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The Power of Together

Custody – Charting a new course

New rules, new assets, COVID-19 and "going digital"

APAC Client Asset Segregation Industry Roundtable Meeting

2020

We recently gathered experienced professionals from major global banks for a roundtable discussion about safe custody and segregation of client assets. The roundtable was chaired by BNY Mellon's David Turley and KWM's Urszula McCormack and conducted via videoconference, drawing participants from multiple locations. In this innovative format, an engaging discussion followed under the Chatham House rule.

In particular, there was vibrant and wide-ranging conversation highlighting the rapid regulatory changes custodians face, market developments with respect to virtual assets, and the impact of the COVID-19 pandemic to custodians.

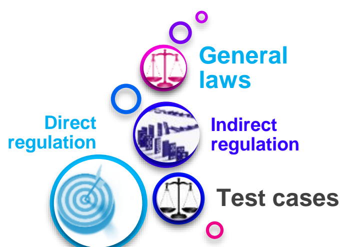
"We are in unprecedented times. Moving online is a way we can continue to move forward."

How are the rules of the game changing?

There was consensus among the group that the complexity and volume of national and extraterritorial regulatory change directly and indirectly impacting custodians is rapidly expanding, and verging on overwhelming.

The dual track of direct and indirect regulation

Traditionally, indirect regulation of custodians has been the go-to for many regulators in respect of client asset custody. This has taken the form of imposing a set of client asset segregation and safekeeping rules, plus custodian selection criteria, upon client-facing licensed entities. Custodians would then be subject to contractual requirements (not licensing), and general rules relating to anti-money laundering, privacy,, consumer protection, insolvency/bankruptcy and (in many cases) trusts.



However, there has been a marked shift to more direct regulation, including licensing requirements. The Financial Action Task Force (**FATF**) is instrumental in driving much of this change, and jurisdictions are beginning to introduce direct regulatory regimes for custodians in line with the FATF Recommendations for trust or company services providers and virtual asset services providers (**VASPs**). The likes of IOSCO, BIS and the FSB are also some of the key global policy influencers.

Custody standards are escalating

Stricter standards for banks, asset managers, exchanges and others already regulated are building. On top of that, direct enforcement of client asset protection rules by regulators in multiple jurisdictions such as Australia, the United Kingdom and Hong Kong is increasing.

Against this backdrop, participants remarked there is an escalating burden of keeping track of rapidly changing regulations across multiple jurisdictions.

Two key drivers for compliance monitoring emerged:

- **Continuous assessment of licensing requirements is required** - Custodians need to assess on an ongoing basis whether new licences or permits are required, particularly when rolling out new services or entering new markets. New regimes are rapidly emerging globally - ranging from basic **professional trust services** through to custodial arrangements for **public funds** and **virtual assets**.
- **Conduct requirements are becoming more granular** - New regulations and specific requirements need to be translated into heightened control measures and operational procedures to address escalating requirements. This may be an area of growing concern in audit investigations.

Some participants shared that they have dedicated teams to monitor any regulatory changes and to inform relevant operational functions to ensure that new or revised requirements are complied with. Nevertheless, the group's experience emphasised that a collective effort of compliance, legal and key operations functions are essential to ensure continuous compliance.

The discussion also touched upon the role regulators play – in particular, how regulators' receptiveness and assistance can facilitate robust compliance. Some participants relayed examples of regulators actively engaging and providing a good, practical and timely steer on how to comply with regulatory requirements.

For details relating to various custody regimes in major financial markets, please refer to the KWM publication on the future of custody. In this publication, KWM also provides compliance tips applicable across a range of asset classes.

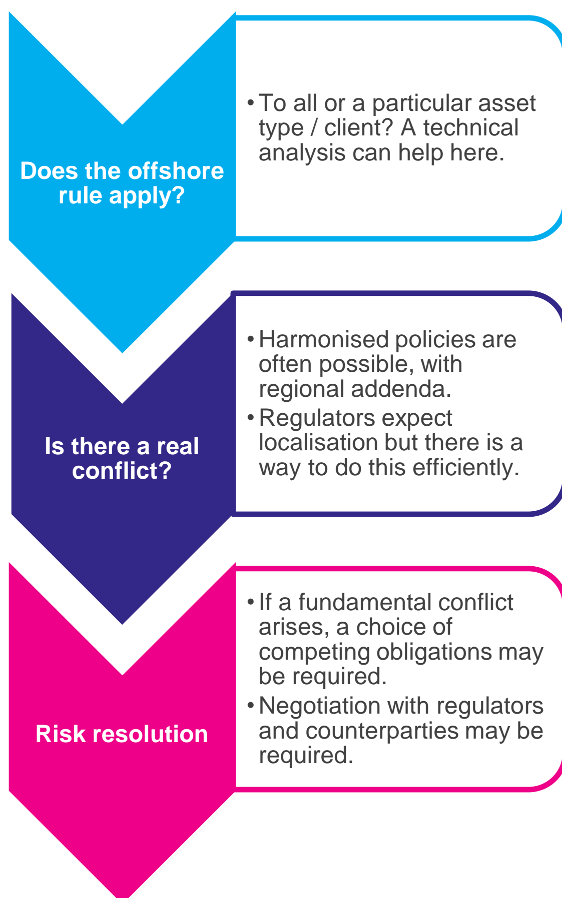
Tech tools to the rescue?

The discussion briefly turned to whether technology was the answer to managing regulatory change, but no resounding recommendations emerged. Lots of solutions exist, but there is always a human element to interpreting change and its application to the business.

Strategic decisions need to be made; implementation involves nuance.

The global dilemma – dealing with myriad obligations

The interplay of international obligations – and the increasing imposition extra-territorial requirements – makes compliance especially interesting for global custodians. There are times that these requirements create contradictory obligations. KWM shared their views on this issue by highlighting the key questions which could help guide participants faced with apparently conflicted requirements:



> **"Client demand for virtual asset custody has not yet been fully assessed – nor have the operational issues.**
>
> **But progress is being made."**

Virtual assets

Are global banks ready for the new world of coins, tokens, tokenised securities….

As virtual asset exchanges become increasingly subject to regulatory purview across jurisdictions, there is growing attention to the quality of custodians that those exchanges employ. And many traditional asset custodians are looking at entering the virtual asset custody market.

Different regulators seek to regulate virtual assets custodians in different ways. For example, Hong Kong has a generic regulatory regime of trust or company service providers and the crux of the Hong Kong regulations comes through indirect regulation. Whereas in Singapore, the forthcoming expansion of the Payment Services Act 2019 emphasises direct regulation. Detailed best practices are also emerging in locations such as Bermuda.

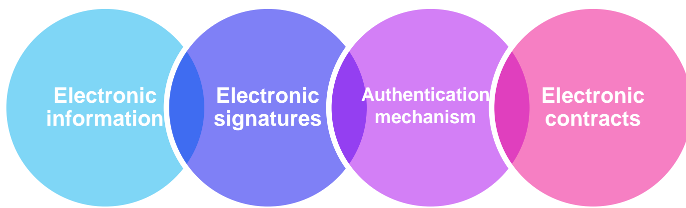
There are pros and cons to direct and indirect regulation approach, with the most important factor being regulatory clarity - both as to the rules, and with respect to regulators' expectations. FATF's VASP regime will also bolster regimes globally.

During the session, the group was polled on their approach to virtual assets and the key hurdles that they face to adoption. Most agreed a combination of factors applied.

Some participants see a lot of opportunity in the area, while some said that virtual asset custody is not on the immediate radar. The group discussed how virtual asset custody poses operational challenges to them, and anticipate that it could require significant resources to tackle.

Ultimately, it depends on whether the client demand received can justify going into the market.

"Going digital" – contracts, notices etc



The impact of COVID-19 – and the challenges of remote and flexible working – was a recurring theme throughout the discussion. To this end, the group discussed how some jurisdictions, such as Hong Kong and Singapore, have in place well-established regimes that facilitate electronic transactions. Generally, participants and their counterparts are receptive to electronic transactions, and aware that in many cases an electronic signature is as good as wet ink.

Of course, certain specific contracts may still require wet ink (eg trust deeds, wills), in accordance with local requirements.

Importantly, consent may be required to transact electronically in some jurisdictions. Client terms and conditions should include provision that recognise electronic contracts and notices. There may also be regulatory requirements which prohibit electronic contracts (eg face-to-face client onboarding requirements).

However, participants also related experiences where a fully electronic solution is not available. For example, a (physical) company seal or chop may be required when executing contracts in some APAC jurisdictions. While there may be workarounds available (eg exchange of signature pages with email confirmation), the benefits of legislative backing here are clear.

"We have to think on our feet."

Managing COVID-19 impacts

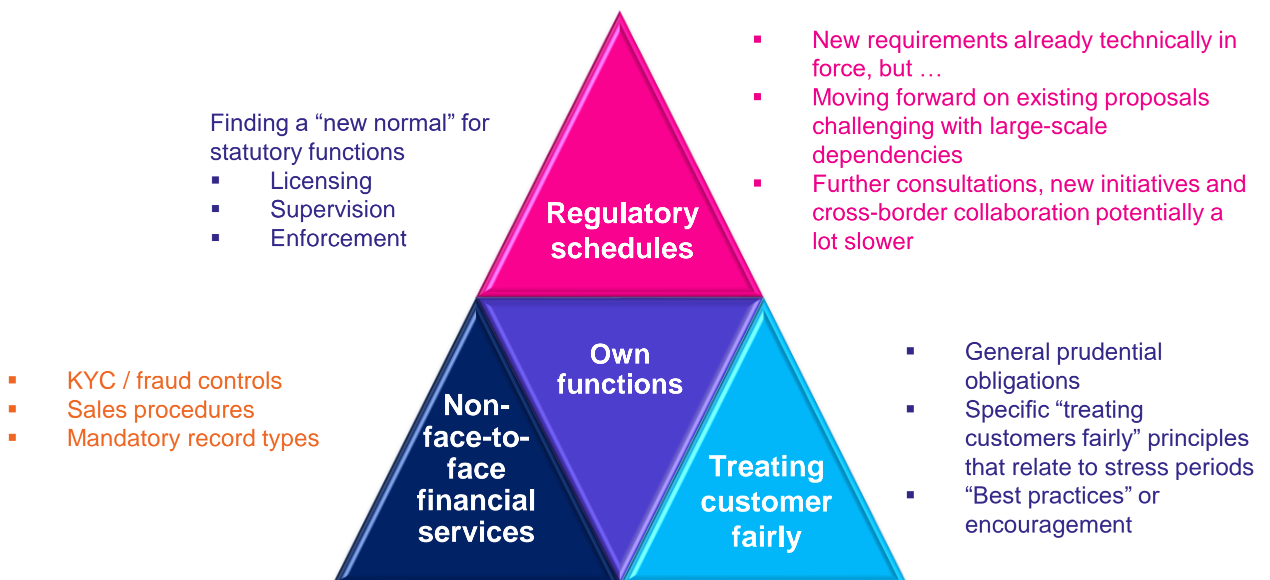
The challenges and the expectations

COVID-19 is having an unprecedented impact globally. Custodians may be affected by staff disruptions and face difficulties and delays in obtaining client instructions. This problem may become particularly apparent given the volatility in the recent market.

Custodial services which entail physical procedures (eg physical scrips storage, gold vaults, cold-storage facilities for virtual assets) may be disrupted in extreme circumstances such as a lockdown. Financial market infrastructure (**FMI**) providers generally have in place detailed procedures during extreme conditions. However, regulators and clients expect custodians to be forward-thinking in terms of their business needs as FMI services may be delayed if there is a prolonged pandemic.

For example, the London Metal Exchange recently reminded short position holders to ensure that they have warrants available for settlement. "Waiting for disaster" and a bailout is not enough.

Other contractual obligations (including payment obligations) generally continue unless the contract provides otherwise. Force majeure provisions are of most relevance in this situation. Of course, general contract law principles such as frustration, as well as the local consumer protection laws, may affect the enforceability of contractual obligations.



Regulatory responses

"There is a patchwork of regulatory forbearance at the moment."

Regulators are trying to help the market, but the approach is not exactly uniform. Participants gave examples of their recent experience with European regulators. Some of them are somewhat accommodating in certain cases, but it appears that there is no consistency in the granting of exceptions.

Another participant mentioned that some regulators expect custodians to continue to strictly comply with their obligations, despite COVID-19. For example, we discussed how some APAC regulators insist on custodians meeting reporting and notification obligations, without much flex regarding deadlines.

Recent regulatory guidance

At around the same time as the roundtable, Hong Kong's Securities and Futures Commission (**SFC**) issued a circular to management companies and trustees and custodians of SFC-authorised funds noting the market volatility caused by the COVID-19 outbreak. The circular reminded custodians of their duty to safeguard fund assets and provide independent oversight of the management of funds (including the valuation of the funds and the use of liquidity risk management tools). Custodians are also required to alert the SFC of any material issues affecting their funds. Fund managers will need to consult with the custodians to consider the need for any fair value adjustment (particularly in respect of less liquid or suspended securities) and to constantly review the propriety and effectiveness of the fair value adjustment policies and procedures in light of the rapidly changing market conditions.

Ultimately, if custodians anticipate that they may not be able to satisfy any regulatory obligations, they should discuss with their professional advisors and relevant regulators as soon as possible.

The way forward – rethinking business continuity plans

Business continuity plans ("**BCP**") plays an important role at times like this, and came up multiple times throughout the discussion. Without a thorough BCP plan, custodians may need to think on the feet when problems arise. Addressing problems one by one as they come along requires more time and resources.

Two key considerations are especially important based on recent experience.

- **Offshore back-up sites** - Offshore back-up sites are often part of BCPs. Currently, many custodians and their service providers have back-up sites across the globe. But, as one participants shared, problems arise when the back-up jurisdiction is subject to the same problems faced by the primary jurisdiction. The nature of COVID-19 as a global pandemic illustrates this vulnerability. Custodians may need to re-think the location of their back-up site, and whether having one back-up site is sufficient.
- **Digitalisation** - Some businesses are called on to consider digitalisation as part of their BCP plan. Some companies are able to find opportunities. Tech-savvy companies, particularly virtual banks and fintechs, are touting their strengths here.

When the crisis is over, custodians should re-think how they address prolonged and global adverse circumstances.

"The short to midterm plan is the priority now – but once the dust settles, we will all need to take a good hard look at our business continuity plans."

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