The transparency challenge in the distribution chain

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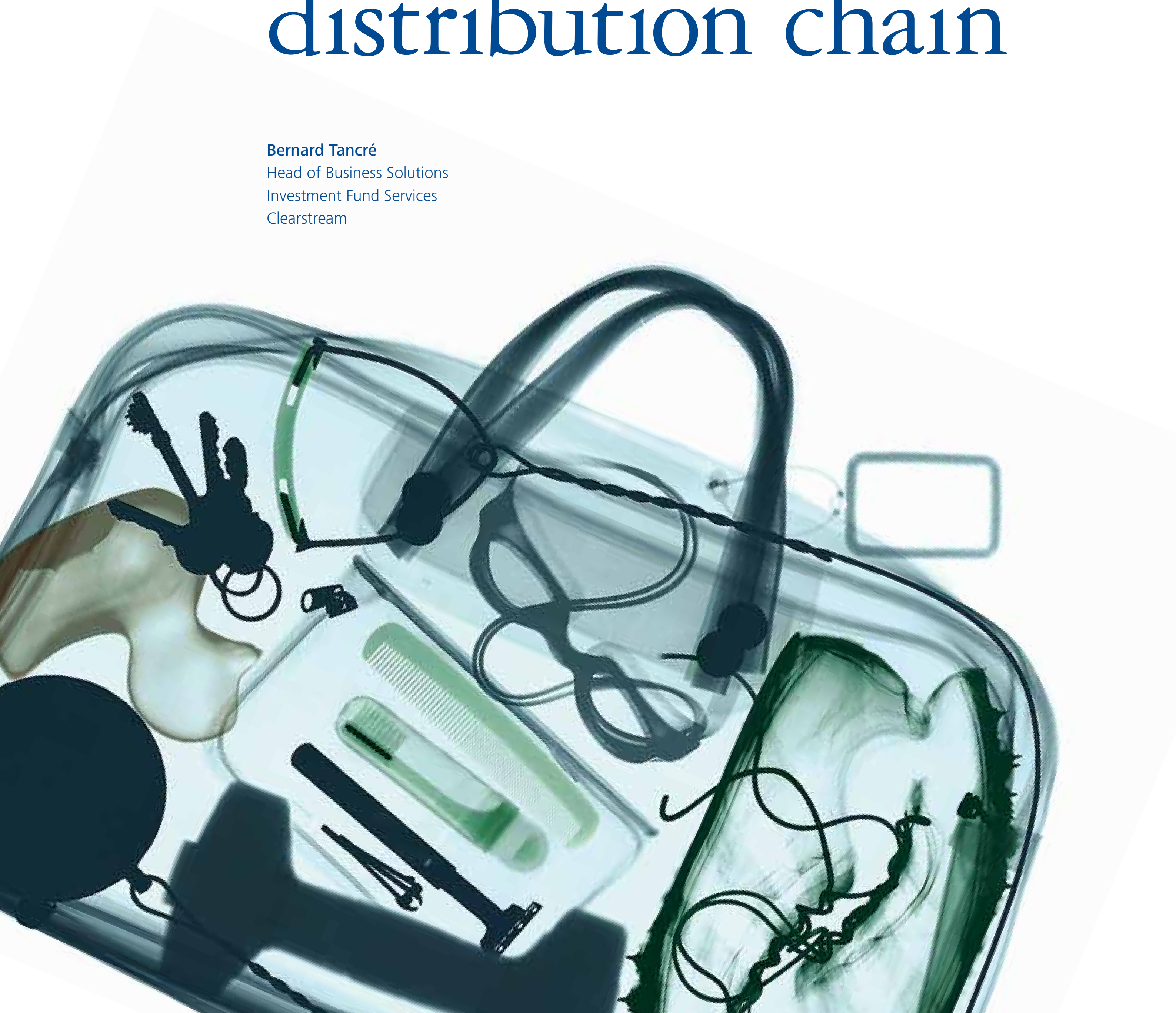


The fund industry is confronted with calls for transparency in the distribution chain for both compliance and commercial reasons. However, there is a clash between the distribution intermediaries' requirement to bundle positions and transactions to ensure efficiency in the custody chain and the fund's need for transparency to monitor distribution and screen investors.

The financial industry is continuously striving to process transactions in a faster and more efficient way. In this spirit, fund distributors resort to bundling positions and transactions before sending them downstream. However, a new focus on disclosing fund investors puts the practice of transaction aggregation and position bundling into question.

The need for transparency

Fund promoters require a clear overview of their investors' or distributors' positions for several reasons. This transparency is used for processing trailer fees as reconciling the distributors' positions claiming payments and the actual positions maintained in the register often remains unnecessarily complex. It is also needed for commercial reasons as fund promoters need to know where the funds are bought and held to measure the success of their sales strategies per region, segment or existing relationship. In addition, fund promoters want to ensure they are dealing with trusted distributors, ideally on the basis of a distribution agreement. Recent regulatory developments and compliance cases act as a further incentive to increase transparency. Regulators are aiming to increase the accountability of funds and promoters for the quality of the investors they accept into the funds in accordance with the 'know your customer' principle and to prevent money laundering or the financing of any criminal activities. This investor screening not only prevents such criminal activities, but is also used to ensure investors are qualified to invest in the fund as per the terms of the regulation or the fund's rules and that they are informed about the level of risk they are taking.

The custody chain

In Europe, fund distribution is mainly carried out by banks in the local markets. These banks may use a local specialist intermediary to support them with this asset class, which in turn can use an international infrastructure to access the funds. This chain of local market participants has the advantage that the fund promoters can benefit from the banks' knowledge of local rules to protect them and the funds. The same logic applies in countries where independent financial advisors distribute the funds and increasingly use local or international fund platforms to support their trade and post-trade activities.

Such holding chains are obviously in the interest of the investors as the banks or platforms effectively create a trading channel which provides them with a single point of access to a broad range of transfer agents and the entire European and international domiciled fund universe. This in turn enables the aggregation of purchasing power across domiciles.

To maintain efficiency and streamline processing, most fund market intermediaries will centralise custody and aggregate orders they receive upstream to move them downstream. Omnibus accounting and aggregate trading remove the need to open thousands of accounts, reduce transaction volumes and simplify reconciliations. Similar to other fungible asset classes, such practices in the fund industry also substantially improve the overall efficiency and liquidity of the market.

The transparency dilemma

Some market participants are concerned that there will be a trade-off between efficiency and transparency and that the efficiency gains achieved by the industry in the custody chain will be sacrificed as bundling is seen as opaque.

However, the industry is not simply facing two camps with the distribution intermediaries that need efficiency and simplicity—and will inevitably generate barriers to transparency—on the one side, and the funds and their promoters requiring transparency on the other side. The dilemma is more subtle than that.

It is important to note that regulatory authorities are not only pushing in one direction but are also part of this dilemma. While the regulatory focus has recently been on ‘know your investors’ as indicated above, regulators nevertheless also want to encourage efficiency, transaction cost reductions for investors and overall safety in the processing chains. Initiatives such as the dematerialisation law in Luxembourg or TARGET 2 - Securities at the European level inevitably also affect the investment fund industry.

Moreover, despite the fact that fund promoters welcome transparency, they are aware of its limits and benefit from the administrative support of intermediaries. Local agents remove the need to maintain countless accounts and to check investors' names under the local rules of the distribution countries in multiple languages or even different alphabets.

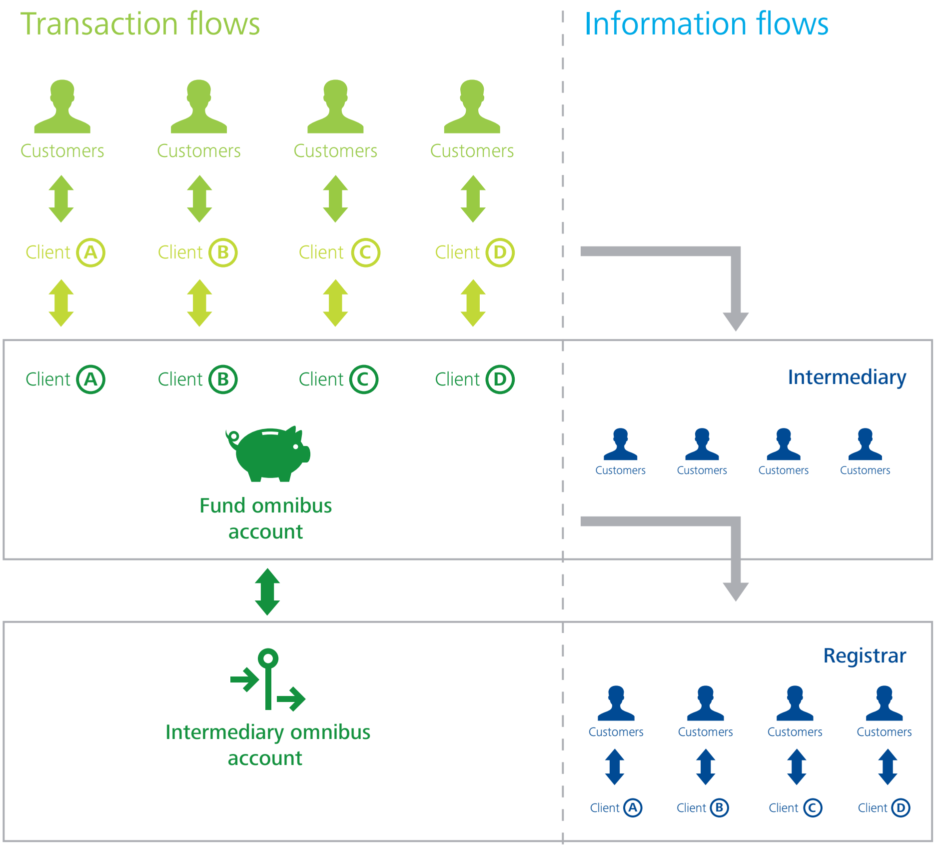
The solution

Unfortunately, there is no magic solution to the dilemma. The proposal pushed by some is full segregation. Even if the fund units have all the required characteristics to be fungible, accounts would be multiplied to provide transparency and individual segregation on fund registers. This actually puts reporting of information in the middle of the transaction process where it does not need to be.

The solution preferred by most is to maintain the custody chains and the omnibus accounting and, at the same time, supplement these operational flows with reporting tools that will provide the additional information needed by the funds and their promoters.

Since the intermediaries in the distribution chain are the ones who bundle the orders and the settlements, they are in a unique position to unbundle them again and provide the information. This unbundling can be performed at both transaction and position level. At transaction level, orders or settlements are tagged with information that will instantly enable the fund to link the transactions with an identified counterparty or a distributor with whom distribution agreements are in place, while registering the transaction on an omnibus account. At position level, daily or monthly reports will unbundle any position of the last intermediary by underlying client positions.

Figure: Parallel transaction and information flows



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This model is best illustrated with an example. An intermediary has an omnibus position in a fund register. That position is composed of positions of clients A, B, and C that are segregated on the intermediary's books. The transactions can all be processed on one single account—only one account needs to be reconciled between the intermediary and the register.

The intermediary can then transfer fund positions across clients A, B or C without requiring any transaction in the register. Yet, if the transfer agent needs to know the composite parts of the omnibus position at any moment, they can do so by sourcing that information from the intermediary. This feed will be specific and will not interfere with any transaction flow.

In that same example, if the new client D wants to invest through the intermediary, he can also do so quickly without going through a full account opening process. The intermediary can check with the transfer agent that client D is trusted by the fund promoter. The transfer agent on the other hand will either be able to rely on the anti-money laundering checks primarily performed by the intermediary, or it can possibly rely on an already existing distribution contract it has separately with client D or request additional information or details. This does not need to be done in the middle of the transaction process. It is even simpler for matters like FATCA where the transfer agent can fully rely on the fact that the intermediary is a participating entity itself.

This flow of information is already in place in many cases. At Clearstream for example, all transactions are tagged with the customers' identification, including distribution contract references where applicable, and reports with the details of daily positions have been available for two decades. Other reports not only enable the transfer of information at the direct client level, but even at one or several levels above. This obviously requires input from clients on their own position unbundling.

More efficient reporting through standardisation

The original purpose of the information flows for distribution transparency of holdings was to facilitate trailer fee processing. Large distributors send their position details to each fund promoter in support of their distribution fee claims. The formats in which these position details are provided are either set by the distributors or by the promoters (or their administrators) who will both expect the other participants in the custody chain to use their formats. In addition, some will use the trade date as the reference to recognise the positions while others prefer to use settled positions. As a result, there will always be one unfortunate member of the chain who will need to reconcile and process information in various formats.

If we want to shield transaction flows from the burden of segregation, we need to ensure that the flow of information required to unbundle the positions is as automated as possible with straight-through, end-to-end processing. This requires investments in connectivity and software throughout the custody chain and such investments are easier to justify when each party is sure to receive the information in a standard format with all data elements they need.

A new ISO message format that covers these needs is in preparation. The format conforms to ISO 20022; an open and internationally recognised standard for financial messaging that can easily be certified, verified and adopted. At the time of writing, the message was in its final development stage before being submitted to the ISO. The message is expected to be authorised and published in early 2015, by which time it can be used on the SWIFT network.

Industry-wide benefits

This standardised reporting offers an efficient solution to one of the biggest dilemmas currently faced by the fund industry: overcoming the trade-off between transparency and efficiency in the custody chain. Thanks to this method of unbundling positions all the way downstream, the fund industry can benefit from both the efficiency of bundling and the transparency of unbundling, effectively providing customers with the best of both worlds under the omnibus account model.

The solution will be readily available for all players in the industry. Embracing this reporting standard might entail system investments to adapt inbound and outbound interfaces. However, the pay-off will be tremendous for the industry, not only in simplifying the exchange of information and its treatment for trailer fee processing, but also in increasing the efficiency of the transaction chains by eliminating the unnecessary segregation requirement.

To the **point**:

- Overcoming the trade-off between transparency and efficiency in the custody chain is a key dilemma in the fund industry
- Competing custody models: full segregation or omnibus accounting
- The solution is to maintain the custody chains as well as omnibus accounting and supplement these operational flows with reporting tools that will provide the additional information needed by the funds and their promoters
- If we want to shield the transaction flows from the burden of segregation, we need to ensure that this flow of information required to unbundle the positions is as automated as possible with straight-though, end-to-end processing
- A new ISO message format will cover these needs conforming to ISO 20022 and should be available from 2015