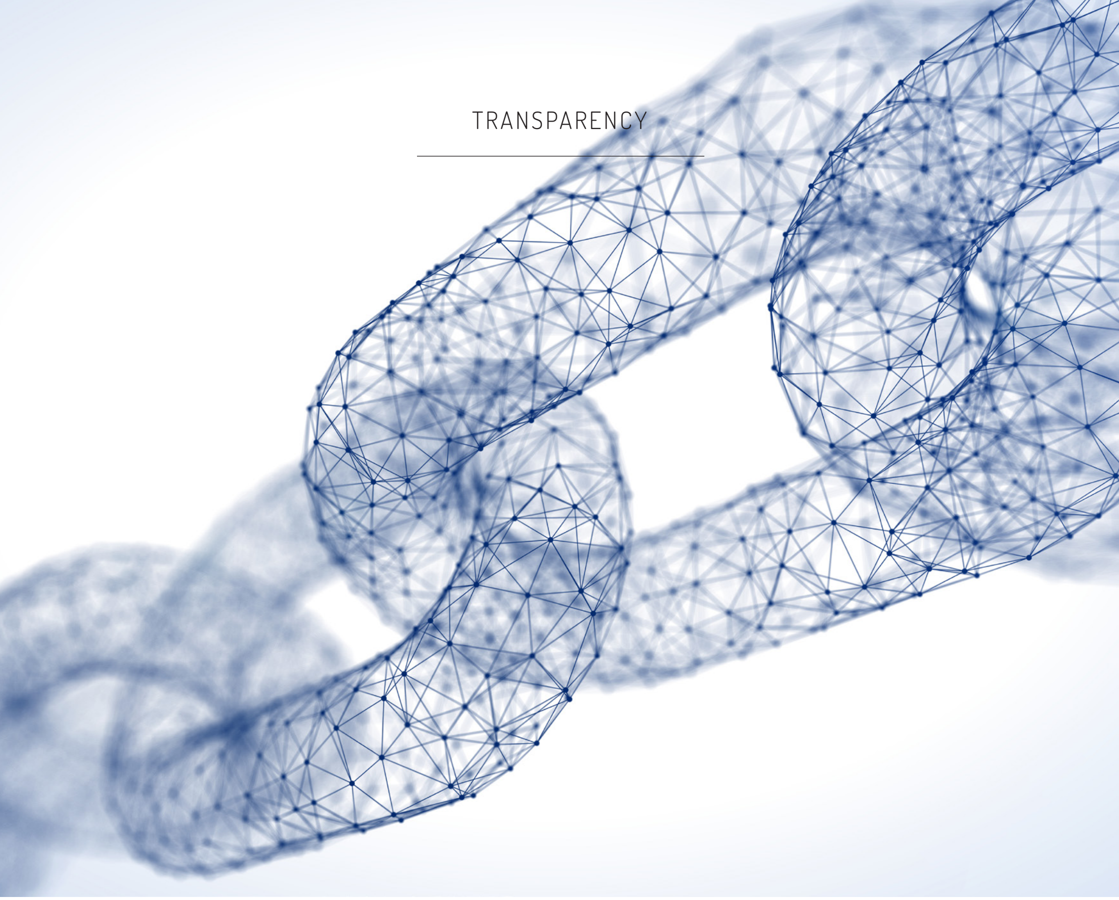
Transparent and efficient information flows are fundamental to the operation of the funds industry. Asset managers require information on fund sales to evaluate the activities of sales teams and to benchmark the performance of their distribution agents.

They may also require information on distributors and investors to meet regulatory compliance obligations. Under the second Markets in Financial Instruments Directive (MiFID II) in the European Union, for example, a management company must, under its product approval process, define a target market of end clients for each financial instrument it sells. It must then take reasonable steps to ensure that the financial product is distributed only to this identified target market and that all risks relating to these product sales are assessed on an ongoing basis.

When selling financial products, firms should also apply a risk-based approach to anti-money laundering (AML) and counter-terrorist financing (CFT) in accordance the European Supervisory Authorities' (ESA) guidelines on AML/CFT Risk Factors. These include details of where enhanced due diligence (EDD) should be used in 'higher-risk' situations – for example, when a transaction involves a politically exposed person, an unusual transaction, a high-risk country or a high-risk correspondent relationship.

While this information flow is important to management companies for commercial and regulatory-compliance purposes, it is important to look carefully at how this information is gathered and who is responsible for passing distributor or end investor information to an upper-tier intermediary. Often requests for information on end investors holding units in a nominee account are justified in the name of meeting customer due diligence obligations under AML and CFT legislation – when in some cases, the request is not strictly risk-based or AML/CFT-related.

This report highlights the need to be clear about the responsibilities borne by different players in the funds value chain and how an effective balance can be achieved between market efficiency and transparency of information.



How much transparency is enough?

FUNDS EUROPE'S LATEST RESEARCH PROJECT, IN PARTNERSHIP WITH CLEARSTREAM, LOOKS AT WHETHER COMMERCIAL INCENTIVES TO ACHIEVE TRANSPARENCY HAVE CREATED CONFUSION ABOUT THE APPROPRIATE DISTRIBUTION MODEL FOR CROSS-BORDER FUNDS.

IN THE NAME of transparency, asset managers are increasing their calls for more data about the distribution supply chain. Their primary motivation is commercial. A better understanding of the end client ought to make it easier for managers to measure and improve the performance of their distributors, marketing teams and product developers.

Regulation has given impetus to this demand for transparency. Rules designed to halt money laundering, on the one hand, and to prevent product mis-selling (the second Markets in Financial Instruments Directive, or MiFID II), are being used to justify the increased sharing of client data with managers.

But in the funds world, an often overlooked problem is that possession of customer-level data is a burden. If total transparency obliges asset managers and their transfer agents to hold records of every individual investor, a significant administrative duty will be assumed – with potential punishments for non-compliance. Not only that, but the potential duplication or triplication of administrative work may reduce the overall efficiency of the funds market.

> "AN OFTEN OVERLOOKED PROBLEM IS THAT POSSESSION OF CUSTOMER-LEVEL DATA IS A BURDEN."

Different practices

Part of the confusion about the feasibility or desirability of total transparency comes from the variation in market practices seen within Europe. Some markets are very far from being transparent. In France, for example, transfer agents typically sit behind regulated entities, namely banks, in the distribution chain. Individual investors generally do not transact directly with transfer agents, which are not in the habit of maintaining records of individual investors. Instead, transfer agents trust the regulated banks to do the various anti-money laundering and counter-financing of terrorism (AML/CFT) checks on their behalf. This type of practice might be called the correspondent banking model.

Luxembourg and Ireland are not that dissimilar from the French model. Although these are registrar markets, there are, in reality, only a few large institutions that appear on the registers, namely Clearstream, Euroclear and a handful of large banks. As in France, these institutions are regulated and have historically been trusted to carry out AML/CFT and other checks.

The UK is something of an exception to this model. In the UK, transfer agents have been geared towards dealing directly with the end investor. This practice arose in part because the structure of the UK's distribution market, unlike elsewhere in Europe, is not dominated by banks but includes a large number of independent financial advisers. The UK model is closer to full transparency than, for instance, the French model. That said, the Retail Distribution Review (RDR), a piece of regulation implemented in 2013 to reform the way advisers charge for financial advice, has altered the UK market by causing more assets to flow to intermediaries, such as fund platforms, and this trend has tended to reduce overall transparency.

Guidelines

Do European regulations call for more sharing of customer-level data between distributors, transfer agents and fund managers? This is not necessarily true, according to documents such as "Joint Guidelines under Articles 17 and 18(4) of Directive (EU) 2015/849 on simplified and enhanced customer due diligence and the factors credit and financial institutions should consider when assessing the money laundering and terrorist financing risk associated with individual business relationships and occasional transactions".

The document does make a recommendation that fund managers take measures to identify and verify the identity of individual investors underlying a financial intermediary. However, the document allows that, to the extent permitted by national law, and provided the situation is "low-risk", fund managers may trust an intermediary with this identification process and to carry out the necessary AML/CFT checks. This outsourcing of responsibility is allowed so long as the intermediary meets certain requirements, namely that it is regulated in a European jurisdiction or one with an equivalent regulatory regime.

Similarly, MiFID II will not necessarily require more sharing of customer-specific data. Its goal with regard to fund distribution is to prevent mis-selling of funds, for instance the sale of high-risk, sophisticated investment products to unsophisticated retail investors. The directive requires fund managers to exercise oversight of their distribution supply chain to prevent mis-selling, but it may be that aggregated and anonymised data in which end investors are split into categories (retail, professional, institutional, etc) would be sufficient to meet this obligation.

Risks ahead

Recent research has shown that funds industry professionals are aware of the risks involved with holding customer data. A survey by *Funds Europe* in partnership with Clearstream found that 72% of 101 respondents in a poll agreed that "fund companies should be careful about how much customer-level data they receive because each piece of data incurs regulatory responsibilities".

"IN A TOTAL TRANSPARENCY MODEL, THE CUSTOMER RECORDS WOULD BE TRIPLICATED AND HELD BY ALL THREE PARTICIPANTS."

Cross-border fund distribution networks help to explain why full information-sharing is burdensome. Let us take the example of a Luxembourg-domiciled Ucits fund that is managed by a Dutch asset manager and distributed by an intermediary, a regulated bank, in Italy.

Under the traditional model, the Italian distributor is responsible for AML/CFT checks and is the only participant in the chain that keeps customer-level records. By contrast, in a total transparency model, the customer records would be triplicated and held by all three participants.

From a compliance point of view, one might ask what purpose is served from this copying of data. The Italian bank is closest to the client and presumably best placed to determine the client's risk of money laundering or involvement in terrorism. Lacking a close relationship with the client, the Dutch asset manager would struggle to conduct its own AML/CFT checks. Yet, by holding the client data, the Dutch manager is exposing itself to regulatory action if the client is found to have laundered money or breached a sanction.

Blissful ignorance

With all that in mind, it might be wise for asset managers and transfer agents to be careful what they wish for. The commercial benefit of possessing customer-level data must be balanced against the administrative burden and regulatory liability entailed. As the saying goes, ignorance is bliss. Of course, some fund companies may argue the commercial imperatives outweigh the risks, but even they must recognise that there is a trade-off. Total transparency, for asset managers and transfer agents, has both a positive and a negative side.

For the following roundtable discussion, *Funds Europe* asked experts on fund distribution to discuss the merits and pitfalls of full transparency. **f**e

The transparency trap

OUR PANEL OF EXPERTS DISCUSSES THE BEST WAYS TO ACHIEVE EFFICIENCY, DATA REGULATIONS, THE CHALLENGE OF FRAGMENTED MARKET PRACTICES AND THE FUTURE ROLE OF TECHNOLOGY.

PANEL

BERNARD TANCRE
Head of Investment Fund Services, Clearstream

GAUTIER DESPRET
Client director, IQ-EQ

KEITH HALE
Fintech investor, non-executive director & adviser

MARK GEM
Chair of Clearstream Risk Committee, Clearstream

RAFAL KWASNY
Vice president, international transfer agent EMEA, Franklin Templeton

REVEL WOOD
Independent director and consultant

Photos: Michel Brumat

***Funds Europe* – How can the demand for transparency be balanced with the need for efficiency in fund distribution?**

Bernard Tancré, Clearstream – As a central securities depositary (CSD), Clearstream is focused on settlement, efficiency and safety. When we look at investment funds, we question why we treat them in a different way to other financial assets. The big difference is the amount of information that flows through the parties of the transaction. For example, the issuer needs information about how its salesforce is performing.

> "WE WANT TO SEPARATE THE INFORMATION THAT NEEDS TO BE PROCESSED FROM THE INFORMATION THE ASSET MANAGER WANTS."
>
> *Bernard Tancré, Clearstream*

There is also the regulatory aspect via AML [anti-money laundering] and KYC [know-your-customer] and the demand from fund providers to have as much transparency as possible and to then check every name from an AML/KYC standpoint. I understand the reasoning but would challenge it. We want to separate the information that needs to be processed from the information the asset manager wants to use for commercial or compliance reasons.

Revel Wood, independent director – There are different needs and demand from different parties. There is also a disconnect between different regulators and their treatment of this data. The FATF [Financial Action Task Force] states there must be a complete look-through to the ultimate asset owner while Esma [the European Securities and Markets Authority] has stopped short of that demand. And then you have fund promoters with their trailer fees that want to know what the distribution chain is costing them and the sales and marketing teams that want to know who's buying funds in which markets. The other side of the transparency debate is the efficiency and I struggle to see how we can achieve full efficiency without cross-industry platform initiatives. In the UK there are banks acting as placement agents, IFAs [independent financial advisers] and third-party marketers, all with different forms and with different local regulations. Europe is not like the US, where all 50 states have the same basic process and rules. This is where the likes of Clearstream could help.

"I STRUGGLE TO SEE HOW WE CAN ACHIEVE FULL EFFICIENCY WITHOUT CROSS-INDUSTRY PLATFORM INITIATIVES."

Revel Wood, independent director

Keith Hale, fintech investor – Does more transparency all the way through the value chain create more efficiency?

Wood – No, I don't think it does, not until standard formats are established as was done in middle-office and settlement processes.

Rafal Kwasny, Franklin Templeton – I think transparency may actually lead to more efficiency. For example, everybody is collecting KYC documents and performing AML processes in the same way and the whole industry sees it as a burden. Sooner or later there will be a solution there that will lead to reduction of paper flows and a more efficient model. I do not see that happening very soon but many people are already working to find a solution. Another example is the transparency around costs. Since 2019, there will be more transparency around cost as a result of MiFID II and that may lead to further cost pressure and greater efficiency.

Hale – If you were starting the investment value chain from scratch today, you would have far fewer intermediaries with more inherent transparency, thereby reducing the need for reconciliations between the various parties such as omnibus accounts and individual investors. So I don't think transparency and efficiency are balanced today, given the current structure of the wider industry.

Tancré – We are looking for this new infrastructure to help with AML/KYC, but a lot of asset managers are already using distributors and paying them a lot of money. One of the things they can do is those AML checks. When we are an element in the chain, there's the desire to look behind rather than really trying to trust the nominee who is doing the work. It's ironic to me that we're trying to find new parties to whom we can delegate but

such delegation is already inherent in the correspondent banking model. That is why this desire for transparency is really motivated by commercial and not regulatory reasons. The problem with the latter is that it very often gets in the way of efficiency and generates additional cost, because all this information needs to flow through the channels that are normally just for the transaction.

Gautier Despret, IQ-EQ – We do not all speak the same language when it comes to transparency. What is requested by the fund manager is different to what is requested by the regulator. They do not want or they do not ask exactly the same thing, so we are sacrificing efficiency for the sake of transparency. We need to find

"TOO MUCH TIME AND EFFORT GOES INTO CHECKING TRANSACTIONS THAT ARE NOT SUSPICIOUS."

Keith Hale, fintech investor

a way to reduce the amount of paper that is involved.

Mark Gem, Clearstream – In all other financial instruments, if you have a value chain where the intermediary is itself equivalently AML-regulated, then you just need to deploy risk-based controls. These controls are not aimed at transparency in the sense of information or documentation, they're aimed at making sure that you as an upper-tier intermediary know if there's a problem downstream to which you should react by, for example, not processing or whatever it may be. Nowhere else, from bonds to equities, does this notion that the investor's identity needs to be known at all steps in the chain ever come up.

***Funds Europe* – Should fund companies be careful about how much customer-level data they receive because of the regulatory responsibilities they might incur?**

Kwasny – Most of the asset managers do not want to own the end customer. They want to know end-investor product needs and their buying behaviour but not necessarily collect their personal identification details. MiFID II [the second Markets in Financial Instruments Directive] rules around collection of data related to product governance do not require sharing all the details such as the beneficial owner's name, address and so on.

Tancré – That's why MiFID II is really welcome from our standpoint, because it provides a good regulation justification and, if you like, leverage to have the commercial information, and the right level of commercial information that you want to have anyway, so that you don't have to call to the AML/KYC which is generating this friction in terms of efficiency.

Wood – This is incredibly complex because there's a large remit of regulations that are sometimes conflicting or different in nature, from the SEC [Securities and Exchange Commission] to MiFID II to AML and KYC to GDPR [General Data Protection Regulation]. The divergent nature and purpose of some of these regulations make it difficult to know how much information and for how long you keep information. It is a problem that we have not solved. We have said over and over again that the fund company, and fund promoters especially, do not need all that client data. As the management company – and here it's been difficult over the years, because the market hasn't been harmonised – we have seen challenges where regulation applying to a management company may contradict target market regulators' data-protection laws. But we still need to ensure the distribution chain is being overseen and that there is equivalent

"BLOCKCHAIN COULD CREATE SOME KIND OF REVOLUTION, PARTICULARLY IN THE ALTERNATIVES WORLD."

Gautier Despret, IQ-EQ

regulation for our delegates and global distributors.

Hale – It depends on what you mean by 'customer' – the end investor or a private or retail bank that is servicing the end investor? Or the fund platform in between? Or any of the other intermediaries in the value chain? From a commercial perspective, the fund wants as many inflows as possible, as well as catering for the necessary regulatory requirements. But the actual end customer is often not clear in what is a multi-layered hierarchy. Currently there is very little data used by the fund manager compared to what is available at the end-investor level. The fund managers don't need complete transparency but I understand why they'd want more understanding of the end clients than they have today, and not just for regulatory purposes.

Tancré – There's an optimum level of data, depending on the distribution model, that will satisfy my commercial needs and no more than that.

Kwasny – It's not a question of whether we should avoid collecting data because we are afraid of not complying with GDPR. It is instead about whether the data can actually

bring extra value and deliver better products and solutions and better client experiences.

Tancré – It's a question of what you get exposed to and the ambition of what you do with it. OK, yes, you have that transparency because you feel you need it, but then you're not consequently doing all the things you need to do with it. That's where the risk is.

***Funds Europe* – Market practice varies significantly between markets. What are the main challenges involved with this fragmentation?**

Despret – One of our main challenges is regulatory surveillance. There are differences between the Luxembourg, French and UK markets, even if the spirit of the

"IF WE COULD ALL TAKE THE DATA FROM A SINGLE SOURCE, THEN IT COULD BE A SINGLE SOURCE OF TRUTH."

Rafal Kwansy, Franklin Templeton

regulations is broadly the same. Once rules are translated into different country law, some of that spirit is lost or diluted.

Wood – It will be interesting to see how the market evolves. One of the consequences of the Retail Distribution Review in the UK was the consolidation of IFAs. We are already seeing consolidation in some of the management company space as a result of increased substance requirements.

Surely at some point, there must be a utility because we all individually collect much of the same information, and I don't believe this creates competitive advantage but does create cost and inefficiency for the end investor. But then the issue of GDPR comes up and how personal data is kept by the central hub but used by multiple parties. I'm sure some smart disruptor firms will figure it out because we have to have more efficiency, transparency and value for money for end investors in an increasing regulatory environment.

Hale – That's the irony of the whole AML situation. Generally speaking, too much time and effort goes into AML and checking transactions that are not suspicious. In fund distribution, you've got the same four or five thousand distributors that everybody uses and the industry puts untold duplicative effort into checking those accounts and transactions by all the TAs and asset managers. Why don't we just have a centralised capability for low-risk transactions and then focus on those peripheral cases where there are dubious-looking entities and transactions?

Gem – Yes, I know and that's exactly the point I'm making, it's diverting that effort.

We'd strongly favour some kind of repository of information that embraced all of the intermediaries and participants in the system, because clearly that's what has to happen for that mission to be fulfilled. It's not rocket science to collect the documentation. One thing that will convince the regulators is if the documentation is provided by the firm itself, not by a data vendor pulling it off the internet. We could do that too. That, to me, would take a lot of pain out of this, and I think even the most risk-based compliance teams are probably only spending 25% of their resources on risk-led duties and the rest on rules-based measures. Compliance teams have a strong incentive to avoid audit and regulatory findings. If you're not collecting the right bits of paper, the auditors may find that you have "structural AML deficiencies".

> **"THERE IS A BLOCKCHAIN GOLD RUSH GOING ON, BUT THE REAL CHALLENGE IS ADOPTION."**
>
> *Keith Hale, fintech investor*

Kwasny – The market fragmentation leads to lots of customisation. There are many market-specific operating models which require you to employ local service providers. In theory, you may be able to do it centrally but in practice, it doesn't make any sense because of cultural reasons, for example. There are plenty of differences in distribution operating models. Some markets are more IFA-focused, some are more dominated by banks or nominee accounts, some are CSD [central securities depositary] markets where you see a different model. That creates extra cost, extra effort and a lot of customisation.

Gem – If you were building it from scratch, you wouldn't do it in this fragmented way. But we are where we are, so let's try and find ways to harmonise and develop a standard, because the current market is inefficient, costly and doesn't really benefit anybody, certainly not the end investor.

***Funds Europe* – What role should blockchain technology play in fund distribution?**

Hale – I'm an investor in a blockchain company called Cygnetise, because I am actually a little bit of a sceptic. Blockchain is a great technology, but it reminds me of the World Wide Web in the late 1990s which resulted in the dotcom boom and bust. There is a blockchain gold rush going on right now, but the real challenge is adoption. Many blockchain initiatives require replacing the current intermediaries to create peer-to-peer communication between parties. However, those intermediaries, including various banking entities, have very high walls and very deep moats due to the nature of their business. In other words, they've got customers, capital, incumbency and competency and lots of different reasons, good and bad, as to why they are there. As a result, they won't be easily replaced without a high level of cost and risk.

Gem – And they've invested in the blockchain companies.

Hale – A lot of blockchain propositions like FundsDLT, FNZ, Calastone and Iznes are attempting to completely change the way that fund distribution works today. These propositions are often based on a single blockchain-based registry that everyone shares. I think it's a commendable concept but the adoption

"QUANTUM COMPUTING IS GOING TO BE THE NEXT THING – IT WILL MAKE AI MEANINGFUL."

Mark Gem, Clearstream

challenges are enormous, due to replacing the complexity and disintermediated processing in the current model servicing trillions of assets in Europe.

Kwasny – I would agree. Blockchain has the potential to impact the distribution of funds only if distributors start using blockchain, but I don't hear much about distributors implementing it. There is this concept of pan-European transfer agent, but it's not about distribution, it's about a new system developed in the new technology rather than a change of the fund distribution model.

Gem – What is transforming parts of financial services distribution? It's certainly not blockchain. Twelve months ago, if you put blockchain in the name of your equity, you got a 40% increase in your stock price in the next seven days. Today, that figure's down to about 17%. We monitor this. Where you can see the transformation actually taking root is in the notion of open banking under PSD2 [the revised Payment Services Directive], where you force bank account providers to make their information available to third parties – fellow banks, but also certain specialists or disruptors. That is indeed transformative in areas like retail FX, in person-to-person payments and so forth.

The technologies that enable that, interestingly, do not include blockchain. The major enabler is the application program interface (API), because it is technology that allows you to make that data available to others.

Hale – The funny thing about APIs is that they've been around ever since I was a programmer in the 80s. It's just that initiatives like Payment Services Directive II have made them fashionable and more relevant to people other than technology geeks.

Kwasny – Blockchain is a technology. It doesn't revolutionise business models on its own. It requires scale and volume, and a lot of cost must be added to build the functionality to make it multi-asset and multi-markets-compliant. The question is whether it will sort any of my business problems. If I replace one system with the other, it's just doing the same in a different technology than the current system. Functionality-wise and from an end-customer perspective, it doesn't sort any of the issues. Distributors still want to send Swift instructions and receive Swift confirmations back.

Hale – These initiatives only work if you manage to get an industry-wide utility off the ground, and to get utilities established is notoriously difficult, because it means removing the high walls and deep moats of the incumbent intermediaries. I'm not sure there is a real business case at this stage.

"IN FINANCIAL SERVICES, WE ARE QUITE BEHIND WHAT IS THE NORM IN OTHER BUSINESSES."

Rafal Kwansy, Franklin Templeton

Tancré – There is a business advantage indeed when you look at the end state. It's the road to that end state that has a difficult business case.

Gem – What adds value is first standardisation, and second the utilities and technology that enable it. Standardisation is only very rarely the limiter. I can think of specific cross-industry processes where even if you told me that I was not allowed to use any technology invented in this millennium, I could take 95% of the cost out, but only if all of the participants cooperate. That's where the value is, but the problem is of course that your cost is someone else's revenue and so forth. A lot of people, including frankly all of us, except maybe Keith, live from friction.

Despret – I think blockchain could create some kind of revolution, particularly in the alternatives world. We need to separate the fantasy from the reality, because we know that we will never have the full disintermediation. We will still need someone to validate the transaction, especially if the transaction is with real money and not with digital assets... But with some asset providers, we think that blockchain could bring something to the industry, maybe not for the fund distribution but more for the transfer agent by adding smart contracts, by just having software in place for the AML/KYC perspective, by just replacing low-value tasks and helping people just to focus on the high-value elements. That's why blockchain could also be helpful, but the issue with blockchain is also the fact that the data is public. This will create some data security issues or restrictions on who will have access to what. Potentially you could have a fund-specific blockchain or a transfer agent blockchain within the blockchain.

Hale – There's no issue with having a private blockchain. The challenge is the industry-wide adoption. To create real value, it needs to become a utility that the industry uses. I get the fact that if you've got a distributed ledger where all players up and down the value chain or across organisations share in the same registry, then there is huge benefit, rather than everybody having parts and copies of the data then reconciliation between them. I think we may see small pockets of blockchain activity appearing in specific regional markets or in an asset class like private equity. But to get it fully adopted in the mainstream is highly challenging, so will take many years.

Kwasny – Various initiatives and industry projects try to do the very complex things in blockchain rather than simple peer-to-peer transactions or sharing public information like market data or of funds-related static data. It is currently a huge spaghetti-like model, so why not put it on the blockchain? Everybody is complying with the same rules, so there is a potential to centralise it. Whether it's data providers or a fund or an insurance business, whoever needs the data, if we would all take the data from a single source, then it could be a single source of truth. To me that's a perfect example where the blockchain business case could be built.

Gem – Why are we so much worse at blockchain than our fathers were? What I mean by that is there are several instances of the industry, particularly in the 70s, where competitors got together and built single points of truth in order to solve real-world problems. Our firm [Clearstream] is a product of that and Euroclear is another. Virtually every single domestic capital market organised a depository function only in the 70s. In other words, when the operational pain of the spaghetti got to a certain point, our fathers grasped for the blockchain, which in those days was obviously more technologically primitive but amounted to the same thing – a single record. Why was it easier then than it is now? Is it just simply that the pain is not enough?

> “I WOULD ASSUME THAT WE WILL TAKE DECADES TO MOVE TO A NEW WORLD.”
>
> *Gautier Despret, IQ-EQ*

Hale – No, it's the cost and risk of changing spaghetti that has been added on to their legacy technology developed in the 70s for storing a single record to deal with the ever-more complex environment we have developed since then. For example, back in the day, asset managers used to have a registry of retail investors. Today we have a highly complex multiple-layered value chain.

Gem – Yes, the settlement agents walked around the City of London with briefcases.

Hale – Now we have a depositary doing the settlement and we have a fund platform with the global distributor talking to a local distributor. The world has got more complicated. There are bigger assets and more complicated, international flows. Because of that legacy, to then reinvent it in a standardised, simplified blockchain-based solution is going to take some time.

Kwasny – There is also people's resistance to change. Even the simple changes have not been fully implemented, for example, moving to Swift ISO20022. There are still people using

ISO15022. And there are still companies sending faxes.

Gem – I asked the same question to Ian Saville who set up Crest in the UK. He said it wasn't just that it was painful and it wasn't just that it was expensive. What triggered people into action cooperatively was the fact that they could not physically get the work done any more. It was the same with the foundation of the DTCC [Depository Trust & Clearing Corporation], because the settlement backlogs were running into months. Maybe you need market failure before you can implement big market changes.

***Funds Europe* – What technologies, other than blockchain, will have a transformative effect on the fund distribution market in the next 12 months?**

Hale – The lowest-hanging fruit is robotic process automation (RPA). There is a huge opportunity to use robotics to solve some mundane, manually processed problems and increase efficiency. You can make some simple fixes to manual processes using RPA technology.

A more interesting subject is the development of robo-advice. At the moment, we are in version 1.0 in terms of the artificial intelligence and machine learning behind robo-advice. But if you can add a more sophisticated layer of machine learning that enables robo-advisers to augment what asset and wealth managers do in terms of generating alpha for their investors, that would be very beneficial. The technology already exists, so it does not involve reinventing the world industry but just doing a better job with better tools.

Kwasny – There is a transformational opportunity with the cognitive tools and artificial intelligence. In financial services, we are quite behind what is the norm in other businesses.

Gem – Robotics has been quietly transformational by keeping costs in check in a way that you can't see. We've had amazing experience with robotics. I'm always been surprised by how primitive the actual technology of AI machine learning still is. Basically, we use the same algorithms as Tesla uses in its self-driving cars to work out whether there's problematic material in a prospectus.

Quantum computing is going to be the next thing, because it will make AI and machine learning actually meaningful beyond just flexible algorithms, which is essentially what they're doing now. I think we're going to start seeing the first edges of that into financial services this year.

Tancré – The danger with robotics is that it hides the lack of technology standardisation. My hope in this short 12 months is that we see more collaboration and adoption of existing standards by a wider group. This would significantly increase efficiency. It's a pity that sometimes we have to use artificial intelligence or robots just to offset the lack of adoption of ISO20022.

Despret – Artificial intelligence will not transform the world tomorrow. Everything we teach the technology will be dictated by the market and its rate of adoption. It will depend whether other parties or customers are ready to have that technology or are tech-averse. There will be no revolution in the short term, but it will be a different world in the longer term. We took decades to digest the current regulations, so I would assume that we will take decades to move to a new world. **fe**

Focusing on where the risk is

THE ISSUES RAISED BY NEW REGULATORY PRESSURES

***Mark Gem**, Chair of Clearstream Risk Committee and Member of the Executive Board at Clearstream, questions why it has become so challenging to fulfil compliance requirements around transparency and disclosure in the collective investments industry when these tasks have been managed efficiently for cash securities instruments for many years.*

FOR ASSET MANAGEMENT companies, there is considerable value in sourcing detailed information on how funds are being sold across their global distribution networks. This is important, for example, in monitoring sales performance across regional marketing teams, in benchmarking local distributors and in analysing retrocession flows. It may be important also for meeting product governance requirements under the second Markets in Financial Instruments Directive (Mifid II). This directive requires that a management company identifies 'target markets' for its fund products and takes reasonable steps to ensure that the financial product is distributed only to this identified target market.

While this information flow is important to management companies for commercial and regulatory-compliance purposes, we need to look more closely at how this information is gathered and who is responsible

"THE CONFUSION ARISING FROM AML-RELATED DUTIES HAS LED TO COMPLEXITY AND FRICTION."

for passing distributor or end investor information through to an upper tier intermediary. In particular, AML-related duties of asset managers, their management companies and distributors have become unnecessarily confused with the role of custodial intermediaries delivering platform services for distributors. This confusion has led to complexity and friction whilst doing little, if anything, to protect the industry from AML-related vulnerabilities.

Often requests for information on end investors holding units in a nominee account are being justified in the name of meeting customer due diligence obligations under anti-money laundering (AML) and countering the financing of terrorism (CFT) legislation, when in many cases the request is not risk-based or AML/CFT-related or, at the very least, is a request rooted in the fund's relationship with its own distributors.

Platform services

As a specialised fund custodian, Clearstream provides a suite of investment fund services via its Vestima platform designed to support the cross-border distribution requirements of the investment fund industry, embracing order routing, delivery-versus-payment (DvP) settlement and asset servicing functions (including fund custody and provisions to facilitate the use of fund shares as collateral).

As a matter of course, we provide details to asset management companies of the distributors that are marketing units in their funds through transactions supported on Vestima. This distributor information is supplied to the transfer agent appointed by the management company with the intention that the agent makes it available to the management company.

As market infrastructure providing fund platform services, Clearstream is regulated at a number of levels – as a securities settlement system in line with CPSS-IOSCO Principles for Financial Market Infrastructures, as a CSD under the CSD Regulation (CSDR) in the EU, and as a credit institution through holding a banking licence in the Luxembourg market.

Beyond this, Clearstream has a system of risk-based triggers in place and will request further disclosure on end investors in a fund when there is a risk-based reason for doing so. This is in accordance with our responsibilities under AML and CFT responsibilities outlined by the Financial Action Task Force (FATF).

This is consistent with the approach that we have long adopted in cash securities markets where, as an industry, a strong contractual architecture has emerged to support a risk-based approach to financial crime-related disclosure. As such, CSD participants holding a security on behalf of an end investor in a nominee account at a Clearstream CSD will, in certain risk-based situations, have a contractual obligation to disclose the identity of that end investor.

It is increasingly worrying in the investment funds segment, however, that pressure is being placed on platform operators to obtain end investor disclosure and documentation from nominee account holders (a fund distributor in this instance). In some cases, we believe that this pressure is not even AML-related but, where it is, the duty to obtain and supply it lies with

"CLEARSTREAM HAS A SYSTEM OF RISK-BASED TRIGGERS IN PLACE AND WILL REQUEST FURTHER DISCLOSURES ON END INVESTORS WHEN THERE IS A REASON FOR DOING SO."

Mark Gem, Clearstream

the distributor with whom the management company has a direct contractual agreement in place.

Clearstream's position is that it is not the responsibility of AML-regulated cross-border settlement platforms such as Vestima to provide a 'look through' of nominee accounts – other than for specific risk-based reasons. This is not required under FATF correspondent banking regulations and we do not believe this contributes to the efficiency of the market. If a management company is concerned that a distributor has failed to comply with the terms of its distribution agreement, this is a matter that the ManCo should take up directly with the distributor.

FATF has issued guidance on correspondent banking services in the wake of the global financial crisis. Importantly, these FATF recommendations do not require that financial institutions conduct due diligence on the customers of their customers.

Rather, these advise that a correspondent banking institution conducts enhanced due diligence on its direct intermediary (distributor) customers and that it "will monitor the respondent institution's transactions with a view to detecting any changes in the respondent institution's risk profile or implementation of risk mitigation measures, along with any unusual activity or transaction on the part of the respondent, or any potential deviations from the agreed terms of the arrangements governing the correspondent relationship."

In practice, where such concerns are detected, the correspondent institution is expected to request further information on the transaction(s) and the customer(s) involved. However, the correspondent banking guidelines state clearly that "there is no expectation, intention or requirement for the correspondent institution to conduct customer due diligence on its respondent institutions' customers".

Risk Factors

The general guidance that is provided at regulatory level in Europe regarding money-laundering and terrorist financing risk assessment is laid out in the European Supervisory Authorities (ESA) guidelines on AML/CFT Risk Factors. These guidelines, issued by the ESA in June 2017, are intended to promote a common understanding of a risk-based approach to AML/CFT and how this should be applied.

These include guidelines on due diligence and details of where enhanced due diligence (EDD) should be used in 'higher-risk' situations – for example, when a transaction involves a politically exposed person, an unusual transaction, a high-risk country or a high-risk correspondent relationship.

The ESA Risk Factors document is aligned in many areas with the standards laid down by the International Securities Services Association (ISSA) for preventing crime in securities markets (known as the Financial Crime Compliance Principles for Securities Custody and Settlement, FCCP). However, section 219 of the ESA Risk Factors specifies that a market participant may apply risk-sensitive measures to assess the adequacy of a service provider's due diligence procedures; and it may also ask for documentation on beneficial owners upon request.

At Clearstream, we strongly support the first of these principles, notably the right of market participants to apply risk-sensitive measures to evaluate the due diligence standards of their service providers. However, the second provision, the requirement to ask nominees to provide supporting documentation on end investors, is often difficult

to fulfil. The General Data Protection Regulation (GDPR) in the EU, for example, often limits our ability to access and pass on identification documentation (e.g. a passport or national identity card) of a beneficial owner.

When this level of look-through is required by a national regulator, a potential solution is to outline this provision in Clearstream's market guidelines. It is then clear to investors that they must adhere to this requirement as a condition for investing in a specific market or product. However, it is uncertain whether either the Luxembourg investment community or the Commission de Surveillance du Secteur Financier (CSSF), the Luxembourg financial regulator, will favour this approach.

A more general concern is that this provision under Section 219 of the ESA Risk Factors is not consistent with global standards around transparency and disclosure. As we have noted, this is not required under FATF Correspondent Banking regulations. Moreover, in the US, the world's largest mutual fund market, the Securities and Exchange Commission provides clear guidance that there is no obligation to look-through a regulated financial intermediary. The industry and the European supervisory community might perhaps ask themselves whether there is a sufficiently strong case to justify departure from global norms, especially when the effect might arguably be to undermine the standards that European regulators apply to all other asset classes whilst relieving key actors of the burden of fulfilling their AML-related duties.

Concluding thoughts

Clearstream is working constantly to offer efficient, automated operational processing and to maintain the highest standards of asset protection. However, we believe that applying AML standards to request information that is not already captured under the EDD provisions of correspondent banking standards is not a good way forwards for the industry.

When a fund processing platform such as Vestima is already regulated as a securities settlement system, as an ICSD and as a bank, asset management companies need to place their confidence in the application of the EDD requirement and to recognise that the identity of the distributor is already being communicated by our fund platform to the TA in a variety of machine-readable formats each and every time a subscription or redemption order is placed.

"APPLYING AML STANDARDS TO REQUEST INFORMATION THAT IS NOT ALREADY CAPTURED UNDER THE EDD PROVISIONS OF CORRESPONDENT BANKING STANDARDS IS NOT A GOOD WAY FORWARDS."

Any further information, over and above this EDD standard, is best captured through having appropriate risk triggers in place. As an industry, the general principle from an ISSA-compliance standpoint is to focus resources where the risk is. We believe that such an approach is also appropriate for the marketing of investment funds. From an AML perspective, UCITS or OEICs are low-risk financial instruments. Criminal parties wishing to launder money or to finance terrorism are unlikely to select these collective investment vehicles - which are publicly offered, tightly regulated and marketed through a closely supervised distribution network – as a means of doing so.

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