

Investment Operations
Certificate

Asset Servicing

Edition 22, March 2026



This workbook relates to syllabus
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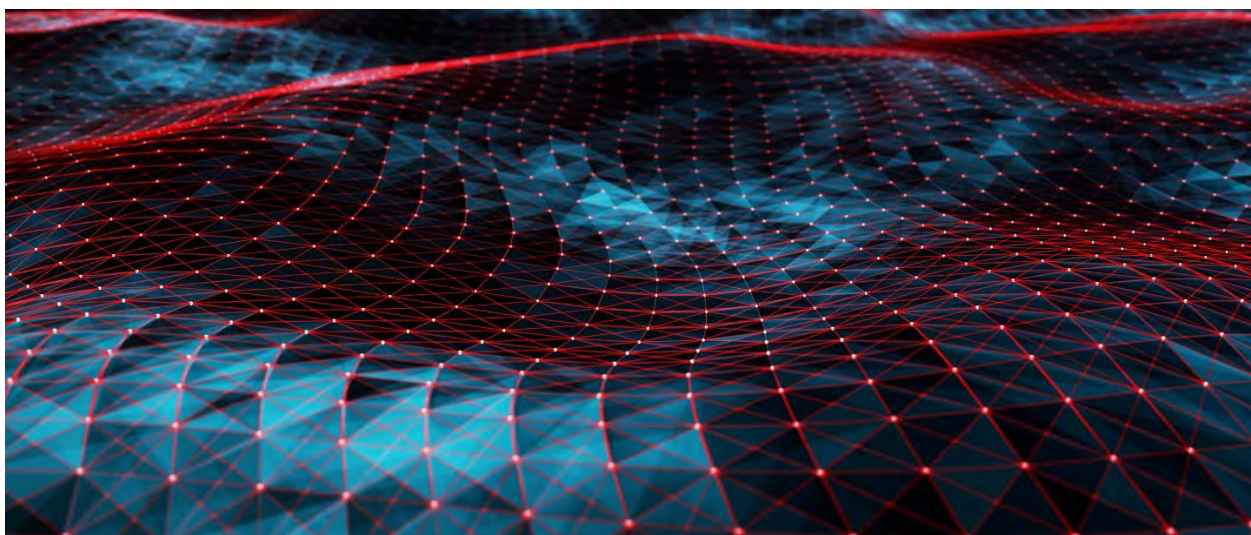
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Welcome to the Investment Operations Certificate (IOC) Programme study material for the Asset Servicing unit.

This workbook has been written to prepare you for the Chartered Institute for Securities & Investment's Asset Servicing examination.

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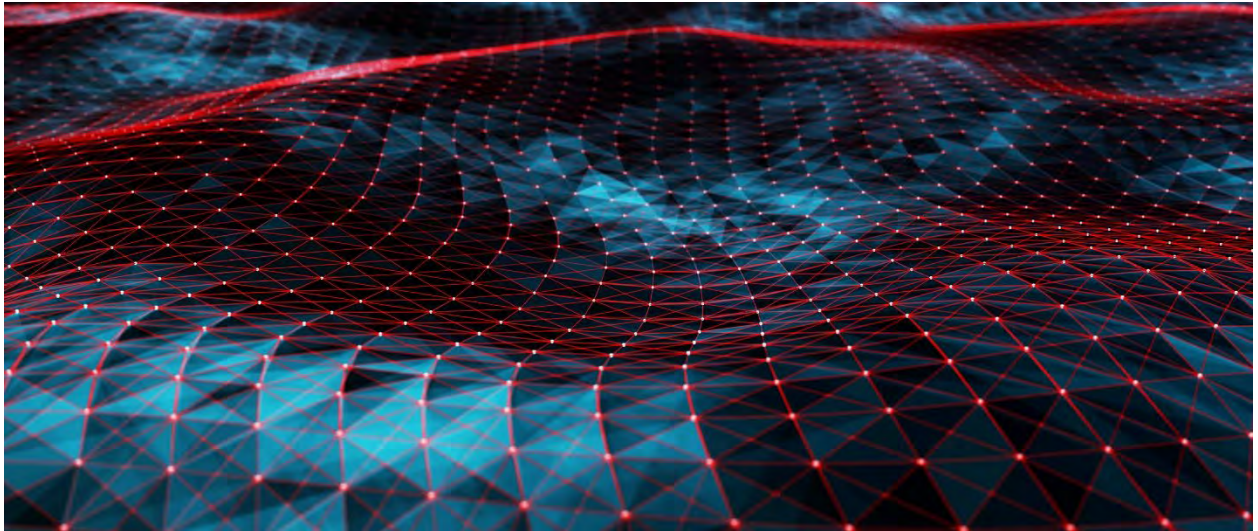
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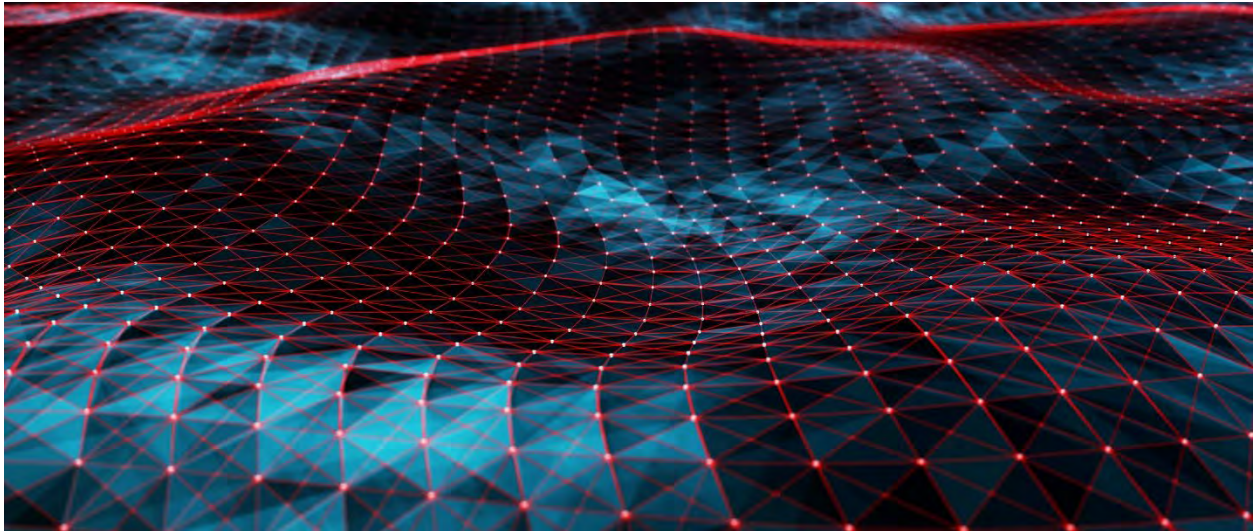




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It is estimated that this workbook will require approximately 80 hours of study time.



Chapter One

Life Cycle of an Event

- Section 1 The Life Cycle of an Asset Servicing Event
- Section 2 Information Gathering and Data Scrubbing
- Section 3 Event Entitlement
- Section 4 Payment, Claims and Post-Payment Reconciliation

This syllabus area will provide approximately 8 of the 50 examination questions

1. The Life Cycle of an Asset Servicing Event

1.1.1 Know event types: voluntary events; mandatory events; mandatory events with options

1.1.2 Know the key stages of the life cycle of an asset servicing event: market announcement; event data collection and validation; notification; election processing; payment/settlement of entitlement; reconciliation; continuous safeguarding; fiduciary responsibilities

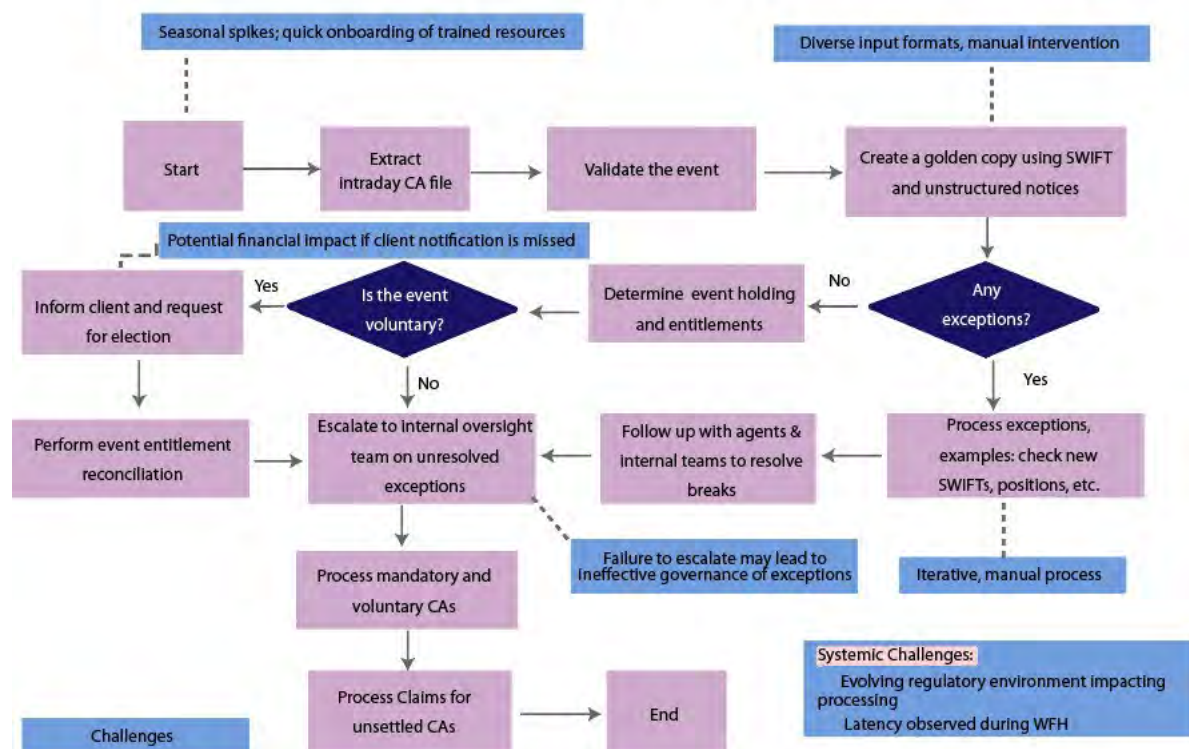
There are many different types of corporate actions, as we will see in the following two chapters. It is possible to generalise to a degree and break down the events into some generic constituent parts.

At the highest level, asset servicing events (corporate actions) can be divided into voluntary events, mandatory events and mandatory events with options. Their characteristics are as follows:

- **Voluntary events** – as the name implies, with a voluntary event there is no obligation on the investor's part to take up any offer made to them, although an investment decision even to take no action still needs to be made. An example is a [warrant exercise](#), when, throughout the lifetime of the [warrant](#), or at set periods, the investor can elect to buy the underlying share at a predetermined price.
- **Mandatory events** – in contrast, a mandatory event will proceed regardless of the views of the investor – it is a scheduled event. Investors have a say in the proposals when they are discussed and voted on during the company meeting, providing that they hold stock with voting rights. One example of a mandatory event is a [subdivision](#), where each share is split into a number of other shares, which reduces the market price of each share, but with an increase to the number of shares in issue.
- **Mandatory events with options** – this event type is a mixture of the previous two. Elements of the event are mandatory and then, after this, the shareholder has an investment decision to make. An example is when a dividend is to be paid and the investor has the option of taking the [dividend](#) in cash or as additional shares. Each company decides a [default](#) method (cash or stock) of dividend payment. If no indication of preference is received from the investor within the period of response, they will receive the default.

The following generic process flow should help illustrate the above text:

Overall Corporate Action Life Cycle & Challenges



1.1 Key Stages of the Life Cycle

The stages of the life cycle of an asset servicing event can be categorised as:

1. **Market announcement** – a company is required to announce to the market details of its impending actions
2. **Event data collection and validation** – this is the information-gathering stage
3. **Calculation of event entitlement and notification to investors**
4. **Response-gathering and instruction** (election processing)
5. **Payment and claims**
6. **Post-payment reconciliation** (event settlement and reconciliation).

In all corporate actions, there may be a significant amount of cash or stock involved when dealing with substantial holdings of securities. An event ignored when it should have been acted upon, a response deadline missed or an entitlement paid to the wrong party are all high-risk occurrences, and can all be costly to an asset servicing firm, damaging its reputation with its clients and in the market generally.

This means from a continuous safeguarding point-of-view, firms need to ensure there is sufficient protection in place for investors' assets to ensure they are held in the correct

name, not co-mingled with other investors' assets and with suitable controls around them.

In a similar vein, firms must not forget their fiduciary responsibilities which means that firms need to always put their investors' interest first (especially if there are issues encountered).

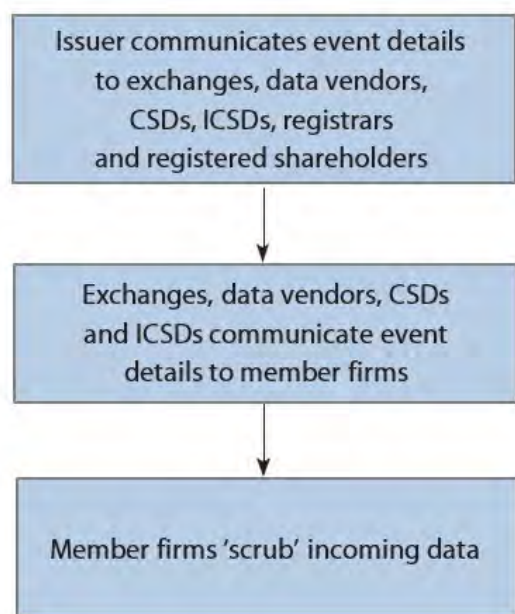
2. Information Gathering and Data Scrubbing

1.2.1 Know the SWIFT and other standards in relation to corporate events: MT564/Corporate Action Notification; MT565/Corporate Action Instruction; MT566/Corporate Action Confirmation; MT567/Corporate Action Status and Processing Advice; MT568/Corporate Action Narrative; MT599 Free-Format Message; Disclosure messages (SIDR, SIDC, SIRE, SIRC, SIRS); Proxy messages (MENO, MECN, MENT, MEIN, MEIC, MEIS, MECO, MERD); ISO15002 and ISO 20022

1.2.2 Know the purpose of information gathering; the purpose of data scrubbing; the impact of distributed ledger technology; tokenisation

Information gathering and data gathering ensures that a firm is aware of events that are coming up and that it allows a sufficient amount of time to effect investment decisions on the event, or to get salespeople, traders, clients and fund managers to make their decisions. Information gathering can be fragmented, as the information will come from a number of sources and will not always be consistent. The timing and methods of announcement are very important; firms will often use multiple sources to ensure all events are detected.

The process of data gathering can be described using the following diagram:



Issuers of securities inform the exchanges on which those securities are traded, and the central securities depositories (CSDs), where the trades are settled, on announcement date.

These institutions then inform their clients. Because many securities are quoted on more than one exchange and/or are held by more than one CSD, this means that client firms may receive multiple notifications in different forms. The more common forms of notification are described in section 2.3. This creates the need for data scrubbing (also known as data cleansing), which is described in section 2.4.

2.1 Timing of Corporate Actions

In general, a company must announce, without delay, any major new developments in its sphere of activity that are not public knowledge that may:

- by virtue of the effect of these developments on the assets and liabilities, or on the financial position, or on the general course of the company business, lead to substantial movement in the price of its listed securities, or
- in the case of a company with debt securities listed, by virtue of the effect of these developments on the assets, liabilities or financial position or on the general course of the company business, lead to substantial movement in the price of its listed securities, or that may significantly affect its ability to meet its commitments.

Corporate actions fall under the above definitions.

There are no simple rules that dictate when a corporate action will occur, but there is a tendency for some types of corporate actions to cluster together, as shown in the examples below:

- A company's financial year-end may be timed to coincide with the end of the tax year or the end of the calendar year. Dividends will be announced following the end-of-year calculation of profit (and potentially six-monthly or quarterly after that). As a result, a securities firm may have to cope with dividend events occurring on many of its holdings simultaneously.
- Mergers, [takeovers](#) and [initial public offerings \(IPOs\)](#) (ie, when a private firm first offers its shares for sale to the public on the market) are more frequent in a buoyant market, as the companies that instigate these events are less cautious and more optimistic. As a result, there may be a cyclical nature to such events: none is seen for months in a particular sector and then suddenly market conditions improve sufficiently for several companies to float, or purchase other companies at roughly the same time.
- [Merger](#) and acquisitions activity may also follow a cycle. A developing sector, such as financial services following deregulation, will fragment as new firms enter the market. As the market matures, it becomes more efficient to merge firms and reap the economies of scale. 'Merger mania' may follow in a particular sector, as all the firms decide that they must grow by merger or acquisition, rather than organically, in order to survive. There may also be a concurrent [rights issue](#) to fund or fight off the attempted acquisition.
- If a particular sector is struggling, there may be a clustering of rights issues to raise additional finance. Often, the first rights issue is the most successful, as the market can rapidly lose its appetite to pump additional funding into the sector.

Once a firm has decided upon a [corporate action](#), there are a number of methods that it can use to notify the market of its intention and to collect responses. Some of the more common ones are listed in section 2.2 and section 2.3.

2.2 The Prospectus

When there is some form of public offering, companies publish all relevant information in a prospectus.

The prospectus is a document that sets out some of the history of the company, plus details of its financial health and its plans for the future. The prospectus has two purposes. Partly, it is a sales document whose intention is to persuade people to buy the shares when they become available, but secondly, because the content of a prospectus is generally regulated by the stock exchange on which it is seeking listing, it must be a fair representation of the company, its prospects and the terms of the offer.

A company may place an advert in the national press stating its intention to issue a security. Interested parties are invited to write for a prospectus or, more recently, register interest on a website and receive the prospectus in electronic format, via a download or email. Existing shareholders must, however, be sent a copy of the prospectus, and major market participants will generally receive documentation automatically.

If a company does not want to bear the expense of advertising and receiving applications from many small investors, it can opt for a [private placement](#). In this case, a prospectus is still produced, but it is only circulated to a list of clients of the investment bank that advised on the deal, or through a network of investment banks. Small investors have to purchase any stocks they want from this network.

If the application is public, an application form for the shares is again printed in the national press along with the terms and conditions of the offer. It will also be available via the internet.

For fixed-interest securities, the prospectus defines among other things:

- how interest and principal will be repaid
- conversion terms (if any)
- the investor's position in the hierarchy of debt, ie, whether this certain [bond](#) issue is:
 - o senior debt (ie, in the event of the [issuer](#) being wound up then investors in this issue have a high-priority claim), or
 - o subordinated debt (ie, in the event of the company being wound up then investors in this issue have a low-priority claim), or
 - o the debt has an equal claim on the issuer's assets with all other debt securities from this issuer
- what the borrower will do if it is unable to pay interest/repay principal, and
- how the issuer plans to use the money raised by this issue.

2.3 Market Announcements and Notifications

This section describes the major methods that exchanges and CSDs use to inform their member firms about forthcoming events.

In the main, the tools that are used are electronic and facilitate a high level of automated processing by the receiving firm. However, readers should be aware that such facilities are not universal. For example, Monte Titoli (the Italian CSD) used to advise its members about events using an MTAQ message, which is delivered electronically, but is simply a scanned copy of the issuer's press release. It is difficult for participants to automate the processing of messages of this kind.

2.3.1 Stock Situation Notices (SSNs)

Stock situation notices (SSNs) are produced by an analytical team at the London Stock Exchange (LSE) and cover corporate actions on stock listed on the LSE, including AIM (the Alternative Investment Market).

A member can elect to access the notices online or receive them by email. There are around 5,000 SSNs produced each year, covering all the types of corporate action. Typically, they will contain items such as:

- security name, International Securities Identification Numbering system (ISIN) and SEDOL references
- event type
- full terms and any ratios
- key dates
- details of how to make an election (for voluntary and mandatory issues with options), and
- [registrar](#) details.

SSNs are generated both as notifications of new events, and updates to existing ones. In addition to providing information about corporate actions, the service also offers its users information about other events, such as stock name changes.

2.3.2 Euroclear Bank Deadlines and Corporate Events (EASYWAY) System

Euroclear Bank has a standardised electronic way of notifying its participants of corporate events and deadlines for stock positions held, commonly known as [EasyWay \(deadlines and corporate events\) notices](#).

Again, they will vary in form depending on the type of event, but, as an example, here are the elements in an offer from Argentina to exchange old bonds for new global bonds.

Element	Example
Exchange ratio	How the exchange ratio will be calculated, when the issue price is announced, and how rounded amounts and unpaid coupons will be treated.
New bonds resulting from the offer	Global bonds due 31 October 2020. ISIN code GB123456789. Coupon rate and issue price to be fixed.

Competitive and non-competitive offers	How to submit either type of bid, and the range of competitive bids that will be considered.
Timing	The timetable of events from launch to settlement of the offer, including key deadline dates.
Contact details	How to obtain the full documentation for the offer.
Offer restrictions	Details of any legal restrictions linked to the event.
Participation details	How to instruct either Euroclear or your lead manager if you wish them to do this on your behalf.

2.3.3 Fidelity Corporate Actions Solutions

Fidelity Corporate Actions Solutions is a set of tools to help manage the life cycle of a corporate action. There are four main elements:

- **Announcement Capture and Validation** – combines multiple data sources into a single composite record.
- **Event Management** – a dashboard (covering validated data) to monitor key event dates and manage exceptions.
- **Election and Instruction Management** – a workflow tool to automate portfolio manager notifications and [custodian](#) instructions.
- **Entitlements and Reconciliation** – automated management of entities with reconciliation of payments across depositories, custodians and agents.

2.3.4 IHS Markit's Managed Corporate Actions

Managed Corporate Actions from IHS Markit provides real-time access to corporate action data. It works by validating data through a set of processes covering mapping, enhancing vendor records, resolving conflicts to provide its customers with a single source corporate action record. Its key benefits are as follows:

- **Cost-effective** – it allows firms to reduce fixed costs to a variable cost triggered by the number of securities they want to monitor.
- **Single source** – it improves the efficiency of the collection, validation and dissemination of corporate announcement operations.
- **Simplified operations** – it eliminates inefficient and error-prone manual processing.
- **Reduced risk** – it reduces the potential for downstream errors caused by poor data.
- **Customer service** – it provides tight timeframes for the validation of events globally.

2.3.5 The Importance of a Golden Copy for Data Items

The challenge with corporate actions notifications (and all reference data items) is that there are often multiple versions of the same notification (or data item) in existence across different teams, processes, systems and suppliers. This multiplicity or duplication can be due to many reasons, including:

- different data providers providing the same data item (with differing underlying attributes)
- the same data being stored on different systems
- the same data item not being updated holistically across all areas, or
- outsourcers/vendors having different versions of the same data item.

This, in turn, creates a problem because if differing versions of the same data item are processed, then it could cause issues. For example, imagine the problems if two different systems processed the same corporate action, but used different [ex-dates](#) and/or pay dates.

Therefore, to combat this, many firms have implemented the concept of a golden copy for corporate action notifications (or any reference data item for that matter).

A golden copy (or sometimes a golden record or even the single version of the truth) is an official and centrally held version of each data item. There can only be one golden copy of each record. Therefore, when any data updates are made, this golden copy is updated initially and, then, copies of the updated data item are distributed to all the systems or processes that need it.

2.3.6 SWIFT and ISO Standards in Relation to Corporate Events

The [Society for Worldwide Interbank Financial Telecommunications \(SWIFT\)](#) is a worldwide global network that enables participant financial institutions to send and receive messages about financial transactions.

Some clients of custodians are not positioned to receive SWIFT messages, so may receive automated faxes instead. However, faxes can go astray and recipients can be away from the office, potentially leading to missed deadlines.

Using SWIFT messages means that delivery is guaranteed, [operational risk](#) is reduced, transmission is secure and there are messaging standards in place to ensure that all the messages are concise and conform to the agreed industry standard.

The MT56X series of messages is used for corporate events under the SWIFT [ISO 15022](#) standard, as follows:

- **MT564 – Corporate Action Notification** – sent by an agent or custodian to advise their client of the details of a forthcoming corporate action.

- **MT565 – Corporate Action Instruction** – sent by a client or custodian to advise the instruction for a corporate action.
- **MT566 – Corporate Action Confirmation** – sent by an agent or custodian to confirm that stock or cash has been debited from or credited to a client account.
- **MT567 – Corporate Action Status and Processing Advice** – used to advise the status, or a change in status, of a corporate action-related transaction previously instructed by, or executed on behalf of, the receiver.
- **MT568 – Corporate Action Narrative** – used to provide complex instructions or details relating to a corporate action event in narrative form. In other words, this message is used as a tag message to include narrative that does not fit into the restricted format of an MT564 message.
- **MT599 – Corporate Action Free Format** – this is a free format message and technically it can be used to communicate almost anything. These messages are generally not so common now, although they may often be used when an unsolicited instruction is required, for example, on an ad hoc warrant conversion. Due to their unstructured and manual nature, upon receipt care should always be taken in managing effectively.

The MT56X series is used to process all common forms of corporate actions on both equity and debt securities. For a simple corporate action – such as a cash dividend payment – the agent will send an MT564 on [record date](#), notifying their client that a dividend is due, and then, on the [payment date](#), will send an MT566 confirming the flow of cash. For a more complex action, the information sent on the MT564 may need to be supplemented by additional information on the MT568.

Since the introduction of ISO 15022 in November 2002, SWIFT has seen an increase in the volume of corporate action messages, and this growth is expected to continue as part of the wider drive for increased corporate-action-processing automation. This has also led to the growth in organisations investing in systems which will allow for the automated reading and interpretation of these messages, therefore allowing for greater [straight-through processing \(STP\)](#).

2.3.7 Migration to New International Standards: ISO 20022

Most national stock exchanges and national CSDs are, like SWIFT, currently sending and receiving corporate action messages based on the ISO 15022 standard, which is close to 20 years old and based on dated technologies. However, the Depository Trust & Clearing Corporation (DTCC), which is the CSD for the US, has, since 2013, been offering its participant firms the opportunity to send and receive corporate actions messages based on the [ISO 20022](#) standard.

This standard, unlike its predecessor standard, is based on a central dictionary of business items used in financial communications. This allows communities of users and message development organisations to define message sets according to an

internationally agreed approach using internationally agreed business semantics. The messages themselves are constructed using [XML](#) standards.

Although the DTCC was one of the first CSDs to make this standard available, many others are expected to follow in the near future.

While the movement from ISO 15022 to the new ISO 20022 standard is still in progress, ISO 20022 messages will be used to support the implementation of enhanced [Shareholder Rights Directive II \(SRD II\)](#), which went live in September 2020. SRD II is discussed in more detail in chapter 7.

Message Definition	Abbreviated Name	Message Identifier
Shareholder Identification Disclosure Request	SIDR	seev.045.001.01
Shareholder Identification Disclosure Request Cancellation Advice	SIDC	seev.046.001.01
Shareholder Identification Disclosure Response	SIRE	seev.047.001.01
Shareholder Identification Disclosure Response Cancellation Advice	SIRC	seev.048.001.01
Shareholder Identification Disclosure Response Status Advice	SIRS	seev.049.001.01
Meeting Notification	MENO	seev.001.001.06
Meeting Cancellation	MECN	seev.002.001.06
Meeting Entitlement Notification	MENT	seev.003.001.06
Meeting Instruction	MEIN	seev.004.001.06
Meeting Instruction Cancellation Request	MEIC	seev.005.001.06
Meeting Instruction Status	MEIS	seev.006.001.06
Meeting Vote Execution Confirmation	MECO	seev.007.001.06
Meeting Result Dissemination	MERD	seev.008.001.06

2.3.8 Data Vendors and their Role

In addition to the notifications provided as a service by the exchanges, [data vendors](#), such as Thomson Reuters, Interactive Data Corporation, Fidessa, Bloomberg and SIX Financial Information (formerly Telekurs), play a key role in providing the investment community with similar information for a fee. Their advantage is that they may cover

various different markets, reducing the overall number of information- providers and also reducing the amount of duplication.

The market data services industry is competitive and constantly developing in terms of quality and automated delivery. For example, a number of vendors are involved in a pilot scheme to deliver elements of their data over the SWIFT network as opposed to their own proprietary delivery mechanism. As explained in the previous section, this would reduce operational risk and head count and allow for lower fees, therefore, making the organisation more attractive to potential customers.

2.4 Data Scrubbing

So far, the information described in section 2.3 seems straightforward. However, from the raw information that is gathered, there has to be a process of selecting the relevant information, known as data scrubbing. Data scrubbing must occur before the event details are entered into any system that plays a role in processing the event.

There are a number of possible situations that could be problematic:

- If a security is held with more than one custodian, the firm will receive notices from more than one place. Only one set of information needs to be recorded, although a comparison of all the information must be carried out.
- There will be a number of corporate actions on securities that the firm does not hold and which can therefore be ignored. Custodians should only notify their clients on stocks they hold with them.
- The reverse of this situation is that the firm acquires a security which it has not previously held and therefore may have ignored a corporate action notice that has already been received. The custodian must inform the client of this situation.

Ideally, there will be automated flows of this information such that duplicate notifications of events are ignored, likewise notices for securities not held. In this environment, it is the responsibility of the asset servicing analyst to keep track of what is happening and to prioritise their work effectively, based on the proximity of the close date and the value of missing the event. The value can be a real cost, ie, being obliged to pay a client compensation because the firm missed a deadline, or an opportunity cost, ie, a potential profit missed because a rights issue had not been subscribed.

Most of this data scrubbing work is performed manually because typically all the data is published in an unstructured form. Examples include raw data, webpages or PDF formats. Therefore, everything has to be manually reviewed, assessed, merged, scrubbed and published. This is a very manual process and, therefore, subject to human errors. Consequently, a number of vendors and firms are looking to employ [blockchain](#) technology to improve the accuracy and efficiency of this process. Blockchain is discussed in more detail under section 2.5 of this chapter.

2.5 How FinTech is Helping with Claims

Financial technology (FinTech) is being used to improve the operational efficiency, timeliness, accuracy, risk levels and cost-effectiveness of information gathering and data scrubbing processes (as well as the entire corporate action process). This has been driven by a number of factors. For example, the increased regulation (eg, SRD II), increased client demands, the need to process activity quicker and the general rise in volumes.

New FinTech Being Used

A wide range of technologies have been used for asset servicing, including the following:

- Machine learning techniques for processing, merging and comparing various data sources for notifications.
- Workflow tools to track and tightly manage the entire process to ensure everything is secure and processed correctly.
- Automated emails, standard messaging (eg, SWIFT) and optical character recognition (OCR), the electronic or mechanical conversion of images into text, to improve the efficiency of all communications.

Furthermore, these new and emerging technologies are also being used across the wider asset management industry as highlighted below:

- A US-based exchange and some firms have rolled out a new market surveillance tool for finding patterns of abusive behaviour.
- A major US-based asset manager is employing a new system that discards traditional **derivative** modelling techniques (such as Black-Scholes) and replaces it with a purely data-driven approach underpinned by machine learning. The first rollout tackled vanilla index options books with future rollouts looking to address single stocks, baskets, and light exotics.
- A system called SCORPEO specialises in helping firms optimise the decision-making process during election for dividends. The default option for managers may be the easiest route, but it is not always the most optimal or best for the investor. Therefore, SCORPEO provides insight into the decision-making process to ensure that the best proactive decision is made.
- A Swiss-based bank is looking to use machine learning to process know your customer (KYC) and anti-money laundering (AML) checks and reporting.
- Several custodians and fund accountants are looking to use machine learning to improve the efficiency of the net asset value (NAV) calculation.
- A number of firms are looking to employ artificial intelligence (AI) technologies to both (a) help with predicting market movements and (b) improve trading and securities-lending efficiencies. This involves analysing past data and performance to aid more accurate forward predictions.

- A number of regulators are looking to use new FinTech to assess firms' reporting. This involves using triangulation techniques to determine both reporting accuracy and cross-market impacts.

Blockchain

Blockchain is a distributed and shared database that maintains a continually growing list of records called 'blocks'. Each block contains a timestamp and a link to its previous block. The contents of each block cannot be altered retrospectively. Its main and most well-known use is providing the ledger that underpins the Bitcoin cryptocurrency and Tokenisation (see below).

Therefore, blockchain could be used to collate and store corporate action data in a structured format as well as ensuring that the data is from a trusted source, up to date and accurately updated.

However, there are two challenges that need addressing:

- The first is whether corporate action data could be organised in a decentralised method. Corporate action data can be complex, unstructured and will often require many parties involved (eg, managers and lawyers) to act on the investor's behalf.
- The second challenge is that blockchain technology can be very slow and there is a concern whether it is likely to meet the demands of corporate action processing.

It will be interesting to see how this area develops over the next couple of years.

Tokenisation

A digital token is a specific type of digital asset that represents a unit of value, right, or ownership. For example a non-digital asset could be a paper share certificate but a digital token could represent this electronically.

The majority of digital tokens are included on block chains (see above), but some do not have to be.

If they are held on a block chain, they are decentralised, transferred peer-to-peer, public auditable, cannot be changed and available at all times.

But if they are held outside a block chain (such as on a database), then they are 'owned' by the central issuer and changes, transfers and day-to-day running are subject to the issuers technology.

Therefore, (similar to Blockchain noted directly above) [digital tokens](#) or [tokenisation](#) is still relevantly new, and it will be interesting to see how this area progresses.

3. Event Entitlement

1.3.1 Know the significance of: record date; ex-date; cum-entitlement; ex-entitlement; special-ex; special-cum; pay date

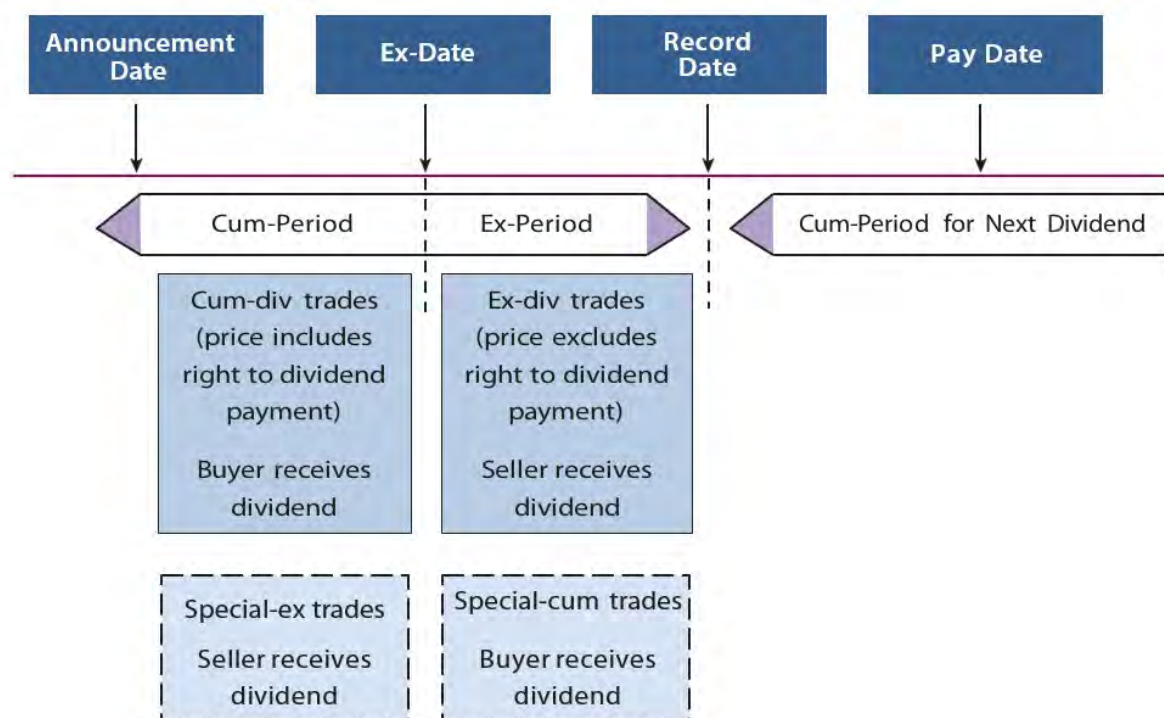
1.3.2 Be able to calculate an entitlement: amended for a late booked or cancelled trade for loaned stock; when there is a special-ex/special-cum trading

1.3.3 Know significant deadlines in relation to an event

1.4.2 Know the implication of pay/effective date in relation to an event, the implication of failing to settle a claim for nil-paid rights prior to the deadline for acceptance in the UK market; how the transformation process may generate claims

3.1 Key Terms

There are a number of corporate actions that have similar characteristics in terms of their timing and when the benefits pass from seller to buyer. In general terms, these are best illustrated by the following diagram, where the benefit is a cash dividend. In other events, the benefit may be an entitlement to take up an offer of additional shares.



Announcement Date

On the announcement date, the directors of a company will announce whether the shareholders have voted to pay a dividend (quarterly, semi-annually or annually). They will also declare the type of dividend, the amount paid per share, the payable date and the record date.

Ex-Date

The ex-date is the date used to determine who is entitled to receive the benefits with respect to the securities being traded.

There are two common options:

- Trades dealt prior to ex-date are dealt cum-entitlement or sometimes just simply cum. This means that the purchaser will receive the benefit.
- Trades dealt on or following ex-date are dealt as ex-entitlement or simply ex. That is, the seller will receive the benefit.

However, by mutual agreement between the two trading parties, it is possible to trade special-ex (ie, [ex-dividend](#) in the [cum-dividend](#) period) or special-cum (ie, cum-dividend in the ex-dividend period).

Record Date

Depending on the market, several days may be required to change stock ownership records following a sale. The registrar takes the stock ownership on record date, normally a few days, or a full settlement cycle, after ex-date, to determine who to pay the dividend or other benefit to.

Payment Date

On the payment date, the dividend is paid. The payment date can range from the record date (usually in bearer markets) through to several weeks or even months later in registered markets; the norm would be two to four weeks.

Special Transactions

In some cases, it is possible to trade a stock prior to ex-date, but only when the buyer agrees that they will not be entitled to the benefit. This is known as a special-ex transaction. The buyer would, of course, pay a lower price in recognition of this. The reverse, when the buyer is entitled to the benefit on or after ex-date, is known as a special-cum transaction, and the buyer would, of course, pay a higher price.

Example

Firm A holds a fully settled position of 10,000 shares that are due to pay a dividend on 5 June. On 12 May, Firm A agrees to sell 2,000 shares to Firm B on a special-ex basis. The trade settles on time on 15 May.

Date	Action	Firm A's settled position	Firm B's settled position
12 May	Opening balance	10,000	0

12 May	Trade date of special-ex sale to Firm B	10,000	0
15 May	Settlement date of special-ex sale to Firm B	8,000	2,000
17 May	Record date	8,000	2,000
5 June	Payment date	8,000	2,000

In this example, Firm B owes Firm A the dividend on 2,000 shares. In most markets, the **depository** has automated procedures to charge B and credit A with the benefit, but in other markets it may be necessary for Firm A to make a claim on Firm B.

The German Cum-Ex Tax Scandal

While we are discussing definitions such as record date, ex-date and cum-entitlement, it seems prudent to mention this issue here.

This scandal (which is often referred to as the ‘German Dividend Tax Scandal’ or ‘The Cum-Ex Files’) is a cross-border tax fraud investigation that involved many people and financial firms. The fraud is linked to a large number of transactions prior to 2012 that exploited a loophole on dividend payments which permitted a number of parties to claim the same tax refund.

Banks and brokers rapidly traded shares with (cum) and without (ex) dividend rights in a method that allowed them to hide the owner of the actual shares. This meant that they could sell the shares before the dividend was paid, but then settle them after the dividend had been paid. This fraud allowed parties to claim [capital gains tax \(CGT\)](#) rebates, thereby creating large profits.

The German authorities believe this has cost them €10 billion in lost tax. However, there could be many other countries involved with estimates of up to €55 billion of tax being lost. Investigators are looking into how this loophole happened, and why it was exploited by so many people in such a widespread manner.

3.2 Entitlement Calculations Including Stock on Loan

One of the key challenges of Asset Servicing is how to manage when holdings are loaned out.

The following example shows the effects of [stock borrowing](#) and lending, as well as failed trades, on the position that is entitled to the benefit:

Example

Consider a holding of BT shares. An interim dividend of 2p per share is announced. The record date is set as 14 January, with the payment date as 14 March. The ex-date, therefore, becomes 12 January. This allows for all cum-trades dealt with a normal settlement period to settle by close of business on the record date.

Consider the following stock record for a firm taken on the ex-date, minus 1. Trades dealt on the ex-date are ex-dividend.

The stock record is a snapshot of:

- trades that are open with the market, and
- stock loans and borrows.

Consider the following record of open transactions at close of business on 11 January, the day prior to ex-date. These are both open trades and **stock lending** and borrowing records.

The opening balance of the account at the custodian is 5,200 BT shares. These are settled trades.

	Trade type	Counterparty/ book	Trade ref	Trade date	Value date	Sell	Buy	Comments
Trades	Sell	ABC Inv Man	123876	5 Jan	10 Jan	1,800		¹ Failed trade
	Sell	GET Securities	123895	10 Jan	13 Jan	300		¹ Pending trade
	Sell	XYZ Securities	123953	10 Jan	13 Jan	100		¹ Pending trade
	Sell	Good Inv Ltd	123986	11 Jan	14 Jan	2,200		¹ Pending trade
	Buy	Best Co inc	123999	11 Jan	14 Jan		2,200	² Pending trade
Stock	Borrow	Lender ABC	3004	18 Dec	17 Jan		12,000	³ Open borrow for return 14 Jan
	Lend	Borrow DEF	3008	28 Nov	5 Feb	10,000		⁴ Open lend for return 5 Feb

The theoretical stock balance resulting from the above transactions is:

Settled trade position	5,200
------------------------	-------

¹ Sell transactions	(4,400)
² Buy transactions	2,200
³ Stock on loan from the market	(12,000)
⁴ Stock being lent to the market	10,000
Balance	1,000

This theoretical position will only be turned into a settled position with the custodian once all the above transactions have been successfully settled and cleared.

- The firm is borrowing stock from a lender and, therefore, will have to pay part of the dividend received to the lender.
- Under a separate transaction the firm is lending stock to a borrower and will, therefore, receive the dividend from the borrower.

Consider the same position at the close of business on 14 January, the record date. Three of the sell trades have settled so the lines of stock held at the custodian have been reduced.

Opening balance at custodian	5,200
Sell trade 123895	(300)
Sell trade 123953	(100)
Sell trade 123986	(2,200)
Closing balance at custodian	2,600

Another trade, 123999 fails because of incorrect instructions. The table is shown below:

	Trade type	Counterparty/ book	Trade ref	Trade date	Value date	Sell	Buy	Comments
Trades	Sell	ABC Inv Man	123876	5 Jan	10 Jan	1,800		Failed trade
	Buy	Best Co Inc	123999	11 Jan	14 Jan		2,200	Failed trade
Stock	Borrow	Lender ABC	3004	18 Dec	17 Jan		2,000	Open borrow for return 14 Jan
	Lend	Borrow DEF	3008	28 Nov	5 Feb	10,000		Open lend for return 5 Feb

The impact on an entitlement is greatest when there are multiple loans and brokers involved for stock held by the same client. While each broker is contractually bound to protect the full entitlement on the positions held by them, there will, over the aggregation of the loans to various brokers, be more than one entitlement calculation. This can lead to a client losing out on one or more shares due to fractional rounding.

Example

Rights issue in the UK registered market

Ratio 5:8

Client x

Loan 1

150,000 shares to Broker A

$150,000 / 8 \times 5 = 93,750$ no fraction

Loan 2

27,530 shares to Broker B

$27,530 / 8 \times 5 = 17,206$ fraction 0.25

Loan 3

253,454 shares to Broker C

$253,454 / 8 \times 5 = 158,408$ fraction 0.75

If this had been one position, then the fractions would add up to one additional share.

The borrowing brokers may, in turn, have lent the shares, in differing amounts to multiple entities, creating further fractional losses of entitlement. Each borrowing **counterparty** is obliged to return an entitlement as derived from the actual position borrowed, regardless of whether onward lending has resulted in further lost fractions. In such cases, additional shares may have to be purchased in order to satisfy such obligations.

The situation is the same for the custodian for the stock split between the custody accounts and the stock on loan, as again each position carries its own entitlement; however, in this case, there is no requirement to purchase the lost fractions, as the client will receive the full entitlement for each position.

3.3 Transformations

The transformation process in the UK is carried out by CREST and it allows trades that are inflight to be converted into their new entitlement and delivered to the counterparty without the need to delete and/ or re-input any transactions.

For mandatory issues without an option, the transformation is carried out automatically by CREST.

For mandatory issues with options, or for voluntary events, the parties to the trade enter their election (using an ACON message) into CREST. If CREST does not receive an election (or an ACON message) then, the trade will transform to the default option.

3.4 Response Gathering and Instruction

For voluntary events or mandatory events with options, the owner of the shares is required to make a decision, eg, to take a dividend as cash or as shares. Normally, the custodian or another agent will collate the decisions made by all its clients and then forward these to the CSD, which will inform the company by relaying to the registrar or [paying agent](#).

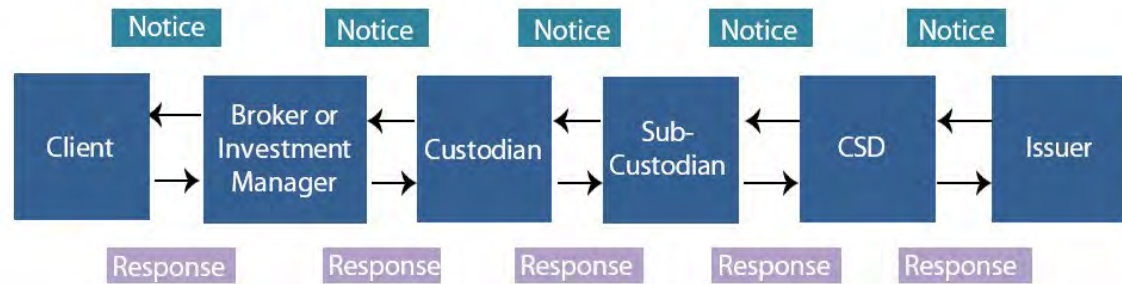
There are, therefore, a number of deadlines.

- The [agent deadline](#) – each agent will require some time to collate and forward the responses to the registrar, and so will set a discretionary deadline, which is earlier than the [market deadline](#), in order to allow sufficient time to complete required tasks.
- The **issuer deadline** – this will normally coincide with the market deadline, but is specifically set by the issuer.
- The **market deadline** – this is the final time by which the company or its representative (registrar) must receive their responses.
- The **deposit deadline** – if stock has to be lodged in a particular account for an event to occur, eg, for a rights issue or conversion, the deadline is often referred to as a deposit deadline. This deadline is usually a time during the day rather than just the day itself. This means that the custodian must ensure that the deadline date and time are met.
- The **buyer protection deadline** – this is the last day and time by which a buyer protection instruction can be given. This is the process whereby a buyer who has yet to receive the underlying securities of an elective corporate action, instructs the seller in order to receive the outturn of their choice.
- The **guaranteed participation date** – this is the last date to buy the underlying security with the right attached to participate in an elective corporate action. In the US, this date is often referred to as the ‘deposit date’.

These deadlines are key within the world of asset servicing, since missing them can mean that benefits due to the shareholders are lost and the cost must be covered by the entity that missed the deadline. Therefore, adherence to these deadlines is critical to processing corporate actions.

If the asset servicing analyst has to elicit responses from many people, such as salespeople and clients, they should work towards the agent deadline.

In a worst-case scenario, the client making the decision may be several steps away from the CSD.



In this case, there will be a chain of deadlines.

There are competing drivers which affect the efficiency of the process:

- The end client, whether a private client or a market trader, may wish to wait until as late as possible so that their decision on whether to accept the offer is based on the most current market price of the shares. If a decision is made too early, and the market falls rapidly, the client may make a loss.
- Any entity which must collate responses and pass them on to the next stage will want to receive the responses as early as possible.

For certain open transactions, when a trade fails to settle, a client who has bought the shares may not be registered in time to take up any option due to them. The trading firm acting on their behalf will normally only take up an option on an express instruction from a client. This is known as a buyer protection instruction. The instruction will request that the option is elected on behalf of the new owner. In the UK, it is necessary within the CREST system to send an ACON message. This is an instruction, linked to the open trade for which a claim will be generated, stating which option the buyer wished to elect for.

However, in the UK, if an open transaction in nil-paid rights (tradeable rights to acquire more shares at a specific price) is not going to settle prior to the acceptance deadline, the seller will automatically protect the buyer, that is, take up the rights on their behalf. They will do this unless they receive a lapse instruction (also via ACON) from the buyer, indicating that they do not wish to take up the rights. This default action is covered in the rules of the LSE.

It is important to note that there are implications for investors if they do not settle prior to the acceptance detail. Namely they will lose the right to the shares which means their holding will be diluted.

Often, when a firm is acting for a client, it will work on '**reasonable endeavours**'. This phrase is a legal expression. It means that, although the firm will do everything it could reasonably be expected to do to meet a deadline on behalf of its client, it is not responsible for any financial impact should it fail to do so if the instruction was passed on later than the client deadline.

4. Payment, Claims and Post-Payment Reconciliation

1.4.1 Know how to validate a claim for the following transactions: repo; buy/sellback; sell/buyback; stock loan; failed trade

1.4.2 Know the implication of pay/effective date in relation to an event, the implication of failing to settle a claim for nil-paid rights prior to the deadline for acceptance in the UK market; how the transformation process may generate claims

4.1 The Payment Process

The payment process can be split into the corporate actions that can be handled by a firm's systems and those that need to be handled manually. They may differ in the amount of authorisation that is required to release messages to SWIFT or other payment systems.

Generally, most securities processing systems have a limited corporate actions functionality that will generate payment messages when a dividend is due to be paid out to a client, and receipt messages when a dividend is due to be received in. To reduce the risk associated with this payment process, many brokers will not pay out a dividend to a client until they have received it. This may require manual intervention to suspend payments to clients if funds are not received.

For other payments, such as a subscription to a rights offer, the payment will need to be raised and authorised according to a firm's internal procedures. This should mean a segregation of duties to reduce the opportunity for fraudulent payments.

An example may be that payment instructions (sometimes referred to as a payment ticket) can only be raised by the front office and must be authorised by a supervisor in operations before it can be released as a payment message into the SWIFT (or other) system.

For cash payments, ie, dividends or coupons, the date on which the cash movement takes place is known as the pay date. For other types of corporate actions where there may be a movement of stock, ie, a **bonus issue**, the date on which the stock movement takes place is known as the effective date or certs due date.

4.2 Claims

There are a number of situations where the entity that is entitled to the benefit will not automatically receive it. This can be for a number of reasons, for example:

- If a trade dealt cum-dividend is unsettled as at close of business on record date. The buyer is entitled to the benefit, but the seller is on the [register](#). The buyer will claim the benefit back from the seller.
- If stock is subject to a [repurchase agreement \(repo\)](#). In a repo, the buyer of the repo becomes the legal owner and so any benefit will be paid to them and must be reclaimed by the seller, if detailed as such under the terms of the repo.
- If a benefit is distributed while stock is out on loan, a readjustment of the stock and the collateral held against it will need to be made; the benefit may be returned to the lender or form part of an adjusted loan.
- CREST claims generated automatically on loans and open trades at record date.

If a trade has been netted at an exchange or [clearing](#) house and is the subject of a claim, the exchange will need to create a number of claims to move the cash or benefits between the parties correctly. For a firm that has netted trades with several clients, it needs to be able to divide the overall claim so that each client receives what is due to them. If two counterparties have a number of claims against each other, they may be able to net them to reduce the overall movement of cash or stock and the risk. If the claim is processed via an exchange, the exchange may do this automatically. In other cases, it is up to the two parties to agree bilaterally to net.

It is common practice to raise a claim for everything that a firm believes that it is owed, even when the trade documentation indicates that the claim should be paid automatically by the party being claimed from.

On rights issues in the UK, when the buyer fails to make an election, it is the market practice default for the seller, as the registered holder, to subscribe to the rights and to deliver the fully paid shares to the counterparty against [consideration](#) for the subscription price.

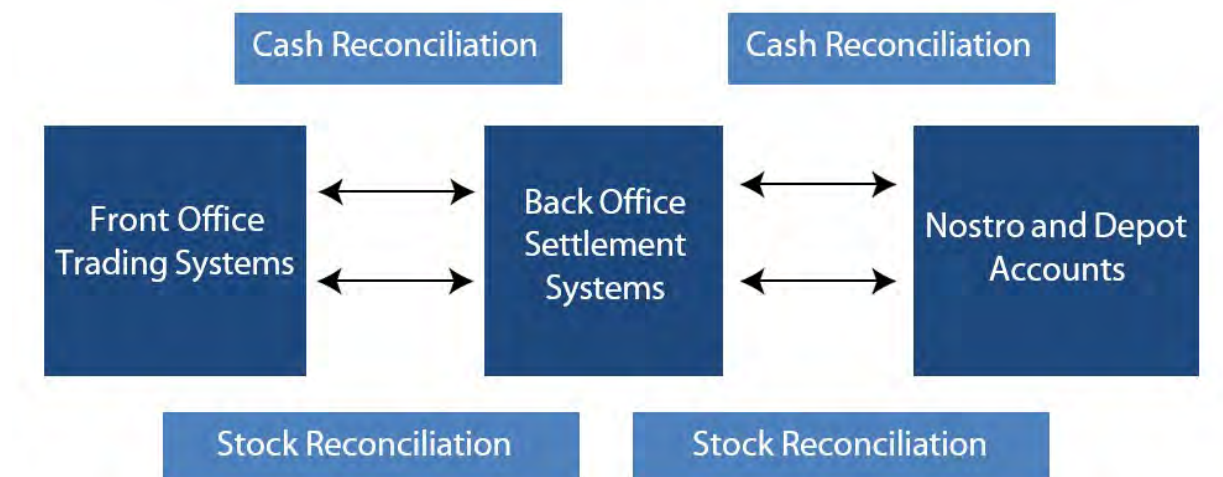
Finally, it is worth noting the importance of response gathering or optimal election based on industry based incidents which can generate a claim.

4.3 Cash and Stock Reconciliations

With a few exceptions, eg, a change of legal name of the issuer, corporate actions will have an impact on either the stock or cash ledgers of a firm, or both. As an example, a dividend will be recorded as a receipt of cash on the firm's ledger. This amount will be calculated from the announced dividend and the ex-date holding. The actual cash is received in the firm's bank account and will appear on its bank statement. In the same

way that high street banks take deposit of people's cash, custodians take deposit of both securities and cash for corporations and other financial institutions. Depository (depot) accounts contain securities and [nostro](#) accounts contain cash.

The statement will be reconciled with the firm's ledger to ensure that all expected movements of stock and cash have taken place. Depending on the booking and settlement process, some firms will also need to ensure that any changes are reflected in the trading systems at the same time as the settlement systems. When this happens, it becomes a three-way reconciliation:



Corporate actions can cause reconciliation breaks for a number of reasons. Some examples are:

- a delay in payment or receipt of funds or stock, for example due to late instruction
- a subdivision or [consolidation](#) that has changed the number of shares held at the depository, but which has not yet been reflected in the firm's system
- the recording of a corporate action in the firm's systems that did not in fact occur, or
- the recording of a dividend receipt as cash when it was received as stock, or vice versa.

A firm may have a separate control function to perform these reconciliations and it may be more familiar with day-to-day trading reasons for reconciliation breaks than those attributable to corporate actions. The corporate actions analyst should be able to identify the reason for each break and the course of action to correct it, ie, for the final item above, cancel the receipt of cash and rebook it as a receipt of stock.

4.4 Auto-Depository Compensation

For rights issues, bonus issues and dividends, there will be situations following failed or delayed settlement where the buyer is entitled to a benefit, either in cash or stock. Depending on the agreement, the depository will automatically raise a claim for the additional benefit from the seller. This is known as [auto-depository compensation](#) or, in the UK, claims processing.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. Give the six stages of the life cycle of an asset-servicing event in their correct order.

Answer reference: Section 1.1

2. Give reasons why the following events may cluster together:

- A. Dividend payments
- B. Mergers
- C. Initial public offerings (IPOs)
- D. Rights issues

Answer reference: Section 2.1

3. What is the common method of advising of initial public offerings (IPOs)?

Answer reference: Section 2.2

4. What is a stock situation notice (SSN) and who would produce one?

Answer reference: Section 2.3.1

5. What does EuroClear EasyWay do?

Answer reference: Section 2.3.2

6. What is the SWIFT messaging standard introduced in 2002, and what is the series of messages used for corporate actions?

Answer reference: Section 2.3.6

7. Give three examples of situations that require data scrubbing.

Answer reference: Section 2.4

8. Describe these four dates related to an event entitlement:

- A. Announcement date
- B. Record date
- C. Ex-date
- D. Payment date

Answer reference: Section 3.1

9. What is the difference between an agent deadline and a market deadline?

Answer reference: Section 3.4

10. Why would the end client wish to wait until as late as possible before deciding whether or not to take up a rights issue?

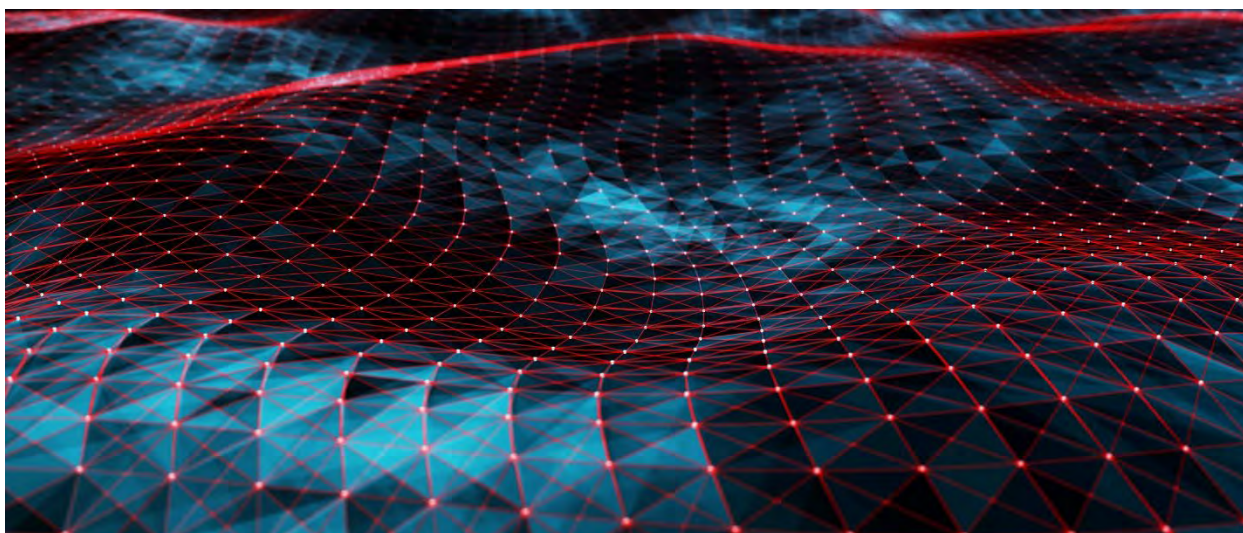
Answer reference: Section 3.4

11. What is the purpose of a protection instruction?

Answer reference: Section 3.4

12. What three-way reconciliation must be performed to ensure that corporate actions have been correctly reflected in all books and records?

Answer reference: Section 4.3



Chapter Two

Mandatory Events

<u>Section 1</u>	<u>Introduction</u>
<u>Section 2</u>	<u>Dividends</u>
<u>Section 3</u>	<u>Bonus Issues</u>
<u>Section 4</u>	<u>Subdivisions and Consolidations</u>
<u>Section 5</u>	<u>Mergers and Demergers</u>
<u>Section 6</u>	<u>Capital Repayments</u>
<u>Section 7</u>	<u>Bond Coupons</u>
<u>Section 8</u>	<u>Delayed/Defaulting Securities</u>
<u>Section 9</u>	<u>Compulsory Redemption</u>
<u>Section 10</u>	<u>Scheme of Arrangement</u>

This syllabus area will provide approximately 10 of the 50 examination questions

1. Introduction

As discussed in the last chapter, a mandatory event is a corporate action that takes place following shareholder approval at a shareholder meeting, but which does not require active investor participation thereafter, although some of these mandatory events may require investors to make a select an option. But the crux is that these events will happen regardless of whether investors like or want it. This is distinct from a voluntary event, which does require the shareholder to make an investment decision, even if it is to take no action or 'lapse' the event. Voluntary events will be discussed in the next chapter.

A custodian's asset servicing department is responsible for the efficient processing of mandatory events and for ensuring that the investor is notified and compensated as appropriate.

The main mandatory events discussed in this chapter are:

- dividends
- bonus issues
- subdivisions
- consolidations
- mergers and [demergers](#)
- [capital repayments](#)
- coupons
- [maturity](#) and [redemptions](#)
- delayed/defaulting securities
- liquidations, and
- redenomination's.

2. Dividends

2.1.1 Know the frequency of the payment timetable for the UK, US, Japan and Italy: ex-dividend date; record dates; special-ex; special-cum; pay date

2.1.2 Know the impact of a dividend on the share price

2.1 What is a Dividend?

A dividend is a distribution of profits to the shareholders of a company. The key facts are as follows:

- Dividends are paid on a periodic basis, determined by market conditions, industry convention and the ability of the company to pay them. Payments are

usually made on a quarterly, semi-annual or annual basis depending on the type of asset involved. For example, most UK companies pay dividends semi-annually, while most US corporations pay dividends quarterly.

- Generally, dividends are stated as a monetary amount, although preference share dividends are sometimes stated as a percentage of the **par value** of the share.
- Dividends must be paid to preference shareholders before any other shareholders are paid.
- If a company's earnings are insufficient to pay dividends, the dividend is normally cancelled for **ordinary shares**, but cumulative preference shareholders will have the payment accumulated and deferred until funds are available.
- Dividends become payable once they are declared by the board of directors. The record and payment date of the dividend are also set by the company. The exchange will then set the ex-date, which determines whether shares are traded cum-dividend or ex-dividend. Although, for stocks on the London Stock Exchange (LSE), the record date is typically one working day after the ex-date.
- If the security has been purchased on the ex-date, the seller is entitled to the dividend. So, a fall in the share price, proportionate to the value of the dividend, is expected on the ex-date.
- The terms 'realised' and 'unrealised' profits are typically used within a fund accounting function. In some situations, for tax or reporting reasons, funds have to recognise income which at a point of time has not been received but, on paper has been earned. For example, a fund's financial year ends on March 31. If one of its holdings declares a dividend on March 28, but the dividend is not paid until April 4, the fund might wish to treat this dividend as income of the year just ended, in which case the fund accountant makes an **accrual** for the amount of the dividend.

Financial firms who hold both stock nominee omnibus accounts (which are single accounts that combine the assets of multiple individuals or entities) and client money for their clients need to be aware of upcoming dividend payment dates for the shareholding their clients hold. Since the individual clients will not be visible to the company paying the dividend, the financial firm will be paid the total amount of dividends for all of its clients. The dividends are then distributed from a central point at the firm to the clients and credited to their accounts.

2.1.1 Japan

Dividends

Dividend entitlements are calculated based on the settled positions held in the Japan Securities Depository Center (JASDEC) and registered holdings for physical shares as of the record date which generally falls on two dates: 30 September and 31 March, respectively. Dividends are usually paid within three months of the record date, interim dividends are paid in December and final dividends are distributed in June.

Most companies pay dividends electronically via the Zengin system on payment date, even though some companies still pay entitlements by cheque mailed to the registered holder. JASDEC is required to notify issuing companies on the record dates of the names of the beneficial shareholders, based on information received from participants. The companies pay income entitlements to the participants' accounts on behalf of the investor for further credit to the clients' accounts. For physical holdings, including securities subject to foreign ownership limit, companies credit dividends directly to the registered holders' accounts.

Interest

Interest on most fixed-income instruments is paid semi-annually, although some corporate issuers may pay on an annual basis. Interest on Japan government bonds (JGBs) is paid semi-annually, usually on 20 March and 20 September, or 20 June and 20 December. For every issue, the issuer must appoint a paying bank and the interest proceeds are generally paid by electronic transfer.

Most Japanese bonds, including JGBs, have bullet maturities, otherwise known as balloon payments, which is when a bond requires the entire principal to be paid in a single lump sum on maturity date, as opposed to principal repayment occurring over equal installments, which is known as a sinking fund.

Corporate Actions

The most common corporate actions are bonus issues. The ex-date falls two business days before the record date. Entitlements are record-date-driven and calculated based on settled positions held in JASDEC and registered positions for physical shares. For securities held in JASDEC, the participants (including the local custodian) provide details of the [beneficial owners](#) and the standing proxy (ie, the local custodian) as of the record date to JASDEC. JASDEC then forwards this information to the companies, which pay corporate actions entitlements to the participants' accounts held at JASDEC on behalf of the investor for further credit to the clients' accounts. For physical holdings, including securities subject to foreign ownership limit, companies credit corporate action entitlements directly to the registered holders' accounts.

Bonus issues are announced about four weeks before the record date. Entitlements are calculated based on settled positions for securities held in JASDEC and registered positions for physical shares. New shares are issued eight to ten weeks after the record date and usually rank [pari passu](#) with the existing shares when issued.

2.1.2 Italy

Dividends

Italian companies pay dividends annually, within one month of their [annual general meeting \(AGM\)](#), which is usually held within four months from the closure of their fiscal year (normally 31 December). These four months can be extended to six months if the

company's by-laws provide for this rule and if the company must issue consolidated group annual statements. The bulk of the dividends are paid between the end of March and the end of July.

All companies are legally obliged to announce dividend distributions. They are announced to the Italian Stock Exchange and the announcement date is usually one month before payment date.

Provisional entitlements are calculated on traded positions as from ex-date up to ex-date+2. Final entitlements are calculated on settled positions at close of ex-date+2.

Record date is the day before the payment date. The payment date is three days after the ex-date.

The distribution of dividends involves the issuing company, the paying agent, the CSD Monte Titoli, and local custodians.

Interest

Interest on debt instruments is usually paid twice a year, although there are cases of annual or quarterly payments.

Italian government bonds issued after the introduction of the euro have an interest calculation based on 365 days.

Interest is credited on payment date based on settled holdings on close of business on pay date – 1. Interest is distributed by Monte Titoli in the same way as dividends. Interest is paid directly to the participants' accounts at the central bank. Monte Titoli credits interest to its participants on a gross basis, ie, without any tax deduction. The Italian local custodian banks act as withholding agents.

The coupon date is the interest payment date for both government debt securities and listed corporate bonds. The payment date for unlisted corporate bonds is set out by the issuing company.

Corporate Actions

Companies approve corporate actions during their AGM or **extraordinary general meeting (EGM)** and must then inform Monte Titoli. In turn, Monte Titoli announces corporate actions to its participants. Information on corporate actions is distributed through the Italian Stock Exchange (for listed companies), issuing companies, Monte Titoli and in the local financial press.

The most common actions are bonus issues. Demergers, subdivisions, rights issues and mergers are also known in the market.

The corporate action peak season is from April to July, but they can be processed throughout the year, depending on the issuing company.

2.1.3 US

Dividends

In the United States, there is no single fixed dividend payment period. Instead, each company sets its own schedule. They are paid gross by cash, stock or a combination of both. Domestic investors receive the proceeds gross of tax, but foreign investors are paid less 30% [withholding tax \(WHT\)](#). See chapter 5 for more information.

Dividends originate with the directors of the issuing corporation making a declaration as to the type and amount of dividend, the payment date, record date, and ex-dividend date (ex-date). Entitlement is based on the settled position as of the record date. Normally, the ex-date is set two business days before the record date. Record date may precede the payment date by at least one week or up to a month.

Interest

- **Registered bonds** – interest on bonds is usually paid on a semi-annual basis. However, some bonds may pay monthly, quarterly or annually. The payment frequency is fixed at the time the bond is issued. Holders of fully registered bonds will receive all payments automatically. Entitlement is based on the settled position as of the record date.
- **Bearer bonds** – interest coupons are clipped from bearer bonds and presented to the paying agent. On the payment date, the paying agent disburses funds to the collection agent, who credits the accounts of beneficial owners. Accrued interest on US issues is usually calculated on the Actual/360- day basis. The interest accrues from the previous payment date (inclusive) to the settlement date (exclusive). The dollar amount of the accrual is computed by dividing the number of days accrued by the number of days in the period, multiplied by the annual interest rate.
- **Dividend/interest claims** – if an expected payment is not received, or is thought to be incorrect, a dividend or interest claim can be initiated. A confirmation is obtained from the transfer or paying agent of the record date holdings (number of shares or units) of the registered shareholder or bondholder. Once the record date holdings are verified, the proper claim can be established and payment made.

Corporate Actions

Common forms of mandatory actions in the US market include mergers, liquidations, bankruptcies, subdivisions and stock distributions.

Voluntary corporate actions, such as tender offers, conversions, [class actions](#) and redemptions, include an effective date, which is when solicitations may legally begin, as well as an expiration date, which is when solicitations may cease. There is generally no fixed pattern when voluntary corporate actions are announced. Most [mandatory](#)

corporate actions carry an effective date and are announced within approximately 48 hours of the effective date.

2.1.4 UK

The rules for the UK are covered elsewhere in this workbook, therefore they are not repeated here to avoid confusion. Dividends are covered in the other parts of this section 2. Interest is covered in section 7 of this chapter. Corporate actions are covered in chapters 2 and 3.

2.2 Scrip Dividends and Dividend Reinvestment Plans

2.1.3 Know the distinction between scrip dividends and dividend reinvestment schemes

2.1.4 Be able to calculate a scrip dividend entitlement given a cash dividend, a reference price for the shares and a record holding date

A **scrip dividend** option is when a company offers investors the choice of payment of a dividend in shares rather than cash. This is a mandatory event with options. If the shareholder does not make an election, they will still receive the default as set by the company.

A scrip dividend is an issue of new shares to the exchange from a company's authorised share capital. Sufficient reserves of **authorised share capital** must exist to cover the terms of the scrip issue, or must otherwise be sought at an EGM or AGM prior to announcement.

The dividend will be declared with a value per share, which reflects the cash value of the dividend.

From the issuer's point of view, a scrip dividend improves the cash flow because new shares are being created rather than cash being paid out.

From the investor's point of view, it allows the accrual of new shares without paying a broker's commission.

$$\text{Number of new shares received} = \frac{\text{number of shares owned} \times \text{dividend amount}}{\text{scrip reference price}}$$

When market volatility negatively impacts the value of stock between the market election deadline and payment date, a company may reserve the right to cancel the scrip issue in the interests of its shareholders. A negative swing of 15% between the reference and market price is generally the trigger for such action, with exact details/terms of cancellation being defined within the issue prospectus.

Example

ABC Ltd shares are trading at £1.80 when it declares a dividend of 8p per share. Shareholders are given the option of payment by cash or in the form of a scrip dividend.

If an investor with a holding of one million shares decides to receive a scrip dividend, how many new shares will they receive, assuming that the share price is unchanged on payment date?

Cash value of dividend $= 1,000,000 \times 0.08 = \text{£}80,000$

Number of new shares received $= (1,000,000 \times 0.08) / 1.80 = 44,444$

The value of the new shares $= 44,444 \times 1.80 = \text{£}79,999.20$

Because it is not possible to receive fractional shares as a result of a scrip issue, the remaining 80p will be either paid in cash, held over until the next dividend or, if the investor has given permission, donated to charity.

Some companies offer [dividend reinvestment plans \(DRIPs\)](#), whereby the actual payment of cash due from the declared dividend is withheld and used to buy shares of the company on the open market. There is generally no predetermined reference price, so elections are unforeseeable; a shareholder does not know the entitlement they will receive at the point they actually make the election. The dividend cash due to shareholders who have elected for DRIP shares is combined and used to purchase shares on the open market, by the company-appointed broker, generally over a one-week period. The reference price is then derived as the mean market price achieved in the purchase of shares over the defined purchase period. Shares purchased under a DRIP scheme are subject to standard market tariff, so in the UK the purchases are subject to [stamp duty](#) and broker's commission.

From the issuing company's point of view, DRIPs have no real effect on cash flow, as the dividend would have been paid anyway and, in effect, the dividend is being used to purchase existing shares on the open market. No [new issue](#) of shares occurs.

There is little, if any, benefit to major shareholders in electing for a DRIP because they would be able to reinvest any cash dividend received probably at better prices than the issuing company could due to their scale and trading volumes. However, small shareholders (who do not benefit from the scale of the major shareholders) may benefit since the purchase of their new shares will be carried out with the purchase of shares for other DRIP subscribers, which will eliminate minimum broker fees. It is, therefore, an efficient way for small shareholders to accrue small additional shareholdings at a realistic price.

The table below outlines the major differences between the scrip and DRIP schemes:

Perspective	Scrip	DRIP
Security issuer	The issuer does not have to pay the dividend; it retains the cash	The issuer must pay the dividend out of profit
	The issuer increases the number of shares in issue, therefore increasing the cost of future dividends and benefits	No new shares are created, therefore the cost of future benefits remains unchanged
Investor	Does not have to pay stamp duty or stamp duty reserve tax (SDRT) when new shares are created	Must pay stamp duty or SDRT when shares are purchased in the market
	As additional shares are issued, then existing shareholders' positions would be diluted	Does not have price certainty in advance of the market transaction

The effect on the share price of a scrip is the same as with a dividend; in theory, the share price would drop by the value of the dividend on ex-date.

Evergreen options are facilities provided by registrars that allow the shareholder to apply (by way of a mandate) for a DRIP or scrip election for all future dividend payments.

2.3 Dividend Access Plans

2.1.5 Know the concept of dividend access plans and the implications of tax on the dividend

UK-based investors who receive dividend income from UK-domiciled companies are entitled to a 'tax credit' of (currently) 10% of the amount declared, which they may offset against their other tax liabilities.

However, UK investors are not entitled to a tax credit on dividends paid by a non-resident company, and in recent years several large companies have changed the domicile of their parent company from the UK to another country with a more favourable corporate tax regime.

A dividend access plan is one way of remedying this situation.

Under such a plan, shareholders may choose whether they receive their dividends from a company resident for tax purposes in the UK, or from the company that issued the shares, which is resident for tax purposes outside the UK.

3. Bonus Issues

2.2.1 Know the following types of bonus issue: bonus issue, bonus issue with rights, B share bonus issues

A bonus issue (or bonus issue with rights), which is a benefit distribution, is a free issue of new shares to existing shareholders at a ratio set by the issuing company in proportion to the shareholders' existing holdings. The shareholder does not pay for the new shares, there is no transfer of funds between the company and its shareholders, and the company does not raise any capital, nor is there any change to the par value of the shares.

A firm may initiate a bonus issue to:

- bring the share capital in line with current business needs
- reduce the share price in order to make the shares more marketable
- increase the liquidity of the shares by increasing the number of them in circulation, or
- replace a cash dividend.

The issue is carried out by transferring some of the reserves to the share capital account within the firm's balance sheet.

Bonus issues are also known as scrip issues or capitalisation issues.

3.1 Bonus Rights

Rather than just issuing new shares, issuers sometimes issue bonus rights. These are tradeable and can be converted to shares at a set date. These mainly occur in bearer markets.

Example

Telefonica issues one bonus right for every one share held. The rights can be converted back to ordinary shares at a ratio of one new share for every ten rights, free of payment. So, if Telefonica is trading at €10 per share with rights, the price will reduce to €9.09 on the ex-date. The rights will subsequently trade at 91 cents each. The rights price will then track the ordinary price.

The share price is calculated by taking the original €10 price and dividing it by 1.1 shares (ie, issue the original share plus the 10:1 rights per share) – ie, €9.09. The rights price is the difference between the original price (of €10) and the new post-rights price (of €9.09) – ie, €0.91.

The reason for issuing bonus rights is to remove fractional entitlements. In the example above, if the bonus issue were converted directly into equity at a ratio of 1:10, then any shareholders not holding an exact multiple of ten would end up with fractions. By issuing tradeable rights, the company allows its shareholders to round up or down before converting back to ordinary shares, or, if the shareholder does not wish to maintain their current level of investment, they can sell out of the rights.

3.2 ‘B’ Share Bonus Issues

Certain companies, including Rolls-Royce, McBride, Betfair, Persimmon and Booker Group, have previously chosen to distribute some of their income by means of a capitalisation/bonus issue instead of paying an increased dividend.

Historically, this has typically taken the form of a distribution of ‘B’ shares at a pre-advised ratio (the bonus) in lieu of a cash dividend. The issued ‘B’ shares then have options attached, at shareholder discretion, and effected by election. However, ‘B’ shares are now very rarely issued.

These issues may be attractive to investors because they are an alternative to dividends, which are taxed differently. If there is a bonus issue, there is no immediate liability to capital gains tax (CGT) when the shareholder receives the bonus shares, but there may be a CGT liability when the shares are sold.

There may be further adaptation to this concept in the future due to changes in tax credits in the UK.

4. Subdivisions and Consolidations

2.3.1 Know the difference between a subdivision and a bonus issue

2.3.2 Be able to calculate the impact of subdivisions and consolidations on the share price of: subdivisions; consolidation

4.1 Subdivision or Stock Split

A subdivision (also known as a stock split) is a decision made by the company's board of directors to increase the number of outstanding shares by issuing more shares to current shareholders. A subdivision occurs after the board of directors authorises the split and it is voted through at the annual general meeting (AGM) by the shareholders. In a 2-for-1 subdivision, every shareholder with one stock is given an additional share, thus doubling the total number of shares that the company has issued.

A subdivision is sometimes a course decided upon by a company when its share price has increased to levels that are unsustainable against comparable companies in the same industry sector. The primary motive is to increase liquidity in the stock by making individual shares more affordable, even though the underlying value of the company has not changed. The market value of the company remains static, so the total value of all shares prior to the subdivision must equal the total value of all shares after the subdivision.

The price of a share is also affected by a subdivision. After a subdivision, the stock price will be reduced since the number of outstanding shares is increased. In the example of a 2-for-1 subdivision, the stock price will be halved.

Example

If an investor owns 100 shares of ABC Ltd with a market value of £10 per share, they will have a total holding worth £1,000. If the company affects a 4-for-1 subdivision, they will consequently own 400 shares with a value of £2.50 per share. While the share price has dropped to reflect the increased number of shares outstanding, the total holding will remain at £1,000.

Note that the par value of the shares will also reduce in a corresponding way, ie, from Ord £1 to Ord 25p shares.

Many subdivisions take place solely for the liquidity reason described above, but subdivisions sometimes occur as part of the spin-off or demerger activities described in section 5.2 of this chapter. There may also be a cash component involved in order to provide shareholders with an equitable value at the conclusion of the issue compared to the position that they held prior to it.

Subdivisions related to spin-offs might involve the division of the [issued share capital](#) into two lines of stock, one of them possibly being an alternative instrument such as a convertible bond, a loan note or a deferred line. The latter may then, subject to receiving shareholder, regulatory and court approval, be cancelled. A more complex subdivision could involve the parent line dividing into multiple lines of new stock of varying instrument types including, but not limited to, different types of equities in different subsidiary parts of the parent corporation, which may also be inclusive of a cash equalisation element.

An example of this could be a company which, over the years has acquired other companies in different markets and now has decided to divest itself of some of these companies as they are of sufficient standing to warrant a listing in their own right. This listing may not be in the country of the parent company, or the company may decide to allow the shareholders to decide which market they wish to hold the subdivided stock in, as it could be listed in multiple markets, such as the US, the UK and Switzerland.

The listing would take place on either a par value or no par value stock, and this will affect the overall package offered to the shareholders. If a stock is trading at \$10 and the company decides to subdivide the parent line into three lines and gives each one a value of \$3, then the cash component would be expected to be around \$1 per share. Although these are mandatory issues, once approved by the shareholders, they still have an elective element, in that the shareholder can decide in what market to hold the resultant stock.

4.2 Difference Between a Subdivision and a Bonus Issue

Subdivisions and bonus issues are seemingly similar in as much as, under both, the investor ends up with a greater number of shares without having to increase the investment to pay for the additional shares. There is a vital difference, however, related to the paid-up share capital, which is the amount of money a company has been paid from shareholders in exchange for stock shares.

In a bonus issue, the paid-up share capital of the company increases. For example, if it is a 1:1 bonus, the paid-up share capital would double, but in a subdivision, the paid-up share capital remains as it is, with the number of shares alone undergoing an increase or decrease – the described par value of the security would be divided by the factor of the subdivision.

4.3 Consolidation or Reverse Split

A consolidation, which can be known as a reverse split, is when the outstanding shares are consolidated so that the total number is decreased. It is typical of stocks with lower than expected share prices that would like to increase their share prices either to gain more respectability in the market, or to prevent the company from being de-listed from the stock exchange – most stock exchanges will de-list stocks if they fall below a certain price per share.

Although the price will vary from market to market, in a 1-for-2 consolidation, each shareholder would lose one share, but the value of each share would double, so that the value of the shareholding is not decreased.

A consolidation could be on a 1-for-5 or 1-for-10 basis, so a shareholder is left with 10% or 20% of the original number of shares.

A consolidation, just like a subdivision, requires shareholder approval.

Example

Company XYZ announces a 1-for-10 consolidation.

Shareholder A owns 100 shares at £10 per share. After the consolidation, they will consequently own ten shares at £100 per share.

The share price increases to reflect the reduced number of shares outstanding but, again, the total value of the investment remains at £1,000. The par value of the shares will also increase correspondingly, ie, from Ord 10p shares to Ord £1 shares.

A consolidation can also be used to offload a part of the company that has failed to make a profit and has had an untoward effect on the company as a whole. In this instance, the company will place a value on this part, consolidate the remainder of the company around the profitable parts of the company, and write off the loss-making element from the books. This is often referred to as ‘returning to its core business’.

A consolidation can also be used by a company to facilitate a restructure, for example, if it is in debt and unable to make payments in cash to its creditors. The company can negotiate with its creditors to issue stock in lieu of the debt; this requires the agreement of both the creditors and the regulatory bodies. If this type of consolidation means that the control of the company passes out of the hands of the current board of directors and the company ownership passes to a new person or company, then shareholder approval is also required.

5. Mergers and Demergers

2.4.1 Be able to calculate the effect on book value of a demerger

5.1 Mergers

Mergers are the joining together, by mutual consent, of two or more organisations of all or part of their operations. They are often motivated by the desire of two companies, whose products and services complement each other in some way, to pool their resources into a single business. In this case, shareholders of both pre-merger companies have a share in the ownership of the post-merged business, with the top management of both companies sharing the top management positions in the new company.

The characteristics of a merger are:

- neither company is publicly portrayed as the acquirer or acquired, although one company may be seen as dominant
- the original companies cease to exist as corporate entities
- both parties participate in establishing the management structure of the combined business
- both companies are of sufficiently similar size that one does not dominate the other when combined, and
- all or most of the consideration involves a share swap rather than a cash payment.

Mergers can also be motivated by the desire of one company to takeover and control another. In this case, top management positions will be filled by the acquiring company. These are more usually termed takeovers or acquisitions and are covered in more detail in the next chapter.

From an asset servicing perspective, knowledge of and information access to merger activity is required to ensure that clients are kept informed, and especially to allow them to register their vote on these issues within the required timescales at company meetings. This process is covered in more general terms in chapter 3.

As a merger is usually an agreed deal between the two parties, albeit subject to shareholder approval, they are usually a meeting of minds and the share price of the newly merged entity may increase during the first few days of trading.

However, if the merger is not well received by the press and the market, the share price can be talked down; as such, there is no agreed formula that can be used to indicate the price of the stock. However, the following simple example has been included to show the impact to the book value of both a cash and stock takeover.

Example

Cash Takeover

Investor ABC purchased 1,000 shares in DEF ltd at £1.00 per share. At the end of the trading, the market price has risen to £1.10.

Therefore, the market value of the holding is now £1,100 (ie, price of £1.10 multiplied by 1,000 shares) and the cost is £1,000 (ie, £1.00 trade price x the 1,000 shares purchased).

At some time in the future, IHJ-ltd perform a takeover of DEF ltd at a price of £3.50 per share.

Therefore, when the takeover is completed, Investor ABC will have received £3,500 in respect of their 1,000 shares which represents a profit of £2,500 (ie, £3,500 receipts less original book value of £1,000 from the original purchase).

Example

Stock Takeover

Investor ABC purchased 1,000 shares in DEF-ltd at £1.00 per share. At the end of the trading, the market price has risen to £1.10. Therefore, the market value of the holding is now £1,100 (ie, price of £1.10 multiplied by 1,000 shares) and the cost is £1,000 (ie, £1.00 trade price x the 1,000 shares purchased).

At some time in the future, IHJ ltd perform a takeover of DEF ltd but they offer 1 x IHJ ltd share for every 10 DEF Ltd shares offer. IHJ ltd shares traded at £40.00 at the time of the takeover.

Therefore, when the takeover is completed, Investor ABC holds 100 IHJ ltd shares (ie, 1,000 DEF ltd shares at 10:1 gives 100 IHJ ltd shares) at a market value of £4,000 (ie, 100 resultant IHJ ltd shares x £40.00).

This represents a profit of £3,000 – ie, £4,000 IHF ltd market values less original book value of £1,000 DEF ltd purchase.

5.2 Demergers (Spin-Offs)

A demerger, which is also known as a spin-off, is a distribution by the parent company of shares in one or more of its subsidiaries to current shareholders. Thus, the subsidiary company becomes an independent listed company in its own right. The shares will be issued to parent company shareholders in proportion to their current holdings, with the subsidiary becoming a separate legal entity.

A company may initiate a spin-off because of a desire to divest part of its business. For instance, the main business of ABC Ltd is long-haul airline travel. It also owns a subsidiary (XYZ Ltd) that specialises in low-cost, short-haul flights. As part of a rationalisation strategy that requires ABC to concentrate on core business, it may decide to spin off XYZ.

A demerger may also be initiated as part of a management buy-out in which management and venture capitalists seek to unlock the value hidden in the subsidiary, or because the subsidiary is so well viewed that it makes the parent company a target for a takeover.

The cost of shares in the resulting company is the actual cost of investment in the demerged company; this is divided by the net worth, multiplied by the net book value of the assets being transferred. Once the calculation has been completed, and the cost of shares in the resulting company determined, the net asset value (NAV) of the shareholder across the new and the parent company remains at the value of the original investment. Please note that spin-off events are sometimes accompanied by subdivision events. See section 4 of this chapter for more information.

Example

On 2 February 2017, Mr Jones bought 1,000 shares of ABC plc for £1.00. On 4 July 2020, a demerger takes place whereby, for every ten ABC shares held, he will receive one share of the demerged DEF plc.

Therefore, he now holds 1,000 ABC and 100 DEF shares.

On the first day of trading, ABC trades at £4.00 per share and DEF at £3.00 per share.

His old holding originally cost £1,000 (ie, 1,000 shares x £1.00) and is now worth £4,300 (ie, 1,000 ABC shares at £4.00) plus 100 DEF shares at £3.00 which are now worth £300.

ABC acquisition cost = $\text{£1,000} \times \text{£4,000} / \text{£4,300} = \text{£930.23}$.

DEF acquisition cost = $\text{£1,000} \times \text{£300} / \text{£4,300} = \text{£69.77}$.

6. Capital Repayments

2.5.1 Know the following methods of achieving a capital repayment: redeemable bonus issue; renominalisation; repayment

A capital repayment is when a company pays back part of the issued share capital to its shareholders. A company may decide to do this if it has an excess of cash that it has no immediate need for. For any form of capital repayment, shareholder approval at an AGM or EGM is required.

Renominalisation (sometimes described as par value change) describes the process of a change in the nominal or the quoted par value of a share, resulting in new tradeable units after a conversion. The nominal value of a share is reduced and the excess funds are paid to the shareholder. **To avoid any confusion, it is important to note the difference between the nominal value of a share and the market price. The nominal is the fixed value assigned to a share when it is first issued (eg, a fixed accounting value) whereas the market price is the price at which a share is actually bought or sold on the stock market.**

It is possible that a company with shares issued at par value £0.25 may wish to make a payment to shareholders, other than a dividend, without reducing the share price or using its reserves. In this case, it could renominalise the par value to £0.15 and pay £0.10 per share to shareholders; however, it is more common that **deferred shares** are issued and subsequently cancelled by the issuer under the terms of the event.

In certain countries, eg, the US, most shares are issued with no par value and, therefore, cannot be renominalised.

7. Bond Coupons

2.6.1 Be able to calculate bond interest using the following methods: (30/360; actual/360; actual/365; actual/actual)

A **coupon** is the common term for the rate of interest paid on the nominal value (face value) of a bond. It derives its name from bearer bond certificates (ie, when an issuer does not maintain a register of legal ownership and so bond ownership is evidenced by ownership of a certificate). Coupon payment dates are typically scheduled in the prospectus at the time of issue.

In order to claim any interest owing on the bond, the owner of the certificate would present a physical coupon to the issuer or their paying agent, and in return, the owner would receive the interest payment for the last interest-bearing period (the coupon

period). The coupons were attached to the certificate, with each coupon representing a specific interest payment due at a given point in the life of the bond.

By contrast, for registered bonds the issuer automatically arranges for the interest payment to be sent to the bondholders who appear on the issuer's register at a given record date. It is the name on the register that confers legal ownership.

Despite the inception of electronic bookkeeping and with bonds existing as electronic records, the word 'coupon' continues to relate to the interest payment, even though there is no longer the requirement to process the paper coupons. 'Coupon' has become a generic term to refer to the interest payment on a fixed-interest security, irrespective of whether it is bearer, registered or **dematerialised** stock.

A coupon can be paid monthly, quarterly, semi-annually or annually and the price of a bond including the interest (known as the **dirty price**) will fall immediately following a coupon payment by the same amount as the interest payment.

To the issuer the coupon represents the cost of borrowing, and to the investor it represents the return on investment, the measure of the return being the bond's **yield**. There are several definitions of, and calculations used to measure bond yield, one of the most common of which is known as redemption yield or yield to maturity (YTM). YTM is best defined as the return an investor would earn if a bond were purchased when issued and held continually through to its maturity. It includes the coupon payments plus any gain or loss on the capital at maturity.

Usually, the longer the term of a bond, the higher the interest rate that is paid to the holder; this compensates the bondholder for the inflation risk of having money tied up for a long time.

Bond prices are inversely correlated with prevailing market interest rates. This is because bonds, typically, pay a fixed interest rate, so if interest rates in general fall, the bond's fixed interest rate becomes more attractive. Therefore, buyers looking to lock in a fixed interest rate will bid up the price of the bond as interest rates, in general decrease. When interest rates rise, bond prices fall.

If interest rates change while a bond is being held, it will be worth more or less on the open market than when it was first issued. If the current interest rates are higher, investors could obtain a better return by buying bonds sold at that current interest rate because an older bond will be sold at less than face value (or at a discounted price). If the current interest rates are lower, an older bond could be sold at more than face value, at a premium to its issued price.

Bond prices are also inversely correlated with stock prices because stocks and bonds are competing for capital. Falling stock prices may indicate a lower level of confidence in the market, causing investors to move towards bond investments which are seen as lower risk. Higher bond yields mean the stock is priced low, and lower bond yields mean the stock is priced high.

A company with a high **credit rating** may expect to pay a lower coupon than a company with a lower credit rating. This difference in coupon represents the extra **credit risk** – that is, the risk of the issuer defaulting on its payments – that an investor is exposed to when investing in a company with a lower credit rating.

The reference point for setting the coupon of a bond is the risk-free rate of borrowing, which is reflected in the more mature markets by the cost of government borrowing – the rate that the government issues its own bonds. Coupon payments are also affected by:

- **interest rate conventions**
- clean/dirty prices
- **zero coupon bonds (ZCBs)**
- **stripping**, and
- first long/first **short coupons**.

7.1 Calculating Bond Interest Amounts

There are four common methods of calculating the interest payable on interest bearing bonds. These are called interest rate conventions. They are:

- Actual/360-day convention
- Actual/365-day convention
- 30/360-day convention, and
- Actual/Actual convention.

Each convention differs slightly in the assumptions about the calculation of the period over which interest is payable. The conventions change depending on the market, for instance:

- UK corporate bonds pay interest based on Actual/365-day convention
- US corporate bonds pay interest based on Actual/360-day convention
- **eurobonds** generally pay interest based on the 30/360-day convention, and
- most **government bonds** pay interest based on the Actual/Actual convention.

Each convention is defined below:

Actual/360-Day Convention

This case assumes and bases the calculation on a 360-day year.

Interest payable = nominal value × annual coupon (%) × actual days in period / 360

Actual/360-Day Convention

This case assumes and bases the calculation on a 365-day year:

$$\text{Interest payable} = \text{nominal value} \times \text{annual coupon (\%)} \times \text{actual days in period} / 365$$

30/360-Day Convention

This case assumes and bases the calculation on there being 30 days in each month and 360 days in a year.

$$\text{Interest payable} = \text{nominal value} \times \text{annual coupon (\%)} \times \text{days in period (assuming 30 days in month)} / 360$$

Actual/Actual Convention

This convention has been defined by the International Capital Market Association (ICMA) and assumes the number of days in the year is equal to the calendar days in the interest period, multiplied by the number of interest periods in the year.

$$\text{Interest payable} = \text{nominal value} \times \text{annual coupon (\%)} \times \text{calendar days in period} / (\text{calendar days in period}) \times (\text{number of interest periods in year})$$

Example

Question

Investor X holds £1 million corporate bonds of ABC Ltd with a coupon of 6%. Interest is paid quarterly, and the interest periods are:

- 1 January to 31 March
- 1 April to 30 June
- 1 July to 30 September, and
- 1 October to 31 December.

Calculate the amount received by the investor per period and in total for each of the four interest rate conventions.

Answer

The interest rate periods are 90 days, 91 days, 92 days and 92 days respectively.

Actual/360-Day Convention

Q1: Interest paid = £1m x 0.06 x 90 / 360 = £15,000

Q2: Interest paid = £1m x 0.06 x 91 / 360 = £15,166.67

Q3: Interest paid = £1m x 0.06 x 92 / 360 = £15,333.33

Q4: Interest paid = £1m x 0.06 x 92 / 360 = £15,333.33

Total interest received = £60,833.33

Actual/365-Day Convention

Q1: Interest paid = $\text{£}1\text{m} \times 0.06 \times 90 / 365 = \text{£}14,794.52$

Q2: Interest paid = $\text{£}1\text{m} \times 0.06 \times 91 / 365 = \text{£}14,958.90$

Q3: Interest paid = $\text{£}1\text{m} \times 0.06 \times 92 / 365 = \text{£}15,123.29$

Q4: Interest paid = $\text{£}1\text{m} \times 0.06 \times 92 / 365 = \text{£}15,123.29$

Total interest received = $\text{£}60,000.00$

30/360-Day Convention

Q1: Interest paid = $\text{£}1\text{m} \times 0.06 \times (3 \times 30) / 360 = \text{£}15,000$

Q2: Interest paid = $\text{£}1\text{m} \times 0.06 \times (3 \times 30) / 360 = \text{£}15,000$

Q3: Interest paid = $\text{£}1\text{m} \times 0.06 \times (3 \times 30) / 360 = \text{£}15,000$

Q4: Interest paid = $\text{£}1\text{m} \times 0.06 \times (3 \times 30) / 360 = \text{£}15,000$

Total interest received = $\text{£}60,000.00$

Actual/Actual Convention

Q1: Interest paid = $\text{£}1\text{m} \times 0.06 \times 90 / (90 \times 4) = \text{£}15,000$

Q2: Interest paid = $\text{£}1\text{m} \times 0.06 \times 91 / (91 \times 4) = \text{£}15,000$

Q3: Interest paid = $\text{£}1\text{m} \times 0.06 \times 92 / (92 \times 4) = \text{£}15,000$

Q4: Interest paid = $\text{£}1\text{m} \times 0.06 \times 92 / (92 \times 4) = \text{£}15,000$

Total interest received = $\text{£}60,000.00$

7.2 Clean and Dirty Prices

2.6.2 Be able to calculate 'clean' and 'dirty' prices

When analysing bond prices, investors need to be able to compare different bonds on a like-for-like basis. This is more difficult when a bond price includes [accrued interest](#).

Accrued interest is the amount of interest that has been earned on a bond but not yet paid to the bondholder as the payment is made on set dates. So, if interest is paid in six months, interest will accrue for up to six months before it is paid. For this reason, the value of the bond increases between one payment date and the next. Therefore, if a bond is sold part-way through the accrual period, this will be factored into the price.

Because accounting for accrued interest makes it difficult to compare bonds, prices are quoted excluding this figure. This is the [clean price](#).

Generally, when a bond is sold, it is sold at its clean price. The final price paid by the buyer, including the accrued interest, is called the dirty price. The rule in the bond market is 'buy clean, pay dirty'.

Record date and pay date are the key dates used to derive interest entitlement. Interest usually accrues from pay date to pay date and receipt is based on a record date. Record date is normally the day before pay date.

This is because, historically, the interest payment was the physical coupon attached to the certificate, and when it was clipped, the bond traded without the interest. However, the record date can be at any time before the pay date. If it is longer than one day before the pay date, it is called an early record date.

The interest is actually paid to the holder of record. Anyone who buys bonds between the record date and pay date will be entitled to the interest, if they paid the accrued interest on the trade, but they have to claim the interest from the seller. These are commonly known as interim trades.

Example

Question

On 22 July, purchaser X buys £100,000 bonds at 98.125% from seller Y. These bonds have a coupon of 6%, which is paid semi-annually on 1 April and 1 October. Interest is calculated on Actual/365-day convention basis.

What is the total amount payable to seller Y, assuming that the trade settles on a T+3 basis and that accrued interest is calculated up to the day prior to settlement date?

Answer

Clean price = 98.125%, therefore, the principal amount is £98,125.00

On settlement date minus one (24 July) the bonds have accrued 115 days' interest since the last payment date of 1 April (30 days in April, 31 in May, 30 in June and 24 in July).

Accrued interest = $£100,000 \times 6\% \times 115 / 365 = £1,890.41$

Total amount payable = $£98,125.00 + £1,890.41 = £100,015.41$

So, the total amount payable is £100,015.41

Therefore, the dirty price is 100.01541%

7.2.1 Zero Coupon Bonds (ZCBs)

A zero coupon bond (ZCB) does not pay interest, instead it is issued at a significant discount to its face value (par). The holder does not receive interest throughout the life of the bond but realises a profit when the bond matures. The discount is calculated to provide a similar rate of return to the investor as might be expected from the payment of periodic interest.

For example, a five-year bond may be issued with a par value of £100 and a coupon of £10. If income tax is 20%, then the investor will receive a net income of £40 over the

five-year period. A ZCB discounted to £60 would, if held to maturity, produce the same net income.

The advantages of ZCBs are:

- the investor does not incur through-life processing costs to service interest payments
- they represent an alternative investment choice for the investor to the receipt of periodic payments by realising profit in terms of capital gain rather than income, which has different tax implications, and
- in international bond markets, there is the additional benefit that the exchange rate risk associated with converting proceeds from a foreign currency to base currency is limited to a single conversion of the redemption value rather than multiple conversions of periodic payments.

7.2.2 Stripping

A stripped bond is a normal bond that has had its coupons removed. The coupons are then sold separately, with a face value and maturity equal to each interest payment. This is called 'stripping'. Both the coupons and the original bond then become ZCBs.

Stripping is used as a tool to change the characteristics of the original bond in order to provide greater flexibility to the investor.

In most markets, stripping is carried out by the [central securities depository \(CSD\)](#), which breaks the security into its components and delivers them back to the investor.

Example

An example would be a bond that has a maturity of five years, a face value of £5 million and annual interest payments of 10%. This could be stripped to produce a five-year ZCB with a face value of £5 million, plus five smaller ZCBs with a face value of £0.5 million and a maturity of between one and five years. This would depend on when the interest rate payment was due.

Stripping of US Treasuries first occurred in 1982 and of UK government bonds in 1997. It is now common in international markets.

7.2.3 First Long/First Short Coupon

A bond does not have to be issued at the beginning of a coupon period. If it is issued at some point between two coupon dates, the first payment will be paid on either:

- the first coupon date, and be equivalent to an amount less than the whole coupon. This is called a short coupon, or
- the second coupon date, and be equivalent to an amount greater than the whole coupon. This is called a [long coupon](#).

The intention to pay a short or long coupon will be stated in the bond's prospectus and will form part of the source data held by corporate action information vendors.

7.2.4 Bond Maturity

The maturity of a bond is the time period from issuance to redemption. This can be expressed with respect to the:

- original maturity, ie, the term to redemption at the time of issue, or
- current maturity, ie, the remaining time to redemption for bonds already in issue.

A bond is redeemed when the issuer repays the principal amount of the debt to the bondholder at maturity. Most bonds are redeemed by single lump sum payments. These are called [bullet redemptions](#).

Example

XYZ Bond 3.5% 31/12/24

Nominal value held by the investor £1,000,000 Current market price £96

In the above situation, the investor will receive an income of 3.5% pa, calculated on their holding of £1,000,000 for the period until maturity, ie, 31 December 2024, assuming the bond is held until that date. More importantly, for this example, the current market value of the bond would be $£1,000,000 \times £96 = £960,000$, representing a discount to the nominal value. If the investor purchases the bond at this price and holds it to redemption, the investor will receive a capital repayment of £1,000,000, resulting in a capital profit of £40,000.

Some issues allow for early redemption, ie, the payment of the principal prior to the published maturity date. The various methods are described below. Note that [call options](#) and [put options](#) are usually described as early redemptions, but [drawings](#) are usually described as methods of [partial redemption](#).

If an early redemption is announced by the issuer of a convertible bond, the holder of a convertible bond may have the right to take up the conversion prior to redemption, depending on the terms and conditions of the bond.

7.2.5 Drawing

For certain bonds, a situation occurs when some, but not all, capital is repaid to bondholders. This can be achieved in one of two ways, namely:

- in a pro rata manner where each investor receives a payment in proportion to the value of their holdings, or
- as the result of a lottery when actual bond numbers are drawn by the issuer in order to qualify for the payment. This process is known as drawing. As the bonds are usually dematerialised, the custodian will perform another lottery to determine who receives the funds.

8. Delayed/Defaulting Securities

2.7.1 Know the effect of issuer default on the servicing of interest and principal payments on: corporate debt; sovereign debt

8.1 Default

Default occurs when a debtor has not met their legal obligations according to the debt contract, eg, they have not made a scheduled coupon or redemption payment, or have violated a loan covenant (condition) of the debt contract. Default may occur if the debtor is either unwilling or unable to pay their debt.

Default can be of two types: debt service default and technical default:

- a. **Debt service default** occurs when the borrower has not made a scheduled payment of interest or principal.
- b. **Technical default** occurs when an affirmative or a negative covenant is violated.
 - i. **Affirmative covenants** are clauses in debt contracts that require firms to maintain certain levels of capital or financial ratios. The most commonly violated restrictions in affirmative covenants are tangible net worth, working capital/short-term liquidity and debt service coverage.
 - ii. **Negative covenants** are clauses in debt contracts that limit or prohibit corporate actions (eg, sale of assets, payment of dividends) that could impair the position of creditors.

8.2 Sovereign Default

Sovereign (government) borrowers are not subject to bankruptcy courts in their own jurisdiction, and thus may be able to default without legal consequences. The most recent example of sovereign default was Greece in March 2012. The Greek government negotiated the biggest sovereign debt restructuring in history with its creditor bondholders, which allowed Greece to wipe some €100 billion from its debts of around €350 billion. This type of negotiated default is known as [orderly default](#).

Holders of €152 billion of the €177 billion of sovereign bonds issued under Greek law signed up to the swap. The rest – those who did not respond to the bond-exchange offer, or the holders of around €9 billion of bonds who opposed it – were forced to accept the deal. The Greek government then invoked a recently enacted law that bound all private bondholders to the bond-swap if more than two thirds of them consented to it. Holders of around €20 billion of the €29 billion of Greek bonds included under foreign law also agreed to the swap.

The practical consequences for asset servicing institutions of this orderly default were that current bonds were redeemed early and exchanged for new securities with lower face values and/or interest rates. This had the effect of creating large numbers of corporate action transactions.

8.3 Corporate Default

Corporate defaults can give the bondholder the right to demand that the company be placed in receivership. It can also lead to the complete [liquidation](#) of a company's assets to pay creditors. To do this, the holders declare the bonds due and payable before a court.

Defaults have a major impact on a company's health and its future outlook. Its credit rating would likely be lowered, which would increase its future cost of borrowing. Its share price would also fall, reflecting the loss of confidence as shareholders seek to offset any future losses by selling their positions. Alternatively, it may be possible to negotiate an orderly default with bondholders. The types of processes that can be negotiated are discussed in section 8 of chapter 2.

8.4 Delayed Interest

As part of an orderly default, interest payments can be delayed. This tactic of delaying interest will result in extended bonds, which are bonds with delayed principal repayments. Collateral normally stays the same. Often, extension terms are stamped on the front of the bonds. Occasionally, companies issue extended debt certificates instead of stamping original bonds.

9. Compulsory Redemption

2.8.1 Know what a compulsory redemption is

A **compulsory redemption** (or a compulsory purchase, compulsory acquisition or sometimes squeeze-out) is when minority shareholders are forced to sell their shares to a majority shareholder (or acquirer or bidder) who has acquired enough control in a company. It is normally part of a takeover or merger situation, where the acquirer wants to gain 100% ownership of the target company to take it private and/or de-list it.

The process works are as follows:

1. The Acquirer makes an offer to buy shares from all shareholders and some of the shareholders will take up the offer to sell their shares to the acquirer.
2. Therefore once the acquirer secures a very high percentage of shares then the acquirer can force (or squeeze-out) the remaining shareholders to sell their shares at the same offer price. The actual percentage (or threshold) changes country by country. In the UK, USA and Australia it is 90%. In the EU it is 90% to 95% because it varies between member state. In Japan it is 66.7% (eg, two thirds).
3. Once the compulsory redemption is completed then the acquirer will have gained full control and the company can be taken private and/or de-listed if appropriate.

These rules exist for the following three main reasons:

- It stops a small group of shareholders blocking a takeover and/or merger that is supported by an overwhelming majority.
- It helps to make mergers and takeovers cleaner – eg, there is one owner as opposed to one large owner and a cluster of smaller owners.
- Finally, it supports smaller or minority shareholders by ensuring they are paid the same amount as larger or majority shareholders receive.

However, there is also something called a 'sell out right' which is effectively the opposite of a compulsory redemption. This is where the small or minority shareholders can demand that the larger or majority shareholders buy their shares (often when similar thresholds noted above are met) so ensure that they are not 'stuck' with shares in a firm that they have no real influence over.

10. Scheme of Arrangement

2.9.1 Know what a scheme of arrangement is

A **Scheme of Arrangement** is a process used in corporate finance to restructure a company, create a compromise with creditors, and/or reorganise ownership. It is widely used in mergers, acquisitions, takeovers, or debt restructuring.

But please note the following two main differences:

- Firstly, is that it needs court approval as well as shareholder agreement. ('Normal' mergers, takeovers and restructures only need shareholder approval). This will add extra time, cost and complexity.
- Secondly, once approved all parties (including dissenting parties) are bound by the scheme. Therefore, this means it should be easier or more straightforward to implement.

The process works as follows:

1. The company proposes a scheme outlining the proposed restructuring plan (including terms and impacts for both creditors and shareholders).
2. The scheme is then reviewed and approved by creditors (typically 75% in value of each creditor class) and shareholders (again typically 75% in value of each class member).
3. After this the company will have to apply for court approval. As part of its review/approval process, the court will check fairness and legal compliance to ensure all stakeholders (particularly those with minority interests) are protected.
4. Finally, once court approval is received, then the scheme becomes legally binding across all parties and can be implemented.

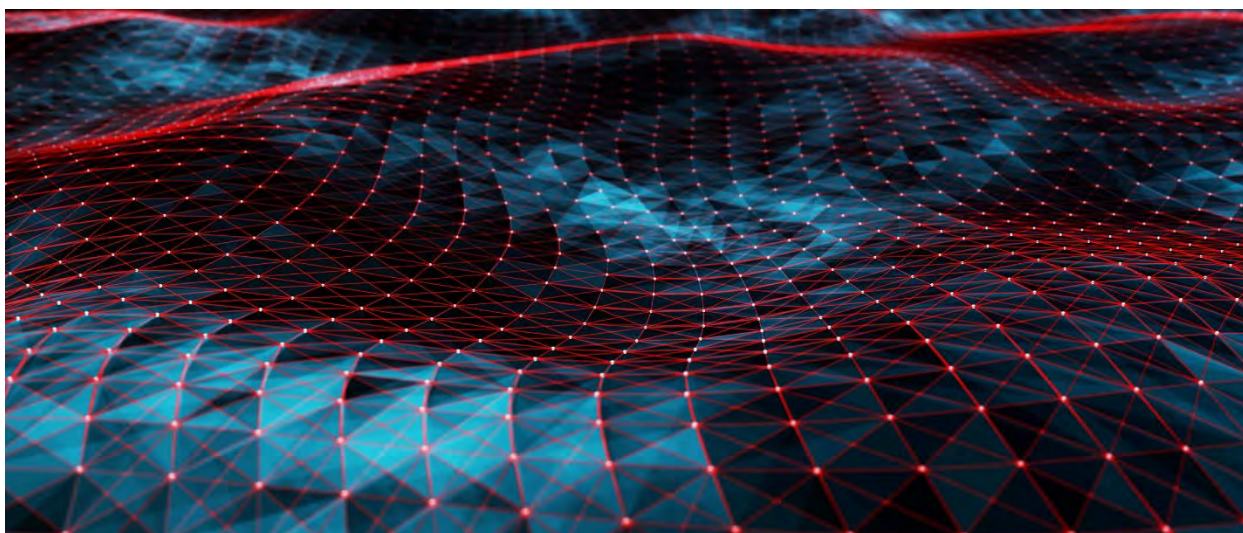
The benefits of a scheme of arrangement are that it is binding on all parties (and therefore, avoids blocking minorities), has legal certainty and can be flexible to cover most restructuring challenges.

The disadvantages are that the process is expensive and time-consuming (due to possibly large legal and court fees), requires high levels of approvals (eg, 75% noted above) and depends on court approvals (which could result in extended timelines, challenge, rework or even rejection).

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. **What is the main reason why mandatory events are called as such?**
Answer reference: Section 1
2. **What is a scrip dividend?**
Answer reference: Section 2.2
3. **What are the two other terms that are synonymous with bonus issue?**
Answer reference: Section 3
4. **Why might a firm initiate a bonus issue?**
Answer reference: Section 3
5. **How does the total value of all shares change as a result of a subdivision and what is its effect on the share price?**
Answer reference: Section 4.1
6. **What are the characteristics of a merger?**
Answer reference: Section 5.1
7. **What is a capital repayment, and why might a company decide this course of action?**
Answer reference: Section 6
8. **What is the formula for Actual/365-day convention?**
Answer reference: Section 7.1
9. **What is accrued interest and what is its effect on the value of a bond?**
Answer reference: Section 7.2
10. **What are the advantages of zero coupon bonds (ZCBs)?**
Answer reference: Section 7.2.1
11. **What is the term describing the removal from a bond and separate sale of coupons?**
Answer reference: Section 7.2.2



Chapter Three

Voluntary Events

Section 1	Overview of Voluntary Events
Section 2	Rights Issues
Section 3	Conversions
Section 4	Warrants
Section 5	Takeovers and Exchanges
Section 6	Tenders
Section 7	Debt Exchange Offers
Section 8	Debt Repurchase

This syllabus area will provide approximately 8 of the 50 examination questions

1. Overview of Voluntary Events

Following on from the description of the life cycle of a mandatory asset servicing event, this chapter provides a detailed description of voluntary events.

From the asset servicing analyst's point of view, voluntary events carry a higher degree of risk than mandatory events as, if deadlines are missed or if the event has not been fully understood or researched, there is frequently a financial penalty and loss of reputation for the custodian or other entity on behalf of its clients. As voluntary events have deadlines, it is vital to track the various stages of the event.

With voluntary event, there is no obligation on the investor to take up any offer made to them. Some of these events, such as a rights issue, have a limited period of validity and it is up to the investor to inform the company if they wish to take up the offer. Other events, such as conversions, may be built into the characteristics of the instrument, an example being a convertible bond that can be converted at any point during the lifetime of the bond, with a decision only being required on the final conversion date.

The events that this chapter will cover are:

- rights issues
- conversions
- warrants
- takeovers and exchanges
- tenders
- debt exchange offers
- debt repurchase.

2. Rights Issues

3.1.1 Know: the stages involved in a rights issue; the reasons for rights issues and the options available to the shareholder; the difference between renounceable and non-renounceable rights; priority offers in the UK; lapsed rights proceeds; poison pill rights in the US

3.1.2 Be able to calculate a theoretical ex rights price and a nil-paid rights price given a cum rights price, a nil-paid rights issue ratio, and a subscription price

3.1.3 Be able to calculate a split rights entitlement

Although a rights issue is categorised as a voluntary event, from a processing point of view, it is perhaps more accurately described as a multi-faceted event. It is, therefore, a mandatory event with options. This is because different stages of the rights issue have different categories, both voluntary and mandatory. A rights issue becomes a voluntary event when the company's subscription deadline is reached. If, at that point, the shareholder declines to make an election, then their holding remains unchanged. However, the net asset value (NAV) of their holding will be reduced if any other shareholders subscribed as more shares would be issued.

2.1 Reasons for Rights Issues

Companies often raise cash for several reasons, such as expanding growth, or investing in new projects and product lines.

Depending on market conditions and the state of the company, a few options are available to firms when raising finance. For example, companies can issue corporate bonds, lend from a bank, or issue shares. For some industries, such as manufacturing, raising capital in the form of fixed-interest bonds may be the most suitable option. This is because the cash flows are known and can be matched with the income derived from projects. Conversely, in a service industry with lower capital requirements, it may make more sense for a company to raise finance through short-term variable rate loans and overdrafts, rather than commit to longer term financing sources.

Furthermore, if a company faces difficulty raising finance through corporate bonds or bank lending, it may decide that its only option is to raise the finance from its existing shareholders in the form of a rights issue. When this happens, the rights issue may be viewed by the market as a sign of a weak company. However, if this action enables the company to takeover a competitor, then a rights issue may be seen as a positive move and will be well received.

2.2 Shareholders' Options

In a rights issue, a company approaches its existing shareholders in the hope that since they are company stakeholders who have an interest in the company, they may wish to invest further at a discounted price for the new shares.

UK company law gives a series of protections to existing shareholders. As already stated, shareholders have **pre-emptive rights** – the right to buy shares so that their proportionate holding is not diluted. A rights issue can be defined as an offer of new shares to existing shareholders, pro rata to their initial holdings. This is because it is an offer and since the shareholders have a choice, this aspect of a right issue is an example of a 'mandatory with options' type of corporate action.

As an example of a rights issue, the company might offer shareholders the right that, for every four shares owned, they can buy one more at a specified price that is at a discount to the current market price. Each shareholder is given a number of options as to how to proceed following a rights issue. They could do one of the following:

- Take up the rights by paying the discounted price and increasing their holding to five shares.
- Sell the rights on to another investor. The rights entitlement is transferable (often described as 'renounceable') and will have a value because it enables the purchase of a share at the discounted price.
- Do nothing. If the investor chooses this option, the company's advisers will usually sell the rights at the best available price and pass on the proceeds (after charges) to the shareholder. These proceeds are known as '**lapsed rights proceeds**'.
- Alternatively, the investor could sell enough of the rights to raise cash and use this to take up the rest.

Underwriters of a share issue agree, for a fee, to buy any portion of the issue not taken up in the market at the issue price. The underwriters then sell the shares they have bought when market conditions seem opportune to them and may make a gain or a loss on this sale. The underwriters agree to buy the shares if no one else will, and the company's investment bank will likely underwrite some of the issue itself.

2.3 The Impact of Rights Issues on Share Prices

The company and its investment banking advisers will have to consider the numbers carefully. If the price at which new shares are offered is too high, the rights issue might flop. This would damage the investment bank's reputation – and costly for any institution that has underwritten the issue.

The initial reaction to the announcement of a planned rights issue will reflect the market's view of the offering. If it is to finance expansion, and the strategy makes sense to the investors, the share price could well rise. If investors have a negative view of why a rights issue is being made and what it says for the future of the company, the share price can fall substantially. This was seen with Halifax Bank of Scotland (HBOS) and Royal Bank of Scotland (RBS) when the price of shares on the open market fell below the discounted rights issue price. The rights issues were flops, and the underwriters were forced to take up all of the unsubscribed new shares.

Example

ABC plc has 100 million shares in issue, currently trading at £4.00 each.

To raise finance for expansion, it decides to offer its existing shareholders the right to buy one new share for every four previously held. This would be described as a 1 for 4 rights issue.

The price of the rights would be set at a discount to the prevailing market price, at say £2.00.

The share price of the investor's existing shares will also adjust to reflect the additional shares that are being issued. So, if the investor originally had four shares priced at £4.00 each, worth £16.00, they can acquire one new share at £2.00. On taking the rights up, the investor will have five shares worth

£18.00 or £3.60 each. The share price will, therefore, change to reflect the effect of the rights issue once the ex-rights date has passed. The adjusted share price of £3.60 is known as the theoretical ex-rights price – it is theoretical because the actual price will be determined by demand and supply.

The rights can be sold and the sale price is known as the premium. In the example above, if the theoretical ex-rights price is £3.60 and a new share can be acquired for £2.00, then the right to do so has a value. That value is the premium and would be £1.60, although again, the actual price would depend upon demand and supply.

Example

An investor holds 3,000 shares in a stock that is priced at £2.00 per share. The company subsequently makes a 2-for-3 rights issue at £1.50, such that each ordinary shareholder has a right, but not an obligation, to purchase two new shares at this price for every three existing shares it holds.

The investor decides to subscribe to the rights issue. Consequently, it purchases a further 2,000 shares through the rights issue at £1.50 to supplement its existing holding of 3,000 shares, each worth £2.00.

Hence, the total value of the investor's shares will be:

$$\begin{aligned} & (3,000 \times 2.00) + (2,000 \times 1.50) \\ &= 6,000 + 3,000 \\ &= 9,000 \end{aligned}$$

The investor now holds 5,000 shares in total:

$$\text{Price per} = 9,000 / 5,000 = \text{£}1.80$$

Hence, the price per share after the rights issue would be expected to adjust to £1.80 (the theoretical ex-rights price). Note that this is a theoretical price because stock market conditions and the level of investor demand will dictate that the share price will be constantly fluctuating for tradeable securities, so the price may rapidly move away from this predicted level.

To estimate the capital gain that the investor may secure by selling the rights, an approximate value may be calculated as follows:

$$\begin{aligned} \text{Nil-paid rights} &= \text{theoretical ex-rights price} - \text{rights issue price} \\ &= \text{£}1.80 - \text{£}1.50 \\ &= \text{£}0.30 \end{aligned}$$

So, we would expect the nil-paid rights to be worth £0.30 per share.

2.4 Mechanics of the Issue

The order of events is as follows:

1. The company makes the announcement of the issue via the stock exchange or local regulatory body, depending on the geographical market.
2. Registered market entitlement calculation – in a registered market, the rights are delivered at the set ratio and then subscribed on a 1-for-1 basis with your entitlement.
3. Bearer market entitlement calculation – in markets where bearer shares are common (such as some continental European countries), the number of rights received is, generally, on a 1-for-1 basis with your holding. The company will issue rights as a ratio to the current shares held. For example, in a 1:1 rights issue, the shareholder will receive a right for each share held; in a 3:1 rights issue, the shareholder will receive three rights for each share held.

For both bearer and registered securities, the rights are issued as a **nil-paid security** (each nil-paid security = a right to buy an ordinary share in the issuing company at the

offer price), which has its own international securities identification number (ISIN); this is different from the ISIN for the ordinary shares of the company. The company registrar will act on the company's behalf and send out the offer documents. If the shares are dematerialised, the nil-paid rights will be electronically transferred to the shareholder's account. If the shares are physical, the company issues the nil-paid rights in physical format; for custodians this may mean splitting the rights into individual shareholder positions as they will receive one allotment letter per market account and may have an omnibus account structure on their books and records.

All shareholders will receive the nil-paid rights. This is the mandatory stage.

Example: Registered Market

You hold 100 shares in a registered security and a 5-for-12 issue is announced.

You will receive 41 rights to 41 additional shares. (Divide 100 by 12, multiply by 5, and discard the fraction).

You can either use these 41 rights to subscribe to the additional 41 shares or sell/lapse the 41 rights.

Example: Bearer Market

You hold 100 shares and a 5-for-12 issue is announced.

You will receive 100 rights to 40 shares. (Divide 100 by 12, discard the fraction, and multiply by 5).

You can either use 96 rights (entitlement divided by 5, multiplied by 12) to subscribe to the additional 40 shares (you will automatically receive fractional sale proceeds on the remaining four rights) or sell/lapse the 100 rights.

The agent receives market allotment letters. The agent will need to split these into individual shares. This may cause a delay in settlement of rights trades.

4. If the shareholder wishes to take up or subscribe to the offer, they will return the nil-paid rights together with the payment for the subscription to the [receiving agent](#). They are now known as [fully paid rights](#), as the shareholder has transferred the full cash amount. This must be done by the deadline stated in the offer document. The last date is known as the [acceptance date](#). This is the voluntary stage.
5. For an investor who has acquired fully paid rights in the market, they must register their holding by the renunciation date (ie, the latest date on which the

seller can renounce their rights to the new shares). Otherwise, the issuer will send the new shares to the shareholder who was allocated the nil- paid rights.

It has become a common practice in the UK for all aspects of a rights issue to be processed electronically in CREST. Rights (technically nil-paid shares) are eligible for settlement in CREST. Rights are generally tradeable for a period of two to three weeks, starting on the ex-date and ending on the day before the final subscription date (the payment date). Rights that are not exercised as of payment date lapse; a company will sell the lapsed rights on the market and distribute the proceeds to relevant shareholders as lapsed rights proceeds.

If rights are not CREST-eligible, then they are physical rights, and the rights letter of allotment is issued by the registrar per registered account. This may require the custodian to request that the letter of allotment be split as per the individual client's shareholdings, which will allow the client to trade their rights position. Trading of physical rights is enacted in the same way as any other physical trading, but on a T+1 basis.

All rights have a **call date** by which the subscription cost must be paid; if it is not paid, then the rights lapse. For pending trade-in rights, it is a market practice that the person actually holding the rights as of the call payment date makes the **call payment** and, thereby, protects the entitlement of the buyer. For an open trade in the nil-paid rights, CREST automatically transforms the transactions from the nil-paid to the fully paid ISIN and increases the consideration to reflect the call payments paid by the seller to protect the buyer.

Should the buyer wish to lapse the rights, it will input an ACON (or corporate action) instruction to notify the CREST system to transform the transaction into the lapsed security. (The ISIN changes to an assented – non-settling – ISIN representing the lapsed rights; the quantity stays the same, as does the consideration.)

2.4.1 Renounceable and Non-Renounceable Rights

If the issue is renounceable, the rights can be freely traded, and a shareholder can sell their nil-paid rights to another investor who can then subscribe to the issue the same way as the shareholder. Conversely, the shareholder can sometimes increase their rights holding by purchasing additional rights, and an investor who does not hold the stock can purchase rights in the market. There may be a market in nil- paid rights up until the subscription deadline.

Non-renounceable rights cannot be traded, and the right is not transferable in any way, although the entitlement may be transferred if it is the subject of a valid market claim.

2.4.2 Splitting Entitlement

Most countries have converted to scripless trading. This means that securities are held electronically or in dematerialised form. In countries that are still holding securities in

physical form, allotment letters are issued to eligible holders. Provisional allotment letters confirm the allocation of the right to the holder.

On occasion, shareholders may issue partial instructions using all the combinations of options. They can sell part, take up part and lapse part of their holding. In these circumstances, the allotment letter must be returned to the registrar for splitting, which requires the registrar to reissue two (or more) allotment letters, one for the number of shares to be sold, one for the number of shares to be taken up and another for those to be lapsed.

Particularly, private investors often issue instructions for what is known as 'tail-swallowing'. This is the name that has been given to the process of selling some proportion of the rights in order to take up another proportion, without the investor having to pay any cash. For example, if the new shares cost £1, and the rights are trading at 10p, the sale of ten rights securities enables the investor to buy one new share without any cash outlay.

2.4.3 Oversubscription

In some rights issues, where the terms and conditions of the offer allow, it is possible to subscribe to more newly issued shares than the holder has the rights to buy.

An application for oversubscription is usually made at the point of exercising the rights held. Generally, there is no ratio, or other restriction, made on the number of additional shares that may be applied for in this manner. However, there may be conditions applied on a per event basis.

In case more shares are being additionally subscribed to (oversubscription) than there are available through the rights issue, a pro-rata allotment will be applied. The total number of shares which may be available through the oversubscription mechanism is entirely dependent upon any current shareholders deciding not to accept any of the rights to which they are eligible. These unsubscribed rights become available to the rest of the shareholders at a pre-determined ratio (eg, the right to purchase 0.25 shares for every existing share held), based upon the total number of unsubscribed shares and the level of oversubscription applications.

There will be a maximum number of rights or warrants available on the whole, and should there be more subscription demand than the supply available, whatever is left over will be allocated on a pro-rata basis to those who pick up their oversubscription privilege. This rate of allocation is known as the scale-back ratio.

There may be various combinations of conditions applied in determining eligibility and level of allotment to oversubscribed shares, such as reference to the original level of shareholding in determining the ratio. When administering any event where an

oversubscription option is available, any [administrator](#) should ensure they are fully cognisant of the conditions and requirements.

Example

A shareholder holds a 2% stake in a company.

The company issues 100,000 new shares.

The shareholder will receive an amount of rights that would entitle them to subscribe to 2,000 new shares (2% of 100,000).

The shareholder exercises all their rights and subscribes to 2,000 new shares and gives instruction to oversubscribe to 1,000 new shares.

After the event is finished, the agent establishes that 95% of the shares were subscribed to by normal means of exercising rights (this would leave 5,000 new shares available for oversubscription).

The agent has received instructions to oversubscribe to a total of 10,000 shares. The scale-back ratio on the oversubscription, in this case, is 50% ($5,000 / 10,000$).

The shareholder in this example will receive and pay for $2,000 + 500$ (oversubscription after scale-back) = 2,500 new shares.

2.4.4 Priority Offer

Priority offers are very similar to rights issues. The key difference is that the rights are non-tradeable and non-transferable.

A [priority offer](#) (also known as a share offer, subscription offer or non-renounceable offer) takes place for similar reasons as a rights issue, ie, when a company wishes to raise capital for the purpose of, for example, major investments, debt repayments, takeovers and bids.

As with a rights issue, the number of shares available is determined by a ratio applied to investors' existing holdings at a specified date, again like rights issues – the record date for the registrar to determine the allocation and ex-date to determine shareholder eligibility.

In some cases, and as with rights issues, holders may be able to subscribe to additional shares in excess of their guaranteed entitlement; this is also known as oversubscription. Similarly, the allocation may be subject to scaling down under the terms of the offer.

It should be noted that lapsed rights proceeds do not normally apply to a priority offer event.

2.4.5 Lapsed Rights Proceeds

Rights issues are usually underwritten by a third party who, in cases where shareholders do not take up their total entitlements of rights, will take up (underwrite) the remaining rights and then sell all the new ordinary shares received.

Any premium (positive difference) over the sale price of the ordinary shares, less commissions/costs, and the take-up price will then be distributed to those shareholders who did not either sell or take up their rights.

If no premium was attained during the sale of new ordinary shares sold by the underwriters, no lapsed rights proceeds will be distributed, and nil-paid shares will be removed from clients' accounts with no associated value.

Priority offer events do not normally benefit from lapsed rights proceeds, although conditions of an event may facilitate such a feature.

2.4.6 Rights to Ordinary

The mechanical sequence of achieving a listing in ordinary shares from a rights issue is generally as follows:

1. **Nil-paid rights** – the rights in their issued/allocated form, giving the right to ultimately purchase ordinary shares. These nil-paid rights have their own unique [security identification number](#) and are traded independently of the ordinary line. They have a limited lifespan – the trading period – usually from the ex-date (date of issue) until the market deadline minus one day (last day to be able to trade and settle within the nil-paid rights life cycle). All subscribed, paid-for, nil-paid rights will be transformed into fully paid rights.
2. **Fully paid rights** – a transitory mechanism between nil-paid and ordinary. These fully paid rights have unique security identification numbers and are traded independently of the ordinary line. Often the transitory period is non-existent (ie, the transfer from nil-paid to fully paid to ordinary happens in a single sequence at the same time). However, fully paid rights may exist for a time period if the newly issued shares are restricted in any way, such as not ranking for a dividend due to be declared. When the restricted period has elapsed, the fully paid shares will then transfer to the ordinary share line against which they will rank pari passu.
3. **Ordinary shares** – rank alongside existing ordinary shares, equal in every way; they rank pari passu.

3. Conversions

3.2.1 Know the following types of conversion: convertible bonds $\Leftrightarrow$ equities; 144a $\Leftrightarrow$ Reg S (and how they differ); 144a $\Leftrightarrow$ unrestricted (registered) line; preference $\Leftrightarrow$ ordinary

3.2.2 Know the process for converting underlying local shares to ADRs/GDRs or vice versa

Conversions are used in some cases to transform the characteristics of a financial instrument to that of a different instrument entirely. The five conversions that are examined in this section are:

- Convertible bonds to equities.
- Rule 144a to regulation S.
- Rule 144a to unrestricted (registered) line.
- Local shares to [depository receipt \(DR\)](#).
- [Preference shares](#) to ordinary Shares.

One important point to note about the conversions described in this chapter is that they do not normally involve the investors paying or receiving cash with one security simply being exchanged for another.

3.1 Convertible Bonds to Equities

When an investor buys a convertible bond it is usually as a long-term investment with an eye to converting it into an equity at a later date. The decision is based on the belief that the conversion to the share will produce a higher return than that on the bond. There are many factors that will affect the return on each of them, such as the prediction of what will happen to interest rates and the prospects for growth of the company.

The mechanics of the conversion in the following outline are based on Euroclear Bank:

1. A conversion notice is completed and returned to a [conversion agent](#) with details of where to deliver the equities.
2. Euroclear Bank is instructed to deliver the bonds to the conversion agent.
3. If the equities are Euroclear Bank-eligible, an instruction to Euroclear to receive the equities may also be sent. This is at the discretion of the shareholder, as they may hold equities directly in the local market. If the shares are not Euroclear Bank-eligible, another custodian will need to be instructed.

In theory, the bonds will be delivered and sometime later, usually a few days, the equities will be received. As the decision to convert bonds to shares will be based on

their relative prices, there may be a sudden rush to convert large quantities of bonds once conditions are right. For this reason, the conversion agent will often state the time period for conversion in the prospectus so they can cope with the volume. This may be a period of several weeks, during which time neither the equities nor the bonds will be available.

3.2 Rule 144a to Regulation S

In general, trading in the US requires instruments to be registered with the Securities and Exchange Commission (SEC).

- Rule 144a permits **qualified institutional buyers (QIBs)** to trade privately placed securities without the two- to three-year holding requirements.
- Regulation S clarifies the conditions under which offers and sales of securities outside the US are exempt from SEC registration requirements.

Rule 144A benefits investors (noting they are mainly large institutional buyers (QIBs)) by providing greater liquidity for privately placed securities, since they can be freely traded among QIBs without full SEC registration. It also gives investors access to a wider range of opportunities, including foreign and high-yield issuers not available in public markets. These securities can offer higher returns or more favourable terms, and deals can be executed faster and with lower regulatory burden. investors can also request key financial information, giving them sufficient transparency despite the private nature of the offering.

The following link provides additional reading if required:

<https://www.isin.net/reg-s-and-144a/>

If a firm wishes to trade Regulation S shares inside the US, or Rule 144a shares outside, then it is possible to convert them from one type to another. This is completed via a conversion agent, usually a US bank. The procedure is as follows:

1. The conversion agent will provide legal documentation that must be completed and returned with duly authorised signatories. The document will state that the shares will only be sold to other QIBs (if under Rule 144a) or that they will only be traded outside the US (if under Regulation S). This form is then medallion-guaranteed by the custodian or US representative; this means that a stamp is applied to authenticate the signatures.
2. Two messages need to be sent to the custodian. One is to deliver the securities **free of payment** to the depository account of the conversion agent, and the other to receive the new securities back into the depository account free of payment.

The Regulation S instruments will be deposited and Rule 144a instruments will be received or vice versa.

3.3 Rule 144a to Unrestricted (Registered) Line

Sometimes a security that was only traded in the US under Rule 144a becomes unrestricted, ie, it can be bought and sold by any investors. This will occur when the issuer has decided to register the security with the SEC. This conversion follows similar procedures to those described in the previous section. A conversion notice specifies the transfer details or name of the agent. This needs to be signed by the converting securities holder. On receipt of the form, the securities are then converted to unrestricted, with all the benefits that this entails.

3.4 Local Shares to Depositary Receipt (DR)

In this case, local equities refer to shares in a market where the investors does not reside and DRs (depositary receipts) refer to receipts in the investor's country of residence. A DR represents ownership of shares in a foreign company that trades on a local exchange.

By converting the local equities to DRs, the investors gains several advantages. The main benefits are as follows:

- The investors receives dividends in their native or base currency and does not have to arrange additional foreign exchange (FX) transactions. The FX transactions become the responsibility of the party issuing the DR.
- The purchase and sale of the DRs are under the laws of their country of residence.
- The trading and settlement process of the DRs will be more familiar to the investors and may be more robust than trading in the local market.

The mechanism is as follows (in this example, the conversion is from a UK share to an [American depositary receipt \(ADR\)](#)):

1. An instruction is sent to a conversion agent who will cancel the local equities and reissue them as DRs. In the case of ADRs this is usually a US bank.
2. Two instruction messages need to be sent to the custodian. One is to deliver the equities free of payment to the UK depository account of the American bank, and the second is to receive the ADRs into the depository account free of payment.
3. The American bank will normally charge a fee for this, and stamp duty reserve tax (SDRT) will also be payable at the higher rate of 0.5% (only on creation of the ADR) as shares are entering a clearing system.

The equities are moved out of the depository account and are replaced by ADRs. For other markets, the procedures will be similar, but the tax situation may be different.

Holders of the ADRs have a different set of entitlements and rights from shareholders:

- The conversion agent will convert the dividends into dollars and pay the ADR holder.

- When there is a bonus issue, the conversion ratio of the ADR is amended. So, if prior to a 1:1 bonus issue an ADR represents ten local equities, after the issue, it would represent 20 shares. The ratio is normally changed rather than additional ADRs being issued.
- Typically, ADR holders are not able to participate in rights issues due to legislative restrictions on domicile. If they are not eligible to participate, they will receive a cash payment in respect of the rights that they cannot take up. This cash payment represents action whereby the depository bank sells the nil-paid rights on the open market and credits the ADR holders with the net proceeds received. The distribution of proceeds is proportionate to the number of rights held for each ADR holder for the average price achieved during the sale process.
- Holders of ADRs do not usually have voting rights.

3.5 Preference Shares to Ordinary Shares

Preference shareholders normally receive a fixed dividend before ordinary shareholders receive their variable dividend. This may be attractive to an investors in the early life of a company in that if anyone is paid a dividend, they will receive one. As a company becomes more mature and the dividend stream becomes more secure, it may prefer the higher return of the ordinary shareholder rather than their existing fixed return.

The mechanism will be like that for convertible bonds to shares. The only significant difference is that a preference for ordinary share conversion normally has limited opportunities to convert over the course of a year. This is set out in the prospectus or on the certificate and is not publicised by the company.

If a custodian fails to meet the market cut-off for the conversion instruction, the liability for obtaining the converted stock lies with them. This may prove very costly, as the conversion price is likely to be below the market price for the stock, and the client would only be liable for the conversion they would have paid.

4. Warrants

3.3.1 Know how to exercise warrants

A warrant issued by a company provides the holder with the right to acquire equities in that company at a pre-determined price and ratio, at or on a future date.

Warrants are often issued by companies as an inducement to investors to invest in a new bond issue by the company. The prospect of a large return from holding a warrant obtained without cost can make a marginally attractive bond issue more palatable to

the investor. The warrant holder is not obliged to exercise the warrant and can sell it before the [expiry date](#) as they can be traded on the major exchanges.

Warrants can be exercised during the lifetime of the warrant on a basis as stipulated in the original terms of the warrant, usually six-monthly or annually.

They can be issued completely separately by a third party, ie, a broker/dealer or investment bank. If the third party owns the underlying shares, it is known as a covered warrant, and if they do not, then it is known as an uncovered warrant, and carries a much greater risk to the issuer.

Warrants come from the same sources as equities and are issued as part of an initial public offering (IPO) or a corporate action. Warrants are usually a freely tradeable instrument in their own right and carry their own ISIN. A holding in warrants can be added to beyond the original issue, or warrants can be invested into, as with any issued instrument.

In all cases, to calculate the profit or loss on exercising the warrants, the original price paid must be considered.

The warrants carry a conversion cost known as the [strike price](#). This is a pre-determined price at which the warrants can be converted into the underlying stock and is set at their point of issue.

The current underlying stock price and any upcoming cash dividends must be included in the calculation. In some cases, although a loss may be made on the conversion, an upcoming corporate action may be attractive enough for the investor to swallow the initial loss.

The calculation can date back years to the original investments, as warrants can have a long time span.

- A = the premium paid to purchase the warrants, plus the strike price to convert, equals the total investment (note, if the warrants were issued as a bonus from a previous corporate action, the premium will be zero).
- B = the current share price, plus the possibility of a cash dividend or a corporate action equals the true real-time market value.

$$\text{Profit or loss} = B - A$$

4.1 The Mechanics of a Warrant Conversion

The holder of the warrant can exercise it at any point, in accordance with the terms of the warrant, and buy the underlying equities. Whether this is done or not, the timing of the conversion depends on the current price at which the underlying share is trading

and what the expectations are of the share movements up to the expiration date of the warrant.

For example, the warrant holder may believe that a higher profit may be realised by waiting. If the warrant can be exercised and the share bought at less than the current market price, the warrant is said to be **in-the-money**. Conversely, if exercising a warrant would mean paying more for the share than the current market value then it is said to be **out-of-the-money**. **At-the-money** is when the market and strike prices match exactly. Note that the premium is ignored when calculating whether a warrant is or is not 'in-the-money'.

Example: Conversion of Warrants

An investor pays a premium of 5p per warrant for 4,000 warrants, with a strike price of 560p.

Their outlay is, therefore, $4,000 \times 5p = £200$

Two months later, the shares are trading at 580p and they exercise the warrants. They receive: $(580p - 560p) \times 4,000 = 20p \times 4,000 = £800$

Their profit is, therefore, $£800 - £200 = £600$

Alternatively, if after two months the shares are trading at 520p and on that day the warrant is due to expire, the same investor will not exercise the warrant, since they can buy the shares at a lower price in the market than the strike price.

If the warrant is in physical form, then the form on the warrant must be completed and sent off with payment to the registrar or firm's agent, who will then return the shares. In dematerialised markets, the conversion is completed electronically.

If a warrant is auto-expiring and it reaches the expiry date, the investor will be automatically paid if the warrant is in-the-money. This payment is the lapsed warrant proceeds and is referred to as **lazy money**, reflecting the lack of effort on the investor's part.

If a warrant is not auto-expiring and the investor fails to instruct for the conversion of warrants by the due date, the warrants will expire and any in-the-money position will be lost.

4.2 Options

While this is not strictly part of this section, it is worth noting the differences between a warrant and an option. Both are similar in concept, but they are different, and unfortunately, they are often confused and, therefore, incorrectly used.

To recap from earlier, a stock warrant is directly issued by the company to the investor.

However, a stock option is a contract between two people or parties to give the investor the right to buy (using a [call option](#)) or sell (using a [put option](#)) a stock at, or before, a specified future time (called the expiration date) and at a specific price (called the strike price).

Example

If an investor feels that a particular stock's price is going to rise and is currently priced at £100 per share, then the investor could buy 100 shares costing £10,000 (ie, £100 price x 100 shares). If the stock prices increase (say to £110 per share), then the investor would make a profit of £1,000 (ie, $100 \times £110$ less $100 \times £100$).

However, if the investor is extremely confident that the stock price will rise, then they could buy a put option of £110 per share which means the investor would have the right to buy 100 shares at that price before the expiration date. The firm that is providing the option will, typically, charge a small fee for this (which for the purposes of this example is £250).

This means if the stock price goes above £110 (say to £150 per share), then the investor would make a profit of £3,750 (ie, $100 \times £150$ less 110×100 less the £250 fee). However, if the stock price drops (say to £80 per share), then the investor would not take up the option and would only lose the £250 fee paid to create the option at the outset.

5. Takeovers and Exchanges

3.1.1 Know: the stages involved in a rights issue; the reasons for rights issues and the options available to the shareholder; the difference between renounceable and non-renounceable rights; priority offers in the UK; lapsed rights proceeds; poison pill rights in the US

3.4.1 Know: the following aspects of takeovers: acceptance; no action; Section 979 notices; buyer protection and trade transformation; key dates; dissenting shareholders; the role of the Panel on Takeovers and Mergers (PTM)

5.1 What is a Takeover?

A takeover is simply the acquisition of one company by another. The motivation for a takeover is usually to improve the performance and profitability of the target company by, among other things:

- gaining market share
- reducing competition
- realising efficiency gains by merging the two organisations
- acquiring teams of talented staff
- believing that it can run the target company more efficiently, and
- selling off the assets of the target company in order to make a profit (this is known as [asset stripping](#)).

A takeover is a voluntary event in which a bidding company attempts to acquire a controlling interest in another company. It can be a hostile takeover, in which the target company's board may attempt to dissuade the shareholders from accepting the bidding company's offer. The board will issue a [defence](#) document stating why it does not agree. Alternatively, if the board of the target company is favourable to the approach, then it will endorse the offer to its shareholders. This is known as a recommended takeover. Some recent examples of hostile takeovers in the UK include the acquisition of Cadbury plc by Kraft Foods Inc in 2010 (which was successful) and the attempt by Northstream plc to acquire Forth Ports in the same year, which the target company successfully defended. In the US, target companies often use [poison pill rights](#) issues to defend themselves against unwanted bidders.

A [poison pill](#) is a strategy that is employed by a company that is the subject of a takeover bid or merger approach that is designed to increase the likelihood of negative results over positive ones for the company that has made the takeover approach. A variation of this poison pill is called poison pill rights, which is a selective rights issue that allows additional shares to be issued to some shareholders, which is used to deter aggressive takeovers by diluting the shareholding of the bidding company.

The bidding company will offer the following in exchange for shares in the target company:

- shares, or other securities such as debt instruments, issued by the bidding company, or a mixture of shares and debt
- cash, or
- a combination of cash and securities.

Ultimately, the bidding company will always have a basic offer upon which any options to the bid itself will be built. If the bidding company is offering a choice of cash or new securities, it may be possible (if the offer terms allow) for the investor to elect to take an increased amount of cash for, say, 50% of their existing shareholding, and new securities for the remaining 50%, when the basic offer is, for example, at 25% cash and 75% shares. Such an election would be known as a mix and match decision with any election, for enhanced receipt of any element, offset by the actions of other shareholders. Such elections are subject to scale-back. For example, if all shareholders elect for the maximum cash option of a mix and match, there will be no offset for the cash distribution, as no holders had elected for enhanced stock. If one holder elected maximum stock, they would receive their desired election with their cash element being distributed pro rata on a shareholding basis to the maximum cash electors.

An exchange offer is a specific case when no cash changes hands; it is purely an exchange of shares.

In a takeover situation, shareholders would expect to be offered a premium to the share price as an incentive to give up their shares. When a takeover is rumoured or announced, the share price usually rises to a value close to the expected takeover price, and so the market capitalisation converges with the takeover value.

5.2 The Mechanics of Takeovers

In the UK, the terms of the offer, together with acceptance forms, are distributed to the shareholders of the target company, who have between 21 and 60 days to respond. Some other important dates in the takeover process include:

- Posting of first defence – day 14.
- Offer details to target – day 28 (28 days to issue formal offer document from the announcement of firm bid).
- Last date for target company announcement – day 39.
- Last date for [predator](#) to revise offer – day 46.

Certificated shareholders who wish to take up the offer send the form of acceptance, together with their share certificates, to the offeror's receiving agent by the deadline.

In the event of an open market claim or failed delivery, the buyer will have to protect their entitlement with the counterparty. This involves the buyer instructing the counterparty as to which option they wish to take. The counterparty then acts on the instruction and, on receipt of the consideration, passes this on to the buyer. Such protection will normally only occur if an option is to be withdrawn at a certain point or at the final stages. This is called buyer protection.

For dematerialised shareholders in the UK who are CREST members, the shares can be transferred to an [escrow](#) account via a CREST Transfer To Escrow (TTE) message, which effectively passes control of the shares over to the offeror. There will be a different escrow account for each option that the bidding company has offered. This type of automation has largely done away with paper acceptance forms within the UK and other dematerialised markets.

If, when the offer closes, the bidding company has achieved the required percentage of the target company's shares as specified in the offer document (usually 80%), the offer becomes unconditional. The agent acting for the offeror then moves the shares out of the escrow account and into the offeror's account.

The shareholders can withdraw acceptance of the offer by transferring the stock back out of the escrow account, normally after day 42 of the offer if it is not unconditional.

Over the course of a takeover offer, securities which are tendered under the terms of the offer are termed assented securities. Such securities are transferred to an escrow account in CREST, and they remain at escrow until the offer is declared wholly unconditional, at which point CREST will release either the cash or securities proceeds resulting from the takeover or, if the conditions of the takeover have not been met and the offer lapses, the original securities are returned from escrow. As part of this there is a process called trade transformation which allows inflight trades to be converted into their new entitlement.

The London Stock Exchange (LSE) allows trading in assented securities during the escrow period and assigns a temporary security code to such securities. Each option of the offer has its own assented security, an example being an offer with cash and a stock option, where the assented assets will be assented for cash and assented for stock so that it is clear to the buyer what they are purchasing.

This also facilitates the systemic payment of cash and/or allocation of stock as a result of the transformation process.

Once the offer has been declared wholly unconditional, possibly at 80% acceptance, the shareholders who elected to take up the offer will receive their cash or shares within six days. If the offeror acquires 90% +1 share of the target company's shares, under a 979 notice, it can undertake a compulsory purchase of the remainder of the shares. By issuing a 979 notice, any shareholders who still do not accept the offer become [dissenting shareholders](#). A 979 notice is usually valid for a period of six weeks from issue, after which all shares that have not been accepted to the offer will be

compulsorily acquired under the basic terms of the offer. Dissenting shareholders remain on their own dissenting shareholders' register. If cash forms the terms of the takeover event, such cash entitlements are placed in a trust account until acceptance. Stock is similarly placed and is entitled to any dividend or other benefits income until eventual acceptance.

One of the biggest challenges is when the buyer does not have the same high value of the firm as the seller. To try and manage this, a **contingent value right (CVR)** issue is sometimes used. A CVR is a derivative which is based on some future event by a specified date and if this event happens, then the CVR distributes a pre-agreed payment, typically in cash. If the event does not happen then the CVR expires and is worthless. This should hopefully bridge the gap between the different values of the buyer and seller. CVRs are more common in the biotech/pharmaceuticals industries because they allow the companies to manage different values on future and risky new drugs because a CVR can be created to cover the risk of the drug not being a success.

Following the takeover, the target company may remain as a separate legal entity, operating as a subsidiary but owned by the bidding company. Alternatively, the bidding company may enrol the company into its own legal entity.

In the case of a transaction that is open (which has not been settled) at the effective date of the offer, the deal would be transformed into an entitlement, and a claim would be made. A very similar process for tender offers takes place, the exception on tender offers being that once tendered the shares are transferred to escrow and cannot be traded.

Taking 'no action' on a takeover will, at the early stage, have the same effect as not accepting any of the offers. This could, in theory, prevent the company from reaching the unconditional stage and prevent the issue from going any further. In effect, the investor is abstaining from the issue.

Certain types of investors can only take action in the later stages of the takeover. For example, tracker funds are under obligation to reflect the percentages of the quoted companies that are covered within the remit of the fund. This is usually the main exchange, such as the FTSE 100. Once the takeover reaches the wholly unconditional stage, then tracker funds accept the offer.

5.3 The Role of the Panel on Takeovers and Mergers (PTM)

The Panel on Takeovers and Mergers (PTM) is an independent body whose main functions are to issue and administer the City Code on Takeovers and Mergers and to supervise and regulate takeovers and other matters to which the Code applies in accordance with the rules set out in the Code.

The PTM regulates takeover bids and other merger transactions for companies which have their registered offices in the UK, the Channel Islands or the Isle of Man if any of their securities are admitted to trading on a regulated market or multilateral trading facility in the United Kingdom or on any stock exchange in the Channel Islands or the Isle of Man. The PTM's remit also covers other public companies and certain private companies which are resident in the United Kingdom, the Channel Islands or the Isle of Man.

While the PTM is very UK focused there are similar bodies across the globe. For example, the Australian Takeovers Panel, Irish Takeover Panel, New Zealand Takeovers Panel and the Swedish Securities Council (*Aktiemarknadsnämnden*).

6. Tenders

3.5.1 Know the following aspects of tender offers: tender offer; Dutch auction; odd lot/mini tender offers; acceptance and no action; oversubscription; scale-back

6.1 Tender Offer

A [tender offer](#) is an offer by the issuing company, or by another company, to buy a set amount of its issued share capital or its outstanding debt over a given period of time. Shareholders are asked to tender and surrender their holdings for a stated value, usually at a premium to the current market price. This is usually subject to the tendering of a minimum and a maximum number of shares.

Another type of tender is a [mini-tender](#) where an offer is made to purchase no more than 5% of the stock of a company. The 5% threshold is critical because any offer to purchase more than 5% of the stock would trigger a variety of regulatory requirements. By staying under the 5% ceiling mini-tender offers can avoid regulatory scrutiny. Therefore, this means that (a) they are treated nervously by investors and (b) if made by an outside party without the company's management approval, could be seen as the start of a hostile takeover.

A tender offer is said to be oversubscribed if, for example, the issuer has announced that it will buy back 10 million shares and shareholders submit bids for 20 million shares. In such a case, the issuer must apportion the shares it intends to repurchase between the investors who have tendered.

The offer may be based on purchasing all the shares at a single price, in which case, if the offer were oversubscribed, each investor would be able to sell 50% of their holding back to the company. Alternatively, the tender offer might take the form of a [Dutch auction](#).

A Dutch auction has similarities to a tender acceptance in that the company offers to purchase its ordinary shares at an amount between two prices. The company details the price range at notification and the increment of acceptance, eg, you can tender between €120 and €150 and can accept in lots of €5 (such as €120, €125, €130, etc, up to €150).

A strike price option is normally offered where a shareholder can accept the final price determined by the company, whatever it may be between the price range – in this example, somewhere between €120 and €150. In the event of a Dutch auction being oversubscribed, the company will fill its required number of shares, starting with the lowest prices accepted and working up, including the strike price elections, until it has the required amount.

An **odd lot** is a quantity of shares which is less than the normal trading unit, not an exact multiple of a **board lot**. These will often be traded at a disadvantageous price to a board lot. Certain companies offer shareholders the opportunity to sell their shares back to the company or in the market at a specified price, free of commission and dealing costs. These offers are usually only available to holders of a low number of shares. Any purchase or sale of fewer than 100 shares is considered an odd lot. By doing this, the company reduces the cost when dividends are paid, as most small shareholders are private individuals who will often receive their dividends by cheque.

The final outcome of some of the events described above can depend on the number of holders participating and the number of shares they offer. It may be the case that a company determines the ratio or ratios at which security or cash benefits will be paid only after all elections have been received (Dutch auctions). In some cases, the final ratio or ratios will be less than the estimated ratios given when the corporate action event was announced; in other cases, the ratio paid out may be dependent on the size of a shareholding, with large holdings typically receiving a lower ratio than small holdings.

If a tender deadline is missed by a custodian, the client may be left with stock that they no longer want. In the case of a tracker fund, they may then have a disproportionate holding. In these circumstances, if the liability for the missed deadline lies with the custodian, then it would be obliged to purchase the shares from the client at the price the client paid, and then dispose of them as soon as possible, thus exposing itself to the risk that the market price may have fallen in the meantime.

The offer may be subject to proration (sometimes known as 'scale-back'), where a surplus of shares may have been tendered. In the context of tender offers, a scale-back occurs when the number of shares tendered by shareholders exceeds the number the bidder has offered to purchase. To manage this, the bidder accepts only a proportion of each shareholder's tendered shares, typically on a pro-rata basis, ensuring that the total purchase does not exceed the maximum specified in the offer.

6.2 Open Market Share Buybacks

An open market share buyback is an alternative to a tender offer. It is the most common share repurchase method in the US, representing almost 95% of all repurchases.

A firm announces that it will repurchase some shares in the open market from time to time, as market conditions dictate, and maintains the option of deciding whether, when, and how much to repurchase. Unlike tender offers, which have a fixed timetable, open market repurchases can span months or even years.

Before the company can take this action, it may have to seek shareholder approval in principle at an annual general meeting (AGM) or extraordinary general meeting (EGM), but once it has this approval, it has a great deal of flexibility. However, as part of the 'approval in principle' process, there may be daily buyback limits that restrict the amount of stock that can be bought over a certain time interval to prevent price volatility. The price at which the shares are repurchased will be the market price on the day of the transaction.

From the investor's point of view, an open market transaction is just the same as any other sale transaction; it is not processed as a corporate action as such.

From the issuer's point of view, the benefits of the open market method as compared to the tender and Dutch auction method transaction are as follows:

1. Open market programmes are very easy to set up. The issuer can just effect trades in the market as and when it sees fit.
2. Consequently, there is no need to set up a special programme with, for example, deadlines for investor responses.

7. Debt Exchange Offers

3.6.1 Know: the stages of a debt exchange; the process involved for 'acceptance' and 'no action'; the concept of scale-back

Debt exchange offers occur when issuers ask bondholders to turn their notes in for new debt at a discount to the face value, usually as part of an orderly default process. This type of action is usually taken because the issuer is having problems meeting its debt repayment and/or interest payment obligations.

Exchange offers reduce the company's debt, and often extend the maturities, but frequently at the expense of debtholders. Such offers may require the issuer to send a consent solicitation or hold a bondholders meeting.

7.1 Competitive Bids

This is a process in which bondholders may submit competitive bids for debt exchange programmes to the issuer and the issuer selects the best price from the aggregated pool.

These requests are not guaranteed. Any failed requests may result in bonds continuing to be blocked until the exchange agent reconciles their books and confirms that relevant shares can be unblocked and made available for trading.

This may not apply if a [lead manager](#) has taken an instruction directly, as sometimes a separate blocking deadline is set after the results of the exchange have been announced. At this stage, the bondholder will know if their competitive bid has been accepted and whether a block is, therefore, required.

7.2 Non-Competitive Bids

Bondholders accept the basic offer at the rate set by the issuer. Acceptance is usually guaranteed; however, some bids may be subject to proration if the amount tendered exceeds the amount the issuer wishes to exchange. In such a case, the stock that is not being exchanged is either placed back on to the client's account, or, in some cases, accepted as the company's default for a cash buyback.

If a market cut-off is not met, the client could just receive the company or government's default and suffer a financial loss.

7.3 The Exchange Offer Process

Typically, there are three dates that are important in an exchange offer.

On the announcement date, the borrower makes the offer to all the holders of the record on a given record date. The announcement spells out the details of the existing securities affected, the new securities that will be created, and any other relevant information, such as the existence of consent solicitations or notice of a bondholders meeting.

The offer also specifies an expiration date which is the latest date on which holders can accept the offer. If holders do not accept the offer then they are deemed to have taken 'no action' and will have to follow the decision other bondholders have approved. An exchange date, is the date when the old securities will be exchanged for the new securities.

7.4 Scale-Back

It is possible for the issuer to make an offer that only applies to a proportion of the outstanding debt, eg, if there is a specific bond issue with a face value of USD 100 million outstanding, the issuer could offer to exchange USD 50 million. In such a case, if USD 75 million were offered by investors, then each respondent would only have bids accepted for two thirds of the amount tendered for exchange.

8. Debt Repurchase

3.7.1 Know: the stages of a debt repurchase; the process involved for 'acceptance' and 'no action'; the concept of a tender cap

A debt repurchase is when a firm removes some (or part) of its debt securities by making an offer to its debtholders to repurchase a pre-defined amount of bonds at a pre-determined price during a set period of time with an incentive fee to repurchase early. Firms will often use a debt repurchase to assist with any refinancing and/or capital restructuring.

Outside Europe, particularly in the US, a debt repurchase is often called a debt tender offer.

8.1 The Stages of the Debt Repurchase Offer

A tender offer document is issued to a debtholder outlining the purchase price (including any early incentive fees), the expiration time, the withdrawal deadline, as well as any other legal conditions (such as the right to extend the deadline or even to terminate the offer).

Debt holders then must either (a) validly tender their debt notes or (b) deliver a completed and executed note of guaranteed delivery prior to the expiration time to be eligible to receive the purchase price. Firms can withdraw any previously presented notes as long as they are completed before the withdrawal deadline. The offer is typically non-negotiable.

Bonds that are repurchased are normally cancelled by the issuing company and cannot be (re)sold in the market. Likewise, they do not appear on the issuer's investment statements anymore.

If an investor takes no action then they simply keep their existing bonds under the same terms, receiving no cash payment from the issuer. The bonds remain outstanding and continue to accrue interest and mature as originally scheduled, although their liquidity may decline if many other holders tender and the remaining issue becomes smaller.

8.2 The Impact of the Tender Cap

For some offers, there is a tender cap where the firm only wants (or needs) to repurchase a certain amount of their debt; say 50% of total debt.

If the tender cap has been reached, then further elections will not be accepted, and any offers received will be pro-rated.

However, if the tender cap has not been reached, then the firm can extend the offer period to allow more offers.

Finally, in some circumstances, firms can adjust the tender cap if required.

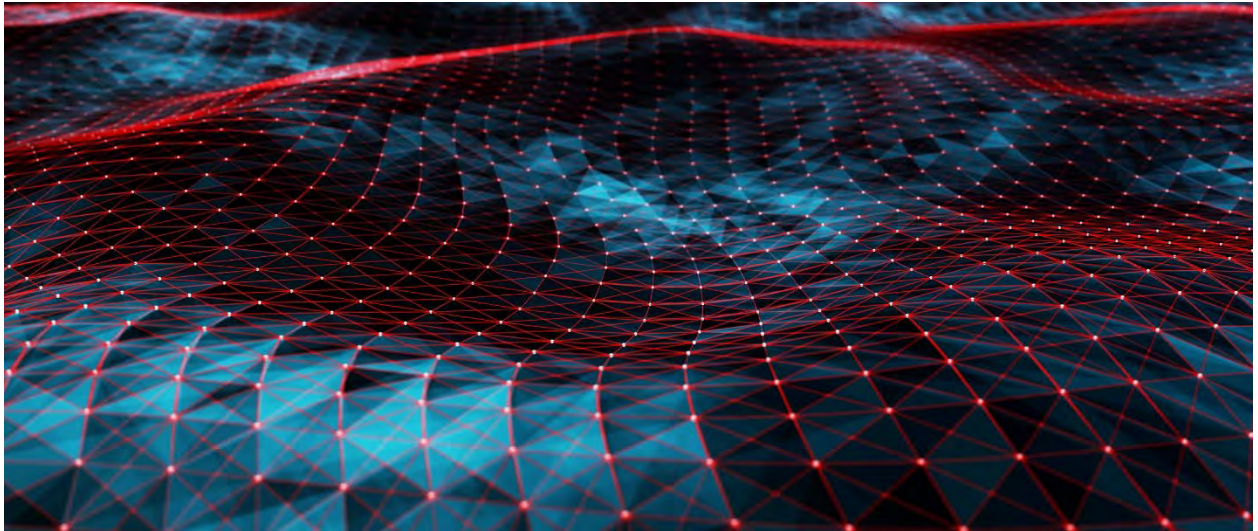
End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. **Give three methods that a firm could use to raise finance.**
Answer reference: Section 2
2. **What is:**
 - A. a nil-paid security?
 - B. the call date?
 - C. the renunciation date?
 - D. a renounceable right?*Answer reference: Section 2*
3. **In respect of the company making the issue, under what circumstances is a rights issue viewed as:**
 - A. a positive move?
 - B. a negative move?*Answer reference: Section 2.1*
4. **List five instances where one financial instrument might be converted to another.**
Answer reference: Section 3
5. **When can a warrant be exercised?**
Answer reference: Section 4
6. **How does the poison pill strategy discourage a hostile takeover?**
Answer reference: Section 5.1
7. **Give three reasons how a company would increase its performance by taking over another company.**
Answer reference: Section 5.1
8. **What is asset stripping?**
Answer reference: Section 5.1
9. **What is the CREST mechanism for accepting a takeover bid?**
Answer reference: Section 5.2
10. **In a takeover, what percentage of shares are required for:**
 - A. the offer to go unconditional?
 - B. compulsory purchase?*Answer reference: Section 5.2*
11. **What is a Contingent Value Right?**
Answer reference: Section 5.2
12. **What is the definition of an odd lot?**
Answer reference: Section 6.1
13. **What is a debt exchange offer?**
Answer reference: Section 7

14. What is a debt repurchase?

Answer reference: Section 8



Chapter Four

Corporate Governance

Section 1	Introduction
Section 2	Types and Dates of Company Meetings
Section 3	Appointing a Proxy
Section 4	Voting
Section 5	Share Ownership

This syllabus area will provide approximately 4 of the 50 examination questions

1. Introduction

Corporate governance is defined as the set of processes, customs, policies and laws that affect the way a company is directed, administered, managed and controlled. The basic concepts apply to the directors and management of the companies concerned as well as to shareholders and other stakeholders such as debt holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives, and other employees.

Corporate governance is a highly topical issue in this century after corporate collapses such as Enron and AIG, and the controversy surrounding the activities of the UK subsidiaries of News Corporation.

In this chapter, we are primarily concerned with those corporate governance issues that affect shareholders, such as company meetings and the way that shareholders use their voting power to influence management.

It is the responsibility of all shareholders, as part- owners of the publicly traded companies, to take an active interest in the running of the companies and to make their views known to the management of the businesses.

Approximately 70% of all stock in the UK is now held through institutions.

Fund managers and pension funds have taken an increasingly active role; in part, these funds are themselves under greater scrutiny and need evidence that they have undertaken the correct corporate governance in connection with their investments. Shareholders have also realised that increased participation can influence the way a company is run and that they can steer it in the direction in which the managers see greater profit potential and make sure that the company does not do anything unethical that could lead to financial difficulty, as happened to Enron or Parmalat. An obvious way of taking interest is through active voting at company meetings such as the annual general meeting (AGM).

Investors' holdings (and, therefore, their voting rights) are established with reference to a record date, usually two days before the meeting. The settled holdings at the close of business on the record date determine the right to attend and vote at the general meeting. This right remains with the seller if shares are traded after the record date and before the meeting.

If securities are held with a depository or custodian, they will generally be registered in the name of a nominee entity. In this instance, the beneficial owner holds the voting rights. Because the nominee entity is the holder of record, there may be delays in transmitting and receiving proxy information between depository, custodian and beneficial owner. A beneficial owner may have grounds for litigation against a depository or custodian if the investment or holdings were adversely affected by a

decision made at a general meeting and the owner was not given the opportunity to vote due to transmission delays beyond their control.

2. Types and Dates of Company Meetings

4.1.1 Know: the timescales for a company calling a meeting; the rights of shareholders to request an EGM and the timescales; the difference between ‘abstaining’ and ‘taking no action’; the difference between an ordinary resolution and a special resolution

4.1.2 Know the implications of consent solicitations

4.1.3 Understand the reasons for calling a bondholder meeting

There are three main types of company meetings at which shareholders can vote in person or by proxy. These are the AGM, the extraordinary general meeting (EGM) and the bondholders meeting. Different markets will have different notification periods for meetings set by law. In the UK, shareholder meetings must be announced at least 21 days before the meeting. The notices are sent by the issuing company or its registrar via postal mail together with a meeting agenda. For international markets, see section 5.

2.1 Annual General Meeting (AGM)

There is a legal requirement for public companies to hold AGMs in the UK within 15 months of the previous meeting, and to have one meeting in each calendar year. All the registered shareholders must be informed of AGMs and must receive the agenda of the meeting and the annual report, usually 21 days before the date of the meeting. The notice must state the meeting agenda.

The ordinary business transacted at an AGM will include:

- receipt of the directors’ reports
- appointment of an auditor
- approval of the company’s accounts
- election/re-election of directors
- remuneration of directors, and
- agreement of dividend payments.

There may also be special business to discuss, such as investor approval to:

- issue new shares

- implement pension provisions
- waive pre-emptive rights (these are rights that allow investors to purchase additional shares of a new issue before they are offered to the general public)
- perform share buy-backs, and
- change the company's constitution.

All business, ordinary and special, will form the resolutions of the meeting. Ordinary resolutions deal with everyday decisions such as approving annual accounts, declaring dividends, or electing directors. They are passed by a simple majority of shareholders (usually more than 50% vote cast). Whereas a special resolutions are for important decisions that can substantially affect the company such as altering its articles of association, changing its name, approving a merger, or even winding up the company. Due to their higher impact, they then require a higher majority (typically 75% or more of votes cast).

Notification of all meetings is through company websites, newspapers and regulatory news service announcements and by mail to registered shareholders. In the UK, a proportionately higher number of meetings have historically been held in March and April, to coincide with the tax year.

Beneficial owners can vote either by physical attendance, by mailing a [proxy voting card](#) or by appointing a proxy to attend the meeting (see section 3). The entitlement date is the date on which a person needs to be entered on the register of the security to be entitled to vote. UK and Irish regulations also allow issuers to specify a time (not more than 48 hours before the meeting). This may cause problems if the nominee company has multiple clients who wish to vote in different ways. See section 4.2 for a fuller explanation of the issues. The issuer's agent has the right to disregard any changes made to the register after this time.

If the beneficial owner's shares are registered in a nominee name, the vote must be lodged by the nominee company. Should the beneficial owners wish to vote through physical presence at the meeting, they must instruct the nominee company of their wish to attend. The nominee company will then lodge a corporate letter of representation nominating the beneficial owners to vote at the meeting. In some markets, further documentation is required.

By abstaining, the shareholder's vote is included in the count, so they have fulfilled their corporate governance duty but have not declared an intention to vote for or against any item. This should not be confused with taking no action. Here, the right to vote is ignored by the investor and, if no proxy vote is received prior to the meeting, it will be assumed that the investor wishes to take no action and, therefore, the vote will not be included in the count.

2.2 Extraordinary General Meeting (EGM)

An EGM may be convened by the company's directors if some business of special importance has arisen that requires investors' involvement and agreement. An EGM may also be convened at the request of members holding a certain percentage of voting power; in the UK, this is set at 10%. The request must state the meeting agenda, be signed by those requisitioning and be deposited at the registered office of the company.

Under UK law, the company's directors must issue a notice of intention to convene an EGM within 21 days of receipt of the request from a quorum of shareholders. The meeting itself must occur within 28 days of the notice. The term 'EGM' can also be used for a special general meeting (SGM).

There is no legal obligation for a company to publish the results of AGMs and EGMs, but it is common for most companies to make this information available through Companies House.

2.3 Consent Solicitations (for Bondholders Only)

A consent solicitation is a request by one party (usually, but not exclusively), the issuer or its agent, to the holders of a certain debt security asking for their consent to a material change in the description of that security that was originally published in its prospectus.

If most stakeholders provide their consent before the consent expiry date, the issuer may then follow through with the proposed amendments. Bondholders who have consented to the amendments may also receive a consent payment.

If it is not approved, the original debt terms remain in effect, and the company must continue to meet its obligations under those terms. This, in turn, could increase the risk of default if the changes were needed to prevent it, potentially triggering penalties, higher interest rates, or legal action, and may force the company to explore alternative strategies such as refinancing, formal restructuring, or individual negotiations with creditors.

Example

In July 2019, Technology Resources announced a consent solicitation seeking to amend the definition of 'Designated Subsidiary' contained in the indenture governing its 1.875% Convertible Subordinated **Debentures** Due 2034 in order to provide Technology Resources with greater strategic and operational flexibility, including greater flexibility to grow and expand the operations of Technology Outsourcing Services Holdings, Technology Cloud Services and its subsidiaries.

The terms of the consent solicitation were as follows: Technology Resources offered a consent fee of \$5.00 per \$1,000 principal amount of the 1.875% Convertible Subordinated Debentures Due 2034 to holders of record at the close of business on 21 July 2019 who validly provided their consent to the proposed amendment by the expiration time of 17:00, New York City time on 31 July 2019.

2.4 Bondholders Meetings

As the name implies, these are special meetings in which all investors in either a particular bond issue or all bond issues by a common borrower are invited to express their opinions and then vote on a proposed change to details published in the relevant prospectuses. They are equivalent to the EGMs of equity investors described in section 2.2 of this chapter.

There are a number of reasons why it might be necessary to convene such a meeting, which is called specifically for, and limited to, the bondholders of a company. The most common reason is that the company is unable to pay interest or repay principal on some or all of its debt. The usual business may include appointing a person or a committee to represent the interests of the bondholders in any discussions with the issuer or other creditors of the issuer.

The actions that the meeting might be asked to approve could involve a possible restructuring of the bonds via a debt exchange offer (see chapter 3, section 7) or conversion of debt to equity, or a mixture of both.

3. Appointing a Proxy

4.2.1 Know: the purpose of using a proxy; who is entitled to appoint a proxy; who is eligible to be a proxy for the selected markets; the different methods of appointing a proxy in selected markets

4.2.2 Know the role played by the proxy voting agent, also in relation to Voting Service Providers (VSPs)

3.1 What is Proxy Voting?

Shareholders, depending upon the nature and rights of the shares they hold, have the right to attend, speak and vote at company general meetings. They may exercise this right personally, send in a postal vote if they cannot or do not wish to attend the meeting, or appoint a representative, or proxy, to act on their behalf. The proxy is a named individual to whom the voting rights are transferred. By appointing a proxy, the investor is granting power of attorney to the proxy to be an authorised substitute. The main reason for proxy votes is to allow an investor to vote at a company [meeting without attending](#).

[Minority investors, or the issuing company itself](#), can organise proxy groups to solicit other investors to vote on a certain issue in a desired way.

Proxy voting is defined as follows:

‘The exercise of the voting rights of an investor in shares, bonds and similar instruments through a third party, based on a legally valid authorisation and in conformity with the investor’s instructions’.

There are few restrictions on who is eligible to cast a proxy vote. An investor can appoint any person as its proxy and either authorise the proxy to vote in a certain way or to use their discretion. It is common practice for companies to issue proxy cards together with AGM notices that allow investors to appoint the chairperson of the meeting as their proxy.

There are different methods for appointing proxies across different markets – namely:

- In the United Kingdom, proxy appointments are regulated by the Companies Act 2006. Shareholders can submit their proxies electronically, by post, or in person using a Form of Proxy provided with the meeting notice. Instructions can specify how the proxy should vote on each resolution. For listed companies, the CREST system enables electronic proxy appointments.
- In the United States, proxy voting is governed by the SEC under the Securities Exchange Act of 1934. Shareholders receive a proxy statement from the company and can appoint a proxy via mail, online platforms, or phone. They may provide specific voting instructions or allow the proxy to vote at their discretion.

Institutional investors often rely on proxy advisory firms, such as ISS or Glass Lewis, to guide their voting decisions.

- Across the European Union, the Shareholder Rights Directive II (SRD II) harmonises rules for listed companies. Shareholders can appoint proxies via paper forms, online platforms, or intermediaries, and many countries maintain centralised electronic voting systems. Proxy instructions are generally required in advance of the meeting.
- In Canada, proxy voting is governed by the Canada Business Corporations Act (CBCA) and provincial securities laws. Shareholders receive a management proxy circular and can appoint a proxy by mail, online, or telephone, with voting instructions that may be specific or discretionary.
- In the Asia-Pacific region, rules vary by country. In Japan, proxies must be appointed in writing using a standard form submitted before the meeting. In Australia, the Corporations Act allows proxies via paper, fax, or online platforms, and voting can be directed or discretionary. In India, the Companies Act 2013 permits proxies via physical form or electronic voting (e-voting), with specific filing deadlines.

3.2 The Role of the Proxy Voting Agent

Globally, more than 85,000 investor meetings are held each year, relating to more than \$100 trillion in global assets. In the current environment, there is increasing regulatory pressure to improve investor participation in, and transparency of, the corporate governance process. Proxy voting allows investors, through their asset servicers and agents, to vote in these meetings without attendance in person.

The expansion of international investment is adding a new layer of complexity to the proxy voting function, driving the need for, and volumes of, cross-border proxy participation in shareholders' meetings.

Institutional investors such as pension funds and mutual funds often delegate their investment decisions to fund managers, and it is fund managers that are charged with voting their clients' holdings at company meetings. When they vote, they have to take into account whether the issue on which they are voting is affected by any corporate governance rules imposed on them by law, by regulation or by the explicit or implicit requirements of their client. For example, if the client were an ethical investment fund and the company were a food processor, the client would almost certainly require them to vote against any proposal to acquire a tobacco grower.

Deciding how to vote can be complex if the legal residence of the client is different from that of the company in which it is invested, and/or if the information the company has provided is in a different language from their own or that of their investor client.

For these reasons, many fund managers use specialist firms to perform some, or all, of the following corporate governance functions:

- Researching into the issues that require a vote, and conformity with objectives set by the fund manager and its clients.
- Translation of relevant documents and presentation of the key points of the issues requiring a vote in a standard form. (Essentially this is the same process as ‘data scrubbing’, which was described in chapter 1, section 2.4).
- Attendance at the meeting, including tabling questions and casting the vote.
- Specialist firms that provide the full range of services are known as voting service providers (VSPs). A firm or individual who simply votes according to their client’s instructions is known as a **proxy voting agent**. It is important to note that while proxy agents follow clients’ instructions, they are still covered by Shareholders Reporting Directive (SRD) II (see chapter 7 later in this workbook). (While it is not the norm to mention specific vendors or products in workbooks, it is important to note that Broadridge is the main vendor in this proxy voting space, although other providers, such as Institutional Shareholder Services and Clearstream, also provide voting services).

4. Voting

4.3.1 Know the instruction process for a proxy vote: corporate letter of representation; implications for asset servicing

4.1 Corporate Letter of Representation

A proxy document must be issued to all holders of record by the company at the same time as the notice for a general meeting. This document will detail the voting options (these are for, against and to abstain) and is used as evidence of the investors’ preferences. It must be signed by the investor and returned to the company within the specified deadline.

For a named individual to have the legal right to vote on an investor’s behalf, the investor must also issue a corporate letter of representation specifying that the individual can attend the meeting and vote on the investor’s behalf.

Corporate letters of representation can present problems for asset servicing institutions. Consider the following example:

Example

Bank A is an asset servicing institution whose name is on the register of a company. Bank A has two clients who hold stock in that company and are designated holders in CREST.

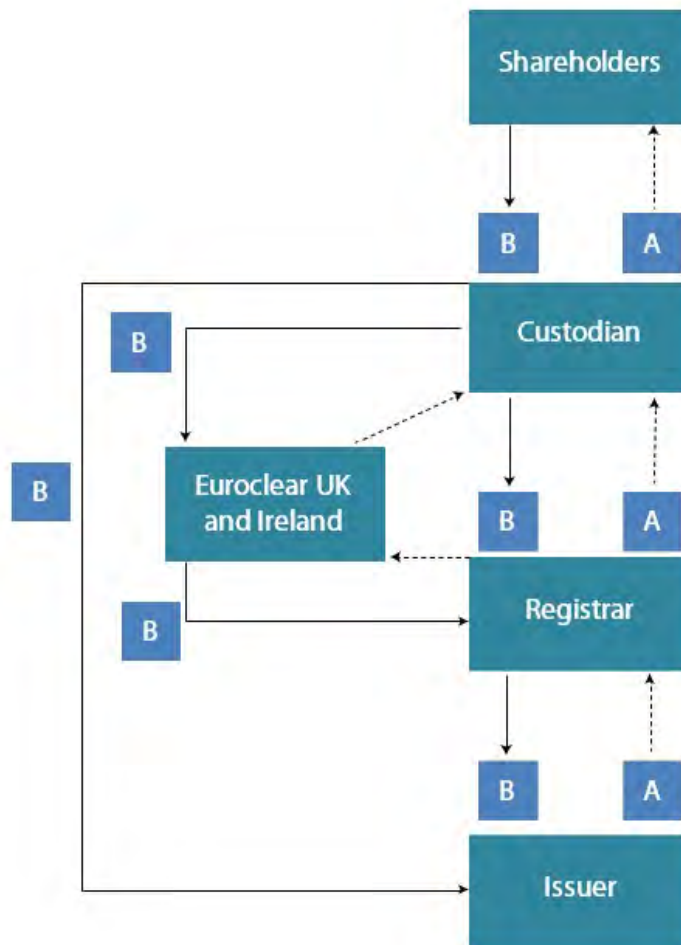
One of these holders has requested a corporate letter of representation, as they wish to vote and/or speak at the meeting.

The problem is that the letter of representation entitles the holder to vote all the stock in Bank A's name, which may not accord with the wishes of the other client. There is no systematic solution to this problem; the asset servicing institution will have to negotiate a solution with the client concerned.

The diagram on the next page shows how the voting process works in practice. A proxy agent may be appointed by the issuing company to handle the information flow efficiently. The custodian will send a list of all beneficial owners to the proxy agent, who will then send details of the meeting directly to them rather than via their intermediaries. Announcements will also be made via the market regulatory news services. Clients will send their proxy votes to their asset servicing departments, who will send them on to the company or through a proxy agent if this has been outsourced, via the company registrar.

4.2 The Implications for Asset Servicing

The main issue for asset servicing departments in administering proxy votes on behalf of clients is the time taken to receive the instruction from the client and send it on to the company. This process has been improved by technological advances and outsource companies (see chapter 4, section 3) specialising in proxy voting.



A = Notification information

B = Instruction information

From the client's perspective, they require certainty that their vote has been registered and that a clear audit trail exists. Most of these issues can be addressed by the introduction of electronic proxy voting. In January 2003, Euroclear UK and Ireland introduced an electronic proxy voting service for domestic securities. This service covers company meeting announcements, the appointment and giving of instructions to a proxy and meeting results.

There is an increasing demand for proxy voting internationally but local regulations do not always cover international investors. This can create issues for asset servicing departments that are contractually obliged to deliver this service.

Many asset servicing departments have outsourced this service. This has the following benefits, such as:

- improved services

- faster turnaround times
- less risk, and
- greater ability to generate revenue.

However, it does not affect or limit the responsibility of the asset servicing companies.

5. Share Ownership

4.4.1 Know: the purpose of Section 793 of the Companies Act 2006; the purpose of SRD II disclosures; relevant data protection issues

5.1 Section 793 of the Companies Act 2006

Section 793 of the Companies Act 2006 allows a company to investigate who currently owns its shares, or who has recently owned them. A company might use these powers if it were the subject of an actual or probable takeover bid, or if it were concerned about a lack of transparency over who was controlling it.

Companies use this power by sending a written 793 notice to any person or company whom they have reasonable cause to believe has, or had, an interest that is defined as owning, controlling or having certain rights over shares in their relevant share capital at some time during the three years immediately preceding the date of issue of the 793 notice. The Companies Act does not specify a set format for such notices. The Bank for International Settlements (BIS) has listed a standard one which companies adapt for their own purposes.

For stock on loan and repos, the stock borrower is the entity with the voting rights.

A company may appoint an agent (other than its registrar) to act on its behalf in the issuance of 793 notices and collation of subsequent data received. Due to the very sensitive nature of such information, it would be prudent of any recipient to a 793 notice from a third-party agent to verify the request with the company secretary of the issuing company.

5.2 SRD II Disclosures

The Shareholder Rights Directive II (SRD II) is a European Union (EU) directive, which sets out to strengthen the position of shareholders and to reduce short termism and excessive risk taking by companies. It builds on the existing SRD rules, and it became effective from 3 September 2020. SRD II is documented in more detail in chapter 7, but it is worthwhile documenting the purposes of its disclosures under this section.

Namely, the enhanced rules now give companies the right to identify their shareholders which means all intermediaries (such as fund managers) need to report the information to ensure the company knows who their shareholders are.

5.3 Relevant Data Protection Issues

The entire corporate governance arena (covering company meetings, appointing a proxy, voting and share ownership) involves holding personal data. This means that firms need to be mindful of the relevant data protection issues and legislation.

The most prominent data protection laws for UK firms called the General Data Protection Regulation (GDPR). GDPR is an EU based law and it was adopted by the UK on 14 April 2016 (when the UK was still part of the EU). It came into effect from 25 May 2018. After BREXIT, the UK still kept GDPR in law but renamed the legislation as UK GDPR. Therefore, there are now two versions of GDPR; namely UK GDPR and EU GDPR.

While there are some subtle differences between the two different versions of GDPR, the key principles are still the same. At its heart it is a regulation that focuses on data privacy and protection. It covers all individuals within the UK (or EU (and the export of personal data outside the UK (or EU))). Its primary aim is to give citizens and residents control over their personal data.

The GDPR has wide-ranging implications which have required firms to implement changes to their policies and supporting operating procedures. However, its key principles are as follows:

- Personal data shall be processed lawfully, fairly and in a transparent manner in relation to the data subject.
- Personal data shall be collected for specified, explicit and legitimate purposes and not further processed in a manner that is incompatible with those purposes.
- Personal data shall be adequate, relevant and limited to what is necessary in relation to the purposes for which they are processed.
- Personal data shall be accurate and, where necessary, kept up to date.
- Personal data shall be kept in a form which permits identification of data subjects for no longer than is necessary for the purposes for which the personal data are processed.
- Personal data shall be processed in a manner that ensures appropriate security of the personal data, including protection against unauthorised or unlawful processing and against accidental loss, destruction or damage, using appropriate technical or organisational measures.
- The controller shall be responsible for and be able to demonstrate compliance with the GDPR.

Therefore, firms need to take into account the above when processing personal data.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. **What business is transacted at an annual general meeting (AGM)?**

Answer reference: Section 2.1

2. **What percentage of voting rights is required to convene an EGM?**

Answer reference: Section 2.2

3. **What is the definition of proxy voting?**

Answer reference: Section 3.1

4. **Why are proxy votes employed?**

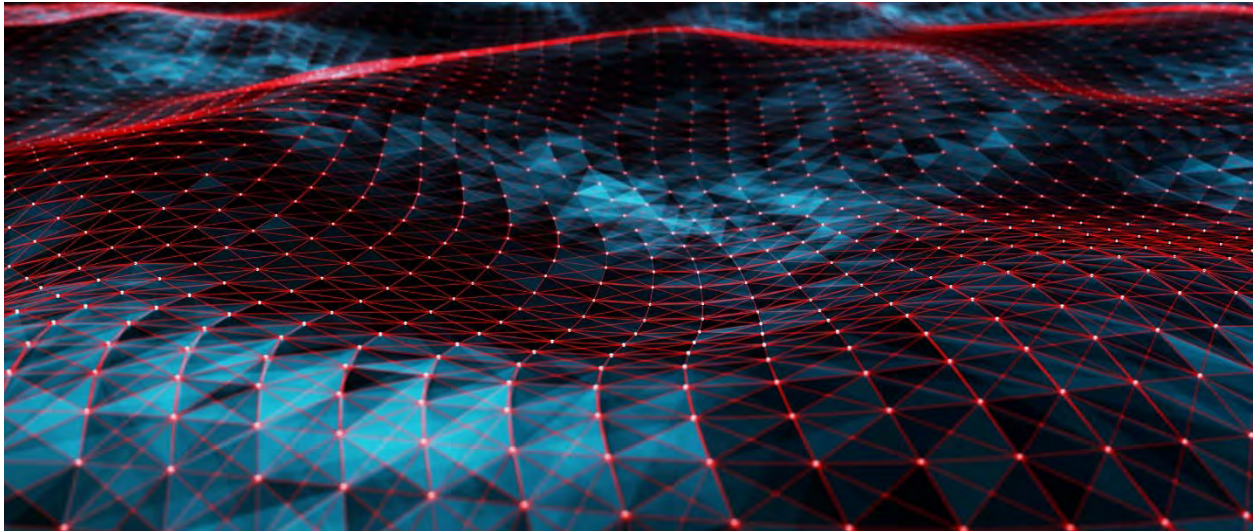
Answer reference: Section 3.2

5. **What document is required in order to transfer the legal right to vote from an investor to a third- party?**

Answer reference: Section 4.1

6. **What are the main implications of the proxy voting process for the asset servicing department?**

Answer reference: Section 4.2



Chapter Five

Tax

Section 1	Introduction
Section 2	The Life Cycle of a Tax Reclaim
Section 3	Deduction at Source and its Implications
Section 4	US Tax Legislation that Affects Asset Servicing Firms Operating Outside the US

This syllabus area will provide approximately 5 of the 50 examination questions

1. Introduction

Tax is familiar to us all on a personal level because we all pay personal taxes in the form of income taxes, property taxes, and sales taxes. However, from an asset servicing point of view, it is a complex area because different investment products and clients will require different tax treatments which will impact the asset servicing service provided and record keeping. Furthermore, there are serious legal, reputational and criminal penalties if tax rules are not followed.

For example, an investor who invests in assets across the globe will have to cope with different tax rules, treaty arrangements, different rates, different accounting treatment and reporting requirements.

For the purposes of this workbook, we are only concerned with certain specific aspects of taxation. This chapter will focus on explaining those aspects and the terms you are likely to come across, with a focus on the tax treatments of the markets featured in the syllabus.

2. The Life Cycle of a Tax Reclaim

5.1.1 Know the life-cycle of a tax reclaim

5.1.7 Know the need to provide proof of residency to the fiscal authorities for the purpose of reclaiming tax and obtaining relief at source

Before diving into the detail of this section, it is important to define three key terms, namely:

- residence
- domicile, and
- tax reclaim.

Residence refers to the place where a person lives temporarily or permanently. It is often a question of fact and depends on where the individual is physically present.

Domicile refers to a person's permanent legal home and is tied to their long-term intentions. It is a legal concept often used for determining tax obligations, inheritance, and personal law. The legal domicile of a person is important, since it, rather than the actual residence, often controls the jurisdiction of the taxing authorities.

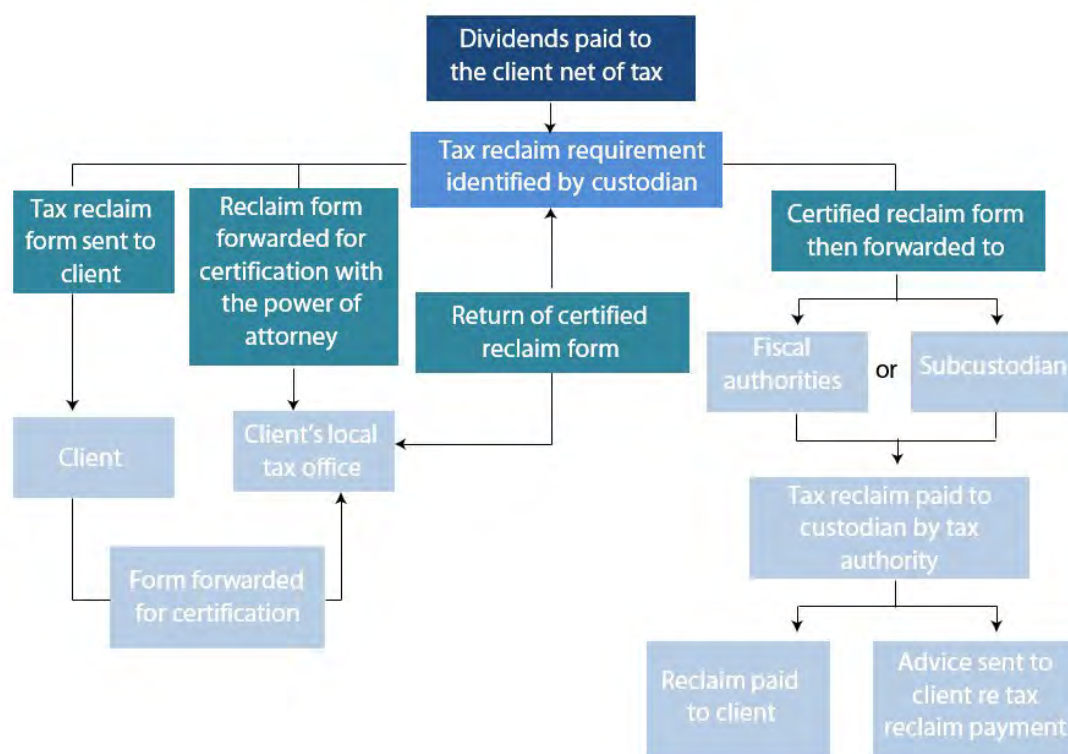
A tax reclaim is the process by which an individual or a business requests a refund of taxes that were either overpaid or erroneously deducted from their income, investments, or transactions. This process ensures that taxpayers recover amounts they are legally entitled to but were unnecessarily withheld or charged.

While the reclaim concept is similar across the different local authorities around the globe, the actual process and timelines vary a fair amount.

As a guide, the main steps in the reclaim process may be as follows:

1. The issuing company instructs its paying agent to pay a dividend.
2. The paying agent pays the withholding tax (WHT) due to the local tax authority.
3. The client or its custodian receives tax relief:
 - a. either by receiving a tax credit against UK tax, meaning that the investor can use the WHT already paid as a credit against their UK tax liability, or
 - b. by a tax reclaim from the overseas tax authority.

The Custodian Tax Reclaim Process



To perform the tax reclaim process on behalf of a client, the custodian must be in possession of the relevant tax documents to prove the client's residence. The following information and documentation are required:

- Certificate of residence from the client's local tax office.
- Power of attorney from its client.
- The completion of a tax questionnaire; this provides details such as the client's tax identification number, place of incorporation and registered address.
- Copies of US Qualified Intermediary (QI) tax documents (if trading US securities); these ensure that the client is operating in accordance with US tax law.

- **Market-specific tax documents:** in certain markets, the client is required to complete tax documentation in order to receive income payment at source at the treaty-eligible rate.

This information must be requested and received in a timely manner in order to allow completion of the relevant tax forms within the correct time limit. Most markets operate a statute of limitations (the time in which you have to file a tax reclaim for any excess WHT) on filing the reclaims. The time it takes to obtain a tax reclaim varies quite significantly between jurisdictions and is also affected by instrument type. The Netherlands usually settles claims in two to three months, while, at the other extreme, some Italian claims take years to settle.

3. Deduction at Source and its Implications

5.1.2 Understand the term ‘deduction at source’ and its implications

3.1 Withholding Tax (WHT) or Tax Deducted at Source

Withholding tax (WHT) or tax deducted at source is a method of collecting income tax in which the payer of certain types of income (such as salaries, interest, dividends, or payments to contractors) is required to deduct a specified percentage of tax at the time of payment and remit it directly to the government on behalf of the recipient. This ensures that the government receives tax revenue upfront and reduces the risk of tax evasion.

The actual rate of WHT varies by country; this can be at any rate, but is usually between 0% and 35%. The tax authority levying the tax is that of the issuing company’s country.

WHT is dependent upon a variety of circumstances; these include the country of residence of the client, the registration details of the sub-account and the country of issuance of the shares. For example, in Taiwan the [stock dividend](#) is made up of both retained and capital shares, and WHT is only payable on the retained portion of the dividend.

A problem occurs for investors if tax is also due on their income in their home country. If it is a UK investor, a dividend payment would also attract UK income tax, leaving the investor with a further reduced return on the original investment. Double taxation treaties (DTTs) exist between countries in order to prevent, or at least alleviate, double taxation.

In a similar vein, market claims are typically auto compensated gross although this again is decided on a country-by-country basis. For example, market claims for

securities issued by Italian issuers in Monte Titoli will be processed on a gross basis without tax adjustment.

WHT is deducted at source; in other words, the custodian in the country that is levying the tax will receive the payments gross. Then it must deduct WHT from any payments that it is making to overseas investors, and account for the deduction to both the investors and the tax authorities.

3.2 Double Taxation Agreements (DTAs)

Double taxation agreements (DTAs), or double taxation treaties (DTTs), are bilateral agreements between two countries. They are negotiated and ratified at ministerial level and exist in order to encourage and maintain an international consensus on cross-border economic activity, and to promote international trade and investment.

The bilateral agreements are designed to:

- protect against the risk of double taxation if the same income is taxable in two countries
- provide certainty of treatment for cross-border trading activity
- prevent tax discrimination against business interests abroad
- protect the government's taxing rights and protect against attempts to avoid or evade tax liability, and
- improve the exchange of information between the taxation authorities of states.

There are more than 1,300 DTTs worldwide, and the UK has the largest network of treaties, covering over 100 countries. A list of countries covered by the UK's network of DTTs can be found at <https://www.gov.uk/government/collections/tax-treaties>. This list is continually updated, and the most up-to-date list, which also shows brief details of the scope of each treaty, is maintained by HM Revenue & Customs (HMRC) at www.hmrc.gov.uk/taxtreaties/dtdigest.pdf.

Each agreement is unique, although there is a standard model produced by the Organisation for Economic Co-operation and Development (OECD) that is used as a template for most agreements.

Under the terms of a typical DTA, the rate of tax incurred by a foreign investor will be equal to the standard rate of WHT levied from non-residents, minus the agreed tax credit between the countries.

No reclaim of UK tax credits is possible for non-UK residents as the UK no longer withholds tax on domestic dividends, either notional or actual.

4. US Tax Legislation that Affects Asset Servicing Firms Operating Outside the US

5.1.3 Understand the role of a qualified intermediary

5.1.4 Know the implications of the US Foreign Account Tax Compliance Act (FATCA)

5.1.5 Know the implications of the Common Reporting Standard (CRS)

5.1.6 Know the implications of the US 302 tax

Two pieces of US legislation, the Qualified Intermediary (QI) regime of 2001 and the [Foreign Account Tax Compliance Act \(FATCA\)](#) of 2010, may have significant operational impact on asset servicing firms which operate outside the US. The primary difference between the QI regime and FATCA is that QI is focused on obtaining personal tax information of non-US resident holders about US securities, whereas FATCA aims to identify non-US accounts held by US citizens, and requires Foreign (meaning non-US) Financial Institutions (FFIs) to obtain certification from account holders (both US and non-US) as to their US tax status, with withholding required on certain US source income.

4.1 The QI Regime

The Internal Revenue Service (IRS) and the US tax authority established a QI Program in 2001 in an attempt to encourage foreign investment into the US and to simplify procedures for tax collection and tax reporting. Foreign institutions granted QI status have a commitment to report to the IRS a list of their non-US clients with investment interests in US securities. Subsequently, QIs will withhold taxes due on US securities held in these investors' accounts and will advance these tax obligations owed to the IRS.

QIs and Asset Servicing

An asset servicing department is responsible for reclaiming WHT on behalf of its client. This can be a complex, manual and burdensome process owing to the following issues:

- There is no standard global approach to tax reclamation. Each country sets its own timescales for claims and repayment; for Italy, for example, it has been known to take over ten years to obtain a refund, and in some cases settlement of a reclamation has never been achieved.

- Calculation of the amount of tax that can be reclaimed is complex, with different tax rates in different countries and different investment instruments having various levels of tax levied on them.
- As international investment continues to grow, more reclaims are becoming viable. The process of checking and collating the documentation is manually intensive and expensive to administer.

Despite these issues, efficient WHT reclamation is increasingly important because the amount that can be reclaimed represents a significant source of additional revenue for clients.

4.2 FATCA

Introduction and Timetable

FATCA was enacted in March 2010 and came into force in January 2013. It is an important development in US efforts to combat tax evasion by US persons holding investments in offshore accounts.

FATCA requires all non-US foreign financial institutions (FFIs), such as banks and custodians, to report customers with indicia of a connection (such as US telephone numbers or addresses) to the US Department of the Treasury, and for US persons to report non-US financial assets annually to the IRS in the US. Non-US and US customers of FFIs must supply certificates of their US tax status to the FFIs or face being reported to the IRS and having a full 30% withholding applied to all US source income. This includes non-US persons and entities that would not otherwise have a US tax obligation.

The UK–US Agreement

The UK (along with France, Germany, Italy, Spain and many other countries) took part in joint discussions with the US government to explore an intergovernmental approach to FATCA, supporting the overall aim of combating tax evasion, while reducing risks and burdens on financial institutions. An intergovernmental agreement was signed in September 2012, which provides a mechanism for UK financial institutions to comply with their obligations without breaching the data protection laws. Under this agreement, financial institutions pass information to HMRC, who will then automatically exchange this information with the IRS.

Because of the very complex due diligence requirement of FATCA, many financial firms in the UK are not accepting US citizens or residents as clients.

New Accounts

FFIs must obtain and examine documentary evidence establishing US or non-US status of individual account holders. For new individual accounts that are identified as held by US persons, the FFI will obtain Form W-9 from the individual holders of the accounts. Non-US persons will supply the relevant version of IRS form W-8. All the client onboarding information collected in connection with a new individual financial account will be examined to identify the possibility of potential US status.

Accounts need to be scrutinised when the following arise:

- Documentation suggesting that account holders are US residents or US citizens
- A US address associated with an account holder's account (whether a residence address or a correspondence address)
- A US place of birth for an account holder of the account, or
- Any other details of potential US status, including a 'care of' address, holding address, or PO box
- A power of attorney or signatory authority granted to a person with a US address
- Standing instructions to transfer funds to an account maintained in the US or directions received from a US address, or
- A US telephone number.

If an FFI does not receive the requested documentation from a customer, then the customer is considered a recalcitrant account holder which ordinarily would result in the application of a 30% FATCA WHT and reporting to the IRS.

Withholding and Reporting

Generally, a withholding agent (a person/institution that has control, receipt, custody, disposal, or payment of any item of income of a foreign person that is subject to withholding) is required to withhold 30% on a US source income made to an FFI, unless the FFI meets the requirements we have already covered. In addition, an FFI must withhold 30% on any payment it makes to a recalcitrant account holder, as well as any payment it makes to another FFI, unless that FFI meets certain requirements.

Under the terms of the intergovernmental agreement, UK FFIs need to report the following information about their reportable accounts to HMRC who, in turn, reports this to the IRS:

- The name, address, and taxpayer identification number (TIN) of each account holder which is a specified US person, and, in the case of any account holder which is a US-owned foreign entity, or an account holder who has neglected to provide valid documentation as to their status and so is considered recalcitrant.
- The name, address, and TIN of each substantial US owner of such entity.
- The account number.
- The account balance or value at year-end.

- Gross dividends, interest and other income paid or credited to the account (timing will be determined in the FFI agreement).

An FFI reporting to the HMRC is required to submit its FATCA reporting prior to 31 May following the reporting year, with HMRC onward reporting to the IRS by September of the same year.

4.3 Common Reporting Standard (CRS)

The European Union (EU) adopted the CRS, which was developed by the OECD (Organization for Economic Co-operation and Development). It calls on participating jurisdictions to automatically exchange certain information with other jurisdictions on an annual basis, to combat tax evasion. The EU adopted the standard on 1 January 2016. The CRS was modelled after FATCA, but the US did not sign up to the CRS reporting standards.

Information to be Exchanged

Annually, each participating country automatically exchanges with the other participating countries:

- the name, address, tax identification number (TIN) and date and place of birth of each reportable person
- the account number
- the name and identifying number of the Reporting Financial Institution, and
- the account balance or value as of the end of the relevant calendar or, if the account was closed during such year or period, the closure of the account.

Reportable Accounts

The OECD does not specify what is reportable – it allows the participating countries to determine what accounts are reportable. ‘Reportable Account’ means a Jurisdiction A Reportable Account or a Jurisdiction B Reportable Account, as the context requires, providing it has been identified as such pursuant to due diligence procedures, consistent with the Annex, in place in Jurisdiction A or Jurisdiction B.

This means that either jurisdiction may negotiate and determine its own Reportable Accounts in its agreement.

4.4 US 302 Tax Law

US 302 tax law is becoming more and more significant now on US mergers. The background is as follows:

- Typically, a company will distribute its profits to shareholders in the form of a dividend and that dividend may or may not be subject to WHT, depending on the jurisdiction's tax regime.
- Separately, a company may choose to redeem its stock and ordinarily a redemption of stock would be subject to CGT, depending on the jurisdiction's tax regime. If a US company chooses to distribute its profits to shareholders by means of a redemption or form of redemption, that is to say, an event such as a merger with cash, stock or cash and stock outcomes, then that redemption may be subject to income rather than CGT under Internal Revenue Code Section 302 and/or Section 304 of the US tax regulations.

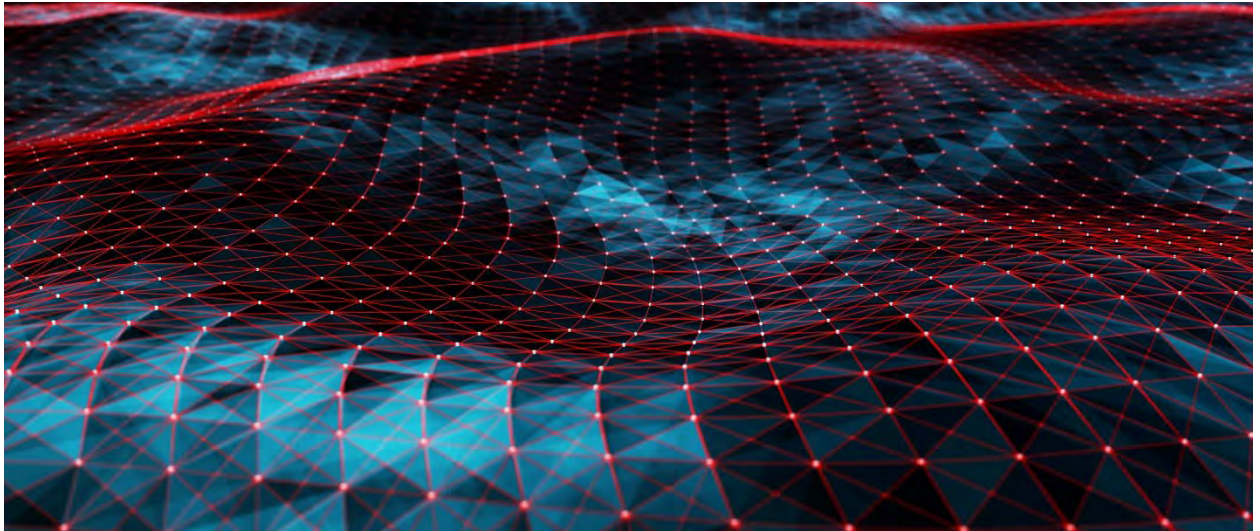
The rules regarding whether a redemption may be subject to income rather than CGT are as follows:

- If a shareholder received only stock in the exchange, then it would be deemed non-taxable and Section 302 would not apply.
- If the shareholder only received cash for the exchange, then it would be taxable and covered by Section 302. The cash received would be treated either as a dividend and/or as capital gain/loss.
- The final scenario is more complex. It relates to where a shareholder receives a combination of both stock and cash in exchange. Any gain would be treated as a capital gain if it met any of the following three tests:
 - o The redemption must not be the equivalent of a dividend. This is actually hard to define although the rule-of-thumb is that only large redemptions that remove a large percentage of their holding meet this test.
 - o If the shareholder's interest in the stock being redeemed is completely terminated. However, even if there is not a full termination, but the shareholder has materially reduced their shares, then the transaction could still be trapped for CGT treatment.
 - o The final test looks at the impact of the redemption of the actual company. Basically, to meet this test there needs to be a demonstrable reduction in the size of the business and the size of the capital employed.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. **What is referred to when discussing the time in which you have to file a tax reclaim for any excess WHT on filing the reclaims?**
Answer reference: Section 2
2. **What is WHT?**
Answer reference: Section 3.1
3. **What does a DTA try to prevent?**
Answer reference: Section 3.2
4. **What are the different purposes of the Qualified Intermediary (QI) regime and Foreign Account Tax Compliance Act (FATCA)?**
Answer reference: Sections 4.1
5. **Under the FATCA legislation, what information are UK-based FFIs required to report about their US-resident account holders, and to whom do they report it?**
Answer reference: Section 4.2
6. **What does CRS stand for?**
Answer reference: Section 4.3



Chapter Six

Participants

Section 1 Introduction

Section 2 Participants

This syllabus area will provide approximately 4 of the 50 examination questions

1. Introduction

Asset servicing involves processing events in which there are a number of bodies and organisations who actively participate in the process. Their participation and significance depend on the servicing event and process undertaken. This process flows from the issuing or affected company on one side, through the local market and subcustodians, on to the investor or shareholder on the other.

The list of participants which follows is not designed to be exhaustive. For example, the regulatory body of the market would be a participant, if only indirectly. The list does, however, reflect the main players in an asset servicing event.

2. Participants

2.1 Custodian/Subcustodian

6.1.1 Know the role played by the custodian/subcustodian

A custodian is a financial institution that primarily provides securities settlement, safekeeping and asset servicing for its clients, possibly on a global scale.

Safekeeping services cover holding securities in physical or electronic form, protecting them against loss or theft, maintaining accurate records, collecting income such as dividends and interest, and managing corporate actions like stock splits, mergers, and proxy voting.

Settlement services involve ensuring that trades are correctly delivered and paid for, matching and reconciling trade details, facilitating cross-border transactions through foreign custodians and central securities depositories, and managing collateral for financing or derivatives.

A custodian will charge a fee for this service. This fee may be calculated on the basis of the amount of assets held under custody and/or the number of transactions processed.

Custodians also offer a wide range of related services, apart from the fundamental ones which take advantage of their expertise and high-volume- processing technology. The services can be categorised as core and value-added.

Some clients appoint a single custodian to provide these services for all countries. Such a custodian is then known as a global custodian. However, the firm that is acting as a global custodian may not have offices in all the countries where its clients hold assets. If that is the case, the global custodian will appoint another firm to act for it in those countries. This local firm is known as the subcustodian.

Institutions and ultra-high-net-worth families might use multiple investment managers to manage assets and make discretionary investment decisions. If these clients also choose to spread their assets across these multiple investment managers, they may be faced with an information consolidation burden and an inability to account for their positions across these providers. These clients may alternatively appoint a single ‘master’ custodian, to hold all securities in one place, while appointing their various investment managers to be able to transact on their respective accounts held at that custodian. This enables the client to maintain their various investment manager relationships while benefitting from a single set of reports in a consistent format using consistent pricing methodologies generated from the single custodian and reporting engine.

2.1.1 Core Services

Core services are those that are considered to be standard across the industry and are provided by all custodians. They are closely related to the basic processes of managing clients’ securities and include:

- safekeeping
- settlement
- cross-border transaction processing
- asset servicing, and
- cash management.

2.1.2 Value-Added Services

Value-added services is a general term for services other than the core services which enhance the client’s portfolio. This enhancement can be in the form of additional revenue, reduced costs, or additional information that provides the client with a competitive advantage. These services include:

- securities lending
- investment accounting
- reporting
- class actions
- proxy voting
- performance evaluation, and
- fund accounting and other operational processes.

Increasingly, these value-added services are becoming part of a custodian’s core services as they develop their offerings in light of the increased interest of fund managers in outsourcing elements of their operations.

2.2 Transfer Agent/Registrar

6.1.2 Know the role played by the transfer agent/registrar

The registrar is the company appointed by an issuing company to maintain the records of legal ownership of securities.

The responsibilities of the registrar include:

- initial registration and distribution of newly issued securities
- monitoring the quantity of shares or bonds in circulation to ensure they are correct, and
- security registration including the duty of certifying that the security is genuine.

In the UK, the registrar can be a separately run subsidiary of a commercial bank or an independent third-party company specialising in the role.

A transfer agent also plays a key role in the administration of a company's securities and helps maintain an accurate record of its shareholders.

- Their primary responsibilities include maintaining the shareholder register, issuing and cancelling certificates for stocks or bonds, and processing transfers of ownership when securities are bought, sold, or inherited.
- Transfer agents also handle dividend and interest payments, facilitate proxy voting by providing voting materials to shareholders, and may assist with lost or stolen certificates.
- Essentially, they act as the intermediary between the company and its shareholders, ensuring that ownership records are accurate, transactions are properly executed, and shareholder communications are efficiently managed.

In summary a registrar maintains the official shareholder register, whereas a transfer agent handles the day-to-day administration of share transactions, dividends, and proxy voting on the registrar's behalf.

2.3 Trustee

6.1.3 Know the role played by the trustee

A **trustee** is a person appointed to administer a trust. A trust is a legal relationship governed by a legal document, known as a trust agreement or trust deed, that places the assets of the creator of the trust under the control of a trustee, for the benefit of a beneficiary or set of beneficiaries. Trusts are often used in family succession planning and, in terms of asset servicing, may be the holder of securities or assets, ie, the account holder.

The trustee is the holder of legal title to the investments that make up the trust and will act in a fiduciary capacity to its clients. This means that the trustee has delegated authority for performance of the fund and must ensure that the investments are properly safeguarded. The trustee must also ensure the trust acts in an ethical and responsible manner.

Apart from the trustee, a trust involves:

- the person creating the trust (known as the settlor), and
- the beneficiary or the person receiving the proceeds from the trust.

In order to ensure that the integrity of the trust is safeguarded, regulations will generally state that:

- the trustee must keep accounting records of the funds held, invested and distributed
- client assets and non-client assets must be segregated
- the trustee must comply with the wishes of the settlor
- the trustee cannot take advantage of their position for profit to the detriment of the beneficiary, and
- the trustee can only invest in classes of instruments defined by local regulations.

2.4 Key Participant Roles

6.1.4 Know the role played by the: tender agents; receiving agent; calculation agent; paying agent; conversion agent

Tender agents, receiving agents, calculation agents, paying agents, and conversion agents are important in financial services because they (a) ensure that complex transactions and securities operations are executed accurately, efficiently, and in compliance with regulations which means (b) they reduce operational risk, enhance transparency, and ensure investors and issuers can process transactions smoothly and reliably.

2.4.1 Tender Agent

The process of tendering securities is the auctioning of a security to the highest bidder. Prospective buyers will submit a formal bid to buy a certain number of securities at a certain price. The tender process is initiated when the issuing company announces the tender and sets a cut-off date for the receipt of bids.

Once the cut-off date has passed, the issuer will allocate securities first to bidders offering the most desirable terms, then to the next desirable and so on until all securities have been allocated.

The [tender agent](#) is the agent bank that manages this tender process on behalf of the issuer.

2.4.2 Receiving Agent

A receiving agent is appointed by an issuer to handle payments and stock movement in respect of certain corporate events. For example, with a rights issue, the receiving agent will handle the return of nil-paid rights and the application of monies in return for fully paid rights. The receiving agent processes instructions from registered shareholders and the asset servicing departments of custodians. It does this either directly or via a third party, such as a securities trading organisation or [clearing agent](#). In the UK, the receiving agent is often the same as the registrar.

The receiving agent must comply with local client protection regulations and must have a suitable credit rating.

2.4.3 Calculation/Paying Agent

The [calculation/paying agent](#) collects monies for disbursement from the issuer; these include dividend payments and proceeds from tender offers. The paying agent advises clearing agents of the monies due and instructs them to make the appropriate payment to the holders of securities.

The calculation/paying agent acts under the control and authority of the issuer and executes instructions on its behalf in return for a fee.

Because the calculation/paying agent holds assets on behalf of its client, it must comply with local regulations to ensure appropriate protection for client assets, including compliance with regulatory rules relating to client segregation and reporting in a timely and accurate manner.

The client must have confidence that the calculation/paying agent is creditworthy and, for this reason, it will usually have a minimum 'A' credit rating.

2.4.4 Conversion Agent

A [conversion event](#) occurs either at the end of the life of the convertible security, at the request of the stockholder, or when the characteristics of a financial instrument are changed. The conversion process is managed by a conversion agent, on behalf of the issuer. The conversion agent will receive the conversion notices from the client and will instruct the depositary accordingly. The conversion agent is also known as the exchange agent.

2.4.5 Other Roles Worth Noting

While the five above roles are the main roles, there are several roles that are worth noting.

Issuer

The issuer is a company or government entity that issues securities through the market (via an initial public offer or IPO), or via a private placement, in order to raise capital. The entity receives a capital benefit as a result of the issue. The intended use for the capital will be described in full in the prospectus attendant upon the issue.

Underwriter

Underwriters of a share issue agree, for a fee, to buy any portion of the issue not taken up in the market at the issue price. The underwriters then sell the shares they have bought when market conditions seem opportune to them and may make a gain or a loss on this sale. The underwriters agree to buy the shares if no one else will and the company's investment bank will probably underwrite some of the issue itself.

If investors have a very negative view of why a rights issue is being made and what it says for the future of the company, the share price can fall substantially. This was seen in 2008 with Halifax Bank of Scotland (HBOS) and Royal Bank of Scotland (RBS), when the price of shares on the open market fell below the discounted rights issue price. The rights issues were flops and the underwriters ended up having to take up all unsubscribed new shares.

If no premium was attained during the sale of new ordinary shares sold by the underwriters, no lapsed rights proceeds will be distributed, and nil-paid shares with no associated value will be removed from clients' accounts.

Lead Manager

The lead manager is the principal investment house in a syndicate handling a new issue of securities and is appointed by the issuing company. The lead manager is said to 'run the book' on behalf of the issuer, hence this firm may also be known as the bookrunner.

The lead manager's responsibility is to coordinate the activities of the syndicate in **placing** the issue in the **primary market**. These activities include the distribution and documentation of the issue to:

- select suitable co-managers, in consultation with the issuer
- determine the terms of the issue, in consultation with the issuer
- select the underwriters
- select the exchange
- select the selling group (see below), and
- ensure the securities are placed; this is done in liaison with the appointed registrar who would manage the physical registration and issuance to security holders.

The selling group, in this context, is those financial institutions that are involved in selling or marketing a new issue of debt or equity, but not necessarily participating in the **underwriting** consortium.

Panel on Takeover and Mergers (or the European Equivalent)

The Panel on Takeovers and Mergers (PTM) is an independent body whose main functions are to issue and administer the City Code on Takeovers and Mergers and to supervise and regulate takeovers and other matters to which the Code applies in accordance with the rules set out in the Code. PTM is discussed in more detail in section 5.4 within chapter 3.

Proxy Voters

The role of the proxy voter was already covered in chapter 4. However, because they are a key participant in asset servicing, the course material has been repeated here.

Proxy voting is defined as voting on company issues by a representative (the proxy) of the shareholder. A proxy voting agent (or voting service provider) is a specialist firm which performs this voting on behalf of investors.

2.5 Trade Associations and Industry Led Working Groups

6.1.5 Know the roles of trade associations; infrastructure and industry led working groups

Firms in the financial services sector collaborate in several groups to share expertise about concerns they have in common.

Trade associations are formed by firms to promote the broad and wider asset management industry (such as improving the stability of a certain part of the industry) whereas an industry working group is formed for a shorter period of time to focus on a specific issue (such as implement a new piece of regulation).

While the different types of groups have different purposes, trade association and infrastructure/ industry led working groups are often used interchangeably.

The purpose of such groupings include:

- lobbying government departments and regulators about concerns
- making rules and recommendations about best practices and the use of common standards in their industry segment, as well as conducting surveys about the extent to which these standards and recommendations are applied, and
- reacting to specific common events and new legislation and providing advice and guidance about how to implement change.

Some of the most active trade associations include the following:

- The **Association of Global Custodians** – established in 1996, the Association of Global Custodians is a group of 12 financial institutions that provide securities safekeeping services and asset servicing functions worldwide to primarily institutional cross-border investors. As a non-partisan advocacy organisation, the association represents members' common interests on regulatory and market structure matters through comment letters, white papers and interaction with legislative and regulatory authorities and financial industry organisations. The member banks are competitors, and the association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses.
- **The Investment Association (IA)** – the IA represents the UK investment management industry. Its members manage over £8.5 trillion of assets on behalf of UK and overseas clients. Many of its policy positions are set out in the responses sent to consultations by the government, regulators, the European Commission (EC) and others. It maintains links with parliamentarians in both Westminster and the European Parliament and has contributed regularly to the deliberations of parliamentary select committees. It publishes and commissions research into various aspects of the industry.
- **The International Securities Lending Association (ISLA)** – the ISLA is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. ISLA works closely with European regulators and, in the UK, has representation on the Securities Lending and Repo Committee – a committee of market practitioners chaired by the Bank of England. The Association has contributed to a number of major market initiatives, including the development of the UK Securities Borrowing and Lending Code of Guidance and the industry- standard lending agreement – the [Global Master Securities Lending Agreement \(GMSLA\)](#).
- **The [Association for Financial Markets in Europe \(AFME\)](#)** – the AFME is the voice of Europe's wholesale financial markets. It represents the leading global and European banks and other significant capital market players. It focuses on a wide range of market, business and prudential issues and offers a pan-European perspective, bringing to bear deep policy and technical expertise and constructive influence on European and global policymakers. Focusing on the creation of a single integrated post-trading process for securities transactions in Europe, the Post-Trade Division seeks to achieve harmonisation, standardisation and consolidation through best practice and regulation. Providing clearing, settlement and custody solutions to reduce costs and risks of market participants, the Division's work covers the operational, legal, tax, and regulatory aspects of post- trading.

2.6 Market Infrastructure

6.1.5 Know the roles of trade associations, infrastructure and industry led working groups

Like all parts of the investment management industry, firms will need to be aware of the various elements of market infrastructure which could impact asset servicing.

2.6.1 Central Securities Depositories (CSDs)

A central securities depository (CSD) is an entity holding all the securities for a particular market. This centralises the securities of a certain market, making settlement easier.

In mature markets, the dominant method of holding will be in dematerialised or non-physical form. This has the following benefits:

- **Settlement of transactions via book entry accounting** – this allows the electronic transfer of securities between seller and buyer.
- **Netting of transactions** – this is when trading partners agree to offset their obligations to settle individual trades. By doing so, they reduce a large number of individual settlements to a single delivery. It is in this netted position that the two trading partners settle their outstanding obligations to transfer cash or securities. Rather than having to settle securities and cash on a trade-by-trade (gross) basis with each of the counterparties that it conducts business with during the trading day, the **central counterparty (CCP)** will net down each participant's respective sales and purchases to a single transfer of securities and a single transfer of cash each day.
- **Operating a delivery versus payment (DvP) settlement environment** – These three benefits reduce the **settlement risk** inherent in the market at the same time as improving safekeeping and making collateral management more efficient.

In less mature markets, paper securities (often **bearer securities**) still exist and can be transferred between seller and buyer (within the CSD). This creates inefficiencies in the transfer and settlement process because of the need to physically move and/or reregister the security. The risk of loss and theft also increase which can slow down settlement.

Each market will have a CSD and a full list can be found at the following link:

<https://www.esma.europa.eu/document/csd-register>

As well as CSDs, which are nationally based, there are two international central securities depositories (ICSDs). These are Euroclear Bank and Clearstream. They were originally set up to hold and clear Eurobonds on behalf of institutional investors. They also provide custody services.

As the business world becomes increasingly global, there is pressure upon national CSDs to merge to offer a single settlement and clearing platform – for example, Euroclear acquired UK-based CREST and the CSDs of France, Belgium, Sweden, Finland and the Netherlands. When CREST was acquired by Euroclear, it changed the company name to Euroclear UK and Ireland (EUI), but the name of the system that EUI uses is still called CREST.

2.6.2 Central Counterparties (CCPs)

The use of a CCP is a practice employed by a number of exchanges to reduce credit risk. The CCP sits between the buyer and seller of a security and acts as a guarantor of contracts. The CCP assumes the credit risk, thereby limiting the exposure of its members by protecting them from the impact of default.

The clearing house of an exchange may act as the CCP rather than two exchange members being involved in a direct counterparty-to-counterparty contract, whereby each party assumes the other's risk. The clearing house acts as the intermediary counterparty to each. If a member defaults, the clearing house will guarantee the performance of the contract to the other member.

Position Monitoring and Margin

Because the CCP takes on the credit risk for all trades, its primary concern is the management of risk. To do this, CCPs have very stringent membership requirements and continuously review the creditworthiness of existing members. On the ICE Futures exchange, where the risk exposure of open positions rises and falls over time, position monitoring and margining are implemented to manage the ongoing risk of default.

- **Position monitoring** – this is the daily analysis of an individual member's exposure risk in relation to their ability to cover their **margin** liabilities and delivery obligations.
- **Margining** – this is the means of receiving collateral on open positions to insure against the risk of default. Two types of margin calls are made by the CCP:
 - o **initial margin** – the call when a position is first opened, and
 - o **variation margin** – the call paid or received at the end of each day, reflecting the daily profit or loss on the open position.

2.6.3 Stock Lenders and Borrowers

Many kinds of market participants lend or borrow securities.

Reasons for Borrowing Securities

- Market makers and other sell side firms often run short positions, ie, they have sold more stock than they have bought. They will therefore borrow stock in order to settle their sales on the correct **value date**.

- Any buy side or sell side firm may have a situation where securities that they have bought cannot be delivered for some reason. If they have sold the stock to another party, then they, of course, will be unable to deliver what they have not received. They, therefore, borrow stock to cover for delivery failures.
- Hedge funds often sell stock short because they expect the price of the security concerned to fall in the future, when they will buy it back at the lower price. They too will borrow stock in order to settle these short sales on the correct value date.
- Hedge funds also use stock borrowing as part of strategies to influence the management of the company concerned, particularly in matters relating to mergers and acquisitions. If a hedge fund borrows stock, then it can vote the borrowed stock at company meetings.
- To take advantage of arbitrage opportunities around a corporate action. For example, the lender may be looking to lapse entitlements in a rights issue, whereas a borrower may see an opportunity to make a profit by subscribing and immediately selling the resulting shares.

Reasons for Lending Securities

- By way of example, traditional fund managers do not sell short; they are sometimes referred to as 'long-only' fund managers in this context. They are prepared to lend stock because of the fee they receive.
- Security lenders receive a fee from the borrower for lending the stock which is certain and predetermined.

2.6.4 Trading Venues

There are a number of different trade venues:

A [multilateral trading facility \(MTF\)](#) is any type of system or service that brings together multiple parties interested in buying and selling financial instruments, especially those that may not have an official market. MTFs are controlled by approved market operators (such as large investment banks). Trading is normally performed electronically and buy/sell trades are matched using a matching engine. The US equivalent of an MTF is an alternative trading system (ATS).

An investment exchange (also known as a regulated market, stock exchange, share market, stock market, bourse or derivatives exchange) is a corporation or mutual organisation that provides facilities for counterparties and firms to trade securities (such as bonds, derivatives and physical commodities such as precious metals and agricultural products) in a smooth and safe manner. Investment exchanges are not allowed to trade as a principal (eg, they are not allowed to 'take a position' in a security).

An **organised trading facility (OTF)** is not a regulated market or MTF but still allows the buying/selling of bonds, structured finance products, emissions allowances or derivatives. Equities are not permitted to be traded through an OTF. The introduction of OTFs meant that many transactions currently categorised as off-venue came within a trading environment which should increase market transparency, reduce the amount of opaque market models/products and increase the quality of price discovery, investor protection and liquidity.

Systematic internalisers (SIs) are investment firms which execute client orders on their own account outside a regulated market, MTF or OTF without employing a multilateral matching system. An SI must publish firm bid/offer quotes for liquid instruments which must reflect the current market. For illiquid instruments, it must disclose quotes on request. (SIs replaced the previous broker crossing networks.)

2.6.5 Outsourced Service Providers

The investment management industry is a heavy user of outsourcing. Various functions such as technology hosting, trade matching, custody, fund accounting and transfer agency are often outsourced.

The advantages of outsourcing are that outsourced functions are performed by specialists who provide a better service, and a better cost model, and allow firms to focus on their core activities. The disadvantages include outsourcing arrangements being complicated to manage, they are hard to reverse or bring back 'in-house', cultural issues, service issues, and information security risks.

2.7 Transfer and Settlement Systems

6.1.6 Know transfer and other settlement systems; cash; assets

Settlement (or clearing as it is sometimes called) is the process for the correct and timely transfer of funds to the seller and assets to the buyer to complete a transaction.

As this is a high-volume, critical and complex activity, there are specialist central organisations, called clearing houses, to perform this.

2.7.1 TARGET2-Securities (T2S)

TARGET2-Securities (T2S) is the European securities settlement engine which offers centralised delivery-versus-payment (DvP) settlement in central bank funds across all European securities markets. It is important to note that T2S is not a CSD, but a platform which will enable CSDs to increase their competitiveness.

Timeline of T2S

After market consultation and a decision by the Governing Council of the European Central Bank (ECB), the project was launched in 2008. Testing by CSDs commenced in October 2014 and the platform launched operations in June 2015.

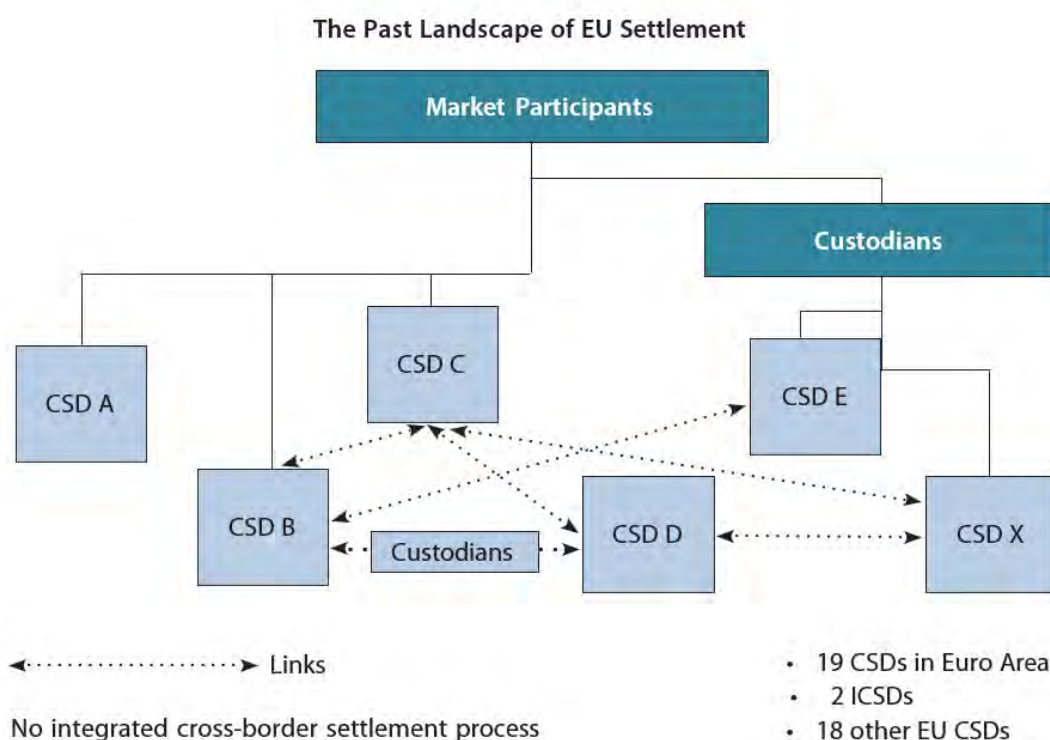
The development and operation of T2S was assigned to four central banks of the Eurosystem; namely those of France, Germany, Italy and Spain. Technical details of the project are available at the ECB T2S project website (ecb.europa.eu/paym/t2s/html/index.en.html).

The actual implementation was completed in five waves with the first wave running in June 2015 and with the final wave being completed in September 2017.

Objectives of T2S

The fundamental objective of the T2S project is to integrate and harmonise the highly fragmented securities settlement infrastructure across Europe. It aims to reduce costs of cross-border securities settlement significantly (prior to T2S, transactions across T2S countries were up to ten times more costly than domestic transactions) and to increase competition and choice among providers of post-trading services in Europe.

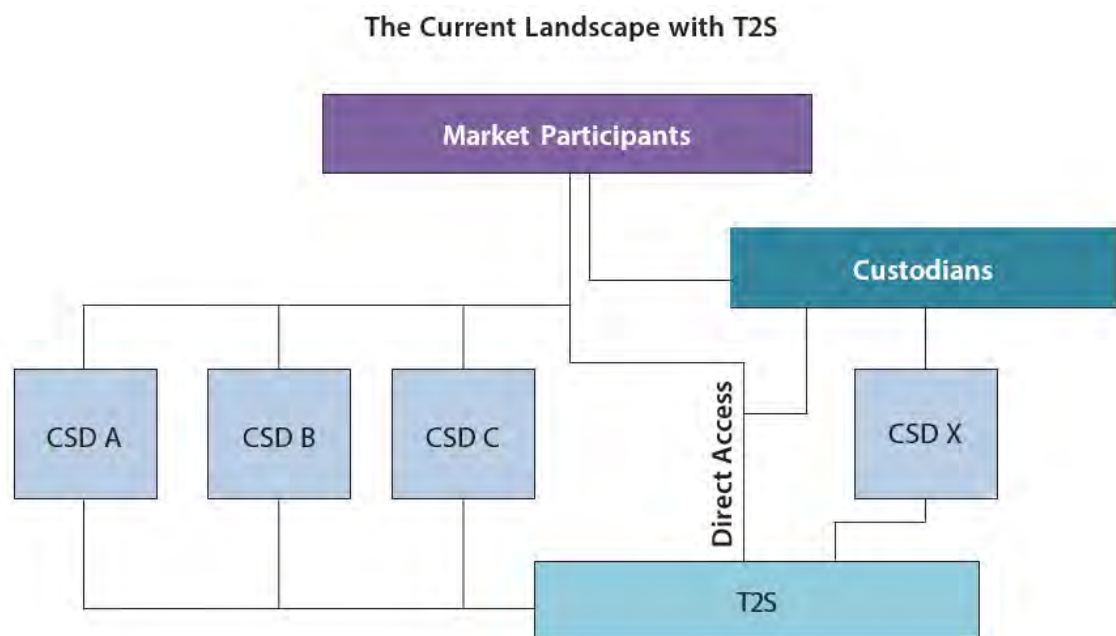
The European settlement infrastructure prior to the launch of T2S is shown in the following diagram:



Prior to the T2S launch, each CSD would settle according to its own technical set-up

and respective national legal requirements, as a result, interaction between CSDs became inefficient and costly.

Post-T2S, the situation can be represented as:



One integrated settlement process
(domestic and cross-border)

One technical platform used by
CSDs for securities settlement

T2S provides all participating CSDs with a single platform for security settlement in Europe, with interaction between CSDs occurring on a harmonised basis. Essentially, the platform provides a definitive step towards a single market for financial services, with industry bodies engaged in determining further opportunities that exist in the harmonisation of processing standards for pre- and post-settlement/ corporate action activities.

2.8 Data Providers

6.1.7 Data providers

Data is absolutely critical to corporate action processing and asset servicing.

Accurate, timely, and complete data is required for the following reasons:

- to determine who receives entitlements
- to ensure correct allocation across systems
- to enable timely processing
- to ensure accurate payment, and
- to support reconciliation & audit trails.

In other words, poor, misleading and/or out-of-date data will cause impacts on firms and (more importantly) end-investors.

However, most firms receive their data from external parties which means that these data providers or vendors will need to be carefully managed.

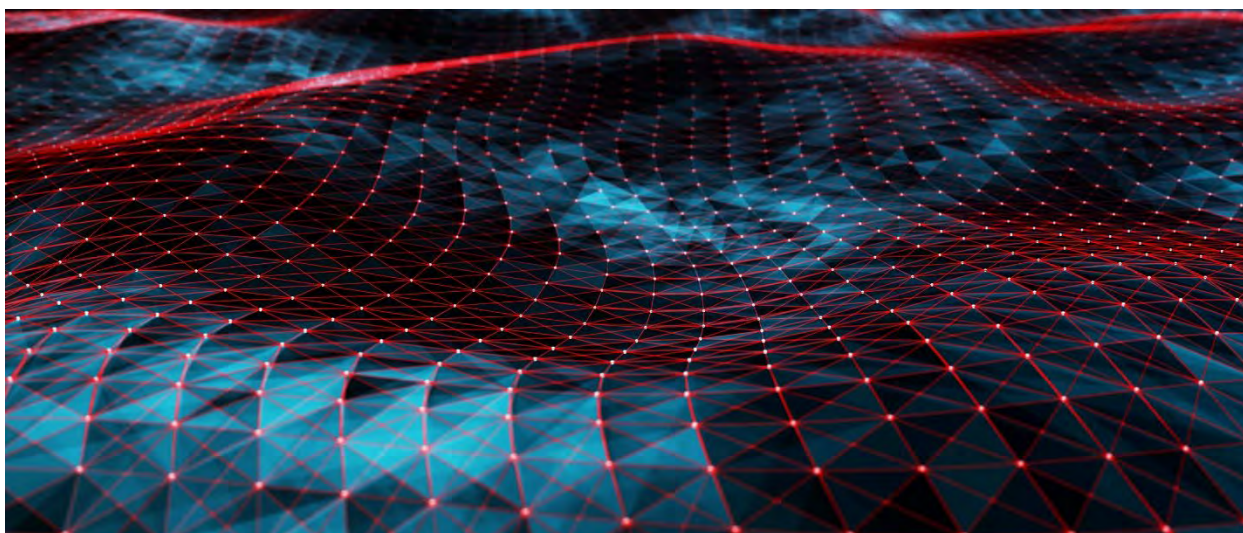
This means asset management firms should manage data providers proactively through careful selection, contracts, governance, quality controls, risk management, and cost-benefit-analysis to ensure data is all received is accurate, timely, reliable, and aligned with regulatory and operational needs.

Furthermore, firms should also ensure they have secondary sources of data to act as both (a) a back-up if the main data source fails and (b) to use as comparison to check the prime data is accurate.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. **What are the five core services of a custodian?**
Answer reference: Section 2.1.1
2. **What are the main responsibilities of a registrar?**
Answer reference: Section 2.2
3. **What is the usual minimum credit rating required for a paying agent?**
Answer reference: Section 2.4.3
4. **What is the role of the Panel on Takeover and Mergers (or the European equivalent)?**
Answer reference: Section 2.4.5
5. **What is the role of a central securities depository (CSD) and why is it important?**
Answer reference: Section 2.6.1
6. **What are the names of the two international central securities depositories (ICSDs)?**
Answer reference: Section 2.6.1
7. **How does a central counterparty (CCP) manage its credit risk?**
Answer reference: Section 2.6.2
8. **Give two reasons for borrowing stock and one for lending stock.**
Answer reference: Section 2.6.3
9. **What are the differences between a Multilateral trading facility (MTF), an investment exchange, an Organised trading facility (OTF) and a Systematic internalisers (SIs)?**
Answer reference: Section 2.6.4
10. **What is the purpose of TARGET2–Securities (T2S)?**
Answer reference: Section 2.7.1



Chapter Seven

Legal and Compliance

Section 1	Introduction
Section 2	Legal and Compliance
Section 3	Global Agreements
Section 4	Sophisticated Investors
Section 5	Client Asset Rules
Section 6	Foreign Ownership Restrictions
Section 7	Restricted List
Section 8	Shareholder Rights Directive II (SRD II)
Section 9	Documentation

This syllabus area will provide approximately 8 of the 50 examination questions

1. Introduction

This chapter introduces and defines some of the regulations and rules governing investment business that are pertinent to asset servicing. It starts by looking at the Client Assets Rules as set out by the UK regulator, then goes on to examine [foreign ownership restrictions](#) and highlights some legal agreements that govern repos and stock lending. Other jurisdictions have similar regulators and similar rules.

Prior to 1 April 2013, the UK regulator was the Financial Services Authority (FSA), but the Financial Services Act 2012 created three new bodies to replace the FSA. This was a reaction to the financial crises of 2008.

These bodies are as follows:

Financial Policy Committee (FPC)

The Financial Policy Committee (FPC), established in the Bank of England (BoE), has responsibility for ‘macro-prudential’ regulation, or regulation of the stability and resilience of the financial system as a whole. Its role is:

‘Contributing to the Bank’s objective to protect and enhance financial stability, through identifying and taking action to remove or reduce systemic risks, with a view to protecting and enhancing the resilience of the UK financial system’.

Prudential Regulation Authority (PRA)

The [Prudential Regulation Authority \(PRA\)](#), a department of the Bank of England, is responsible for prudential regulation of financial firms that manage significant risks on their balance sheets. It is responsible for the regulation and supervision of ‘significant’ individual firms including all deposit-taking institutions, insurers and other prudentially significant firms.

The PRA has a primary objective of enhancing financial stability by promoting the safety and soundness of PRA-authorised firms in a way which minimises the disruption caused by any firms that fail. In fulfilling its objective, it can pre-empt a firm if it looks likely to fail.

This process is subject to continuous assessment, with more focused supervisory action on those firms deemed most at risk of failure.

Financial Conduct Authority (FCA)

The [Financial Conduct Authority \(FCA\)](#) is responsible for conduct issues across the entire spectrum of financial services; it is also responsible for market supervision. In addition, it is responsible for the prudential regulation of approximately 25,000 smaller firms that are not regulated by the PRA.

The FCA looks to achieve the right outcomes for consumers and market participants. It has three operational objectives:

1. Ensuring that markets operate with integrity.
2. Promoting effective competition.
3. Requiring firms to put the well-being of their customers at the heart of how they run their business.

2. Legal and Compliance

7.1.1 Know how residency and tax domicile can affect eligibility to receive a benefit or participate in an event

7.1.2 Know the implications of consumer duty and how it impacts Asset Servicing

2.1 Residency and Tax Domicile

Some restrictions may be placed on what kinds of securities an investor may hold (and, therefore, what options they may choose when an event creates a new security) depending on their tax domicile.

The terms domicile and residence are defined in chapter 5 section 2, but due to their importance it is worth noting these definitions again.

Residence refers to the place where a person lives temporarily or permanently. It is often a question of fact and depends on where the individual is physically present.

Domicile, however, refers to a person's permanent legal home and is tied to their long-term intentions. It is a legal concept often used for determining tax obligations, inheritance and personal law. The legal domicile of a person is important since it, rather than the actual residence, often controls the jurisdiction of the taxing authorities.

The types of restrictions that may be placed on an investor because of their tax domicile include, but are not limited to, the following examples:

1. A company may offer shares to its employees at a discounted price. The terms of the offer satisfy the tax authorities of the country in which the company is domiciled, but do not satisfy the tax authorities of some of the countries in which some of its employees are domiciled. In such a case, those employees are not able to take up the offer.
2. The corporate action of a company domiciled in Country A creates a type of security which Country B either does not permit its citizens to own at all, or which places an onerous tax burden on them. If this happens, then any shareholders in Country B need to take a cash alternative, or, if no such

alternative is provided, to sell the resultant holding at the earliest possible opportunity.

As well as restrictions that are based on tax domicile, other restrictions may be placed on investors which limit their participation in a corporate action. Institutional investors can be barred from taking up issues of new shares in cases when the issue is aimed at the private investor market only. Non-residents may not be able to participate in the issuing of new shares because of a country's foreign ownership restrictions. Foreign ownership restrictions are examined in more detail in section 6.

It is also important to understand what the regulations are in regard to investor compensation. The Financial Services Compensation Scheme (FSCS) is the UK's statutory compensation scheme for customers of authorised financial services firms. The FSCS's rules are set by the FCA. This means that the FSCS can pay compensation if a firm is unable, or likely to be unable, to pay claims against it should the firm become insolvent.

The FSCS's compensation limits are as follows:

- **Deposits** – 100% of the first £85,000 per person per authorised firm.
- **Investments** – 100% of the first £85,000 per person per firm.
- **Mortgage advice and arranging** – 100% of the first £50,000 per person per firm.
- **Insurance business** – 90% of the claim with no upper limit.
- **General insurance advice and arranging** – (for business conducted on or after 14 January 2005) – 90% of the claim with no upper limit.

2.2 Consumer Duty

The UK [Consumer Duty](#) is a regulatory requirement introduced by the Financial Conduct Authority (FCA) that obliges financial firms to act in the best interests of their retail customers, ensuring they deliver good outcomes. It requires firms to provide clear, fair, and not misleading products and services, offer transparent information, and monitor whether customers are actually benefiting from their products. The duty aims to raise standards across financial services, putting customer outcomes at the center of all business activities.

In other words, firms need to put their customers' interests ahead of their own interests. Therefore, Consumer Duty will have impacts to asset servicing which firms need to take on-board; namely:

- **Timely processing** – Firms will need to ensure all dividend, corporate action/process is processed on time.
- **Clear communication** – Investors must receive timely and accurate information on processing details, entitlements, and if there are any issues.
- **Fair treatment of all customers** – All clients (both large and small) must be treated fairly. They should also ensure no customer groups are disadvantaged.

- **Robust processes and controls** – Firms must implement strong systems to minimise errors and/or delays.
- **Monitoring and Remediation** – Any mistakes or errors (say processing errors) must be corrected as quickly as possible. If necessary, firms may need to implement financial compensation ensure customers are not harmed.

3. Global Agreements

7.2.1 Know how the: GMSLA master agreement deals with income distributions and events in respect of securities out on loan; GMRA master agreement deals with income distributions and stock events in respect of bonds out on repo

To reduce the legal risk and improve the efficiency of securities lending, the industry developed [global agreements](#) to standardise the terms and conditions for lending and borrowing. These have had a major impact on improving the liquidity of the securities lending market. Two such agreements are:

- the Global Master Securities Lending Agreement (GMSLA), and
- the [Global Master Repurchase Agreement \(GMRA\)](#).

3.1 The Global Master Securities Lending Agreement (GMSLA)

The GMSLA is the accepted industry contractual template for securities-lending transactions. It covers situations where corporate actions take place or income payments are made while the stock is out on loan. The template contains the following conditions:

- Income payments such as interest, dividends or other distributions received by the borrower are to be repaid to the lender.
- When income is paid to the borrower in the form of securities, the securities are aggregated into the loan and delivered to the lender at the end of the loan period.
- Rights relating to corporate action events such as conversions, subdivisions, consolidations and takeovers may be exercised by the lender. The lender can instruct the borrower to take up the rights within a mutually agreed time frame, to sell them, or to take up a proportion of them. Delivery of the resulting security will take place at the end of the loan period.
- The borrower has no obligation to arrange for voting rights to be exercised by the lender.

3.2 The Global Master Repurchase Agreement (GMRA)

Similar to the GMSLA, the GMRA is the accepted industry contractual template, developed during the 1990s, covering repos and buy/sell-back transactions. It was developed by The Bond Market Association (TBMA) and the International Securities Market Association (ISMA), which has since become known as the International Capital Market Association (ICMA). They drafted a market standard legal agreement with a view to compliance with English law.

It deals with the following corporate actions:

- Income payments that are received by the repo buyer must be credited to the seller on the same day.
- Income payments credited to the repo seller must be made gross of tax unless otherwise agreed.

4. Sophisticated Investors

7.3.1 Know the two basic objectives of the [1933 Securities Acts](#): implications of SEC rule 144a; the use of sophisticated investor letters (SILs)

4.1 1933 Securities Act

The [1933 Securities Act](#) is a foundational US federal law that regulates the offer and sale of securities to the public.

Its primary purpose is to ensure transparency, protect investors, and prevent fraud in the securities markets.

It requires companies issuing securities to register with the SEC and provide full and accurate disclosure of financial and other material information, allowing investors to make informed decisions.

The Act is needed to promote investor confidence, establish fair practices in securities offerings, and reduce the risk of misleading or fraudulent sales that could harm the integrity of the capital markets.

The requirements for disclosure include:

- the price of the public offering
- details of the issuer, the name, type of business, capitalisation, funded debt, details of directors, history of previous issues, major shareholders and relevant financial statements

- details of the underwriters, the names and addresses, copies of the contracts and agreements
- jurisdiction, and
- a formal assessment of the legality of the issue.

If the issuer fails to provide the necessary information, the purchaser can litigate to recover any subsequent losses. Exemptions to the Act include the following bodies:

- local or national government
- banks (but not bank holding companies)
- trustee companies, and
- any securities, such as [commercial paper \(CP\)](#) and bankers' acceptances, that have a maturity of less than 270 days.

4.2 SEC Rule 144a

Rule 144A is a US Securities Act provision that allows certain restricted securities, often issued by foreign or private companies, to be sold to qualified institutional buyers (QIBs) without SEC registration. It gives institutional investors access to private placements that are more liquid than traditional private securities, often offering attractive yields, while reducing disclosure requirements. While it enables efficient trading among QIBs, it also carries higher risk due to limited public information, requiring investors to carefully assess the securities before investing.

Private placements are a means of issuing securities to specific investors rather than to the general public. Because they are not listed in the normal manner, there is not the same level of disclosure or registration as listed securities.

Private placements are allowable only if purchasers are qualified institutional buyers (QIBs). QIBs are defined as sophisticated investors who invest, on behalf of themselves, their client and other QIBs, at least \$100 million worth of securities. In addition, if the investing institution is a bank, it must have a minimum net worth of \$25 million.

Securities sold under a private placement are a form of restricted security in that, once the transaction has been completed, the purchaser may not resell to the general public for a minimum time period, usually one year. This is known as the holding period and it begins when the securities are bought and paid for fully.

The purchaser of securities sold under a private placement must certify to the issuer that the purchase is for investment purposes only and that there is no intention to immediately re-offer the securities publicly. This forms part of the contract between both parties. Even after the one-year holding period expires, the number of shares that may be sold into the public market is still carefully controlled. During any three-month period this amount cannot exceed either:

- 1% of the outstanding shares of the same class being sold, or
- 1% of the average reported weekly trading volume during the four weeks preceding the filing of a notice of the sale on form 144.

Because of these restrictions, the affected security is not as liquid as a listed security even of the same company, and therefore, may have a lower market value.

4.3 Sophisticated Investor Letters (SILs)

In the UK, under the [Financial Services and Markets Act 2000 \(FSMA 2000\)](#), a person in the course of business is prohibited from communicating an invitation or inducement to engage in investment activity unless the person is authorised or the communication has been approved by an authorised person. The scope of the provision is wide and includes various forms of communication, including electronic media, solicited and unsolicited calls and letters, newsletters and prospectuses.

There are a few exceptions, one of which is a communication to a certified [sophisticated investor](#). A sophisticated investor is one in possession of a [sophisticated investor letter \(SIL\)](#) that has been produced and signed by an authorised person. This letter states that the investor is sufficiently knowledgeable to understand the risks associated with the stated type of investment, for example, a derivative or security. The letter is deemed to be current if it has been produced within the three years preceding the communication.

5. Client Asset Rules

7.3.2 Understand the impact of Client Asset Rules on asset servicing functions

Client Assets are assets belonging to clients which a firm is holding on behalf of their clients. These assets cover anything the firm could manage such as cash, equities, collectives and so on. Client Asset regulation is often referred to as 'CASS' (or the 'Client Asset Sourcebook').

The main objective of the FCA's CASS Rules is to keep Client Assets safe in the event of a firm's failure. This means that firms must keep client money and assets separate from the firm's own assets in segregated bank, register or custody assets. This means these assets are separate (or ring fenced) if the firm managing them fails.

This means that all client assets must be identified, and segregated on a daily basis. The FCA takes a serious view of failures to segregate and reconcile client assets (such as securities held in a safekeeping account). For example, in 2012, an [investment management company](#) was fined £9.5 million by the FSA (the predecessor regulator to

the FCA) for failing to make sure that £1.3 billion in client assets were properly ring-fenced for more than three years.

The US investment group placed client money in short-term money-market deposits without making sure that the receiving banks knew they were holding assets that belonged to customers rather than the firm itself.

6. Foreign Ownership Restrictions

7.3.3 Know the implications of foreign ownership limits

Some countries impose limits on the percentage of share capital that may be owned by foreign investors in companies in certain industries. Such limits are usually applied to industries that are deemed to be critical to developing and maintaining the country's infrastructure, such as airlines, airports and telecoms. Examples include the US, which restricts foreign ownership of airline stocks to 49%, and India, which places a 26% limit on foreign ownership of insurance companies.

The practical consequence of these restrictions for asset servicing institutions is that sometimes, a purchase of stock by one of their clients means that the foreign ownership limit is breached. If the breach is very large then the client needs to be advised and the client/firm may have no alternative other than to sell some of its holding. However, if the breach is small and the stock concerned is widely traded, then subsequent sales by other foreign holders in the next few days may regularise the situation, so the client could be advised to 'wait and see' for a short period. In the meantime, the holding cannot be registered in the client's name, and the client may not be entitled to receive dividends or other benefits or to vote. The stock can only be registered in [street name](#), ie, the name of a broker who is a resident of the country concerned.

If an asset servicer has advised its client to 'wait and see', then it needs to have processes in place to continually monitor the level of foreign ownership of the stock concerned and register it correctly at the earliest possible opportunity.

7. Restricted List

7.3.3 Know how a restricted list may impact a corporate action

7.1 What is a Restricted List?

According to the Corporate Financial Institute (<https://corporatefinanceinstitute.com>) a *'restricted list is a list of securities which a bank's employees are prohibited from buying or selling, either themselves or via any other person or third party'* (such as a client).

The Corporate Financial Institute also provides two reasons why a security would be placed on a restricted trading list:

- a material transaction in which the bank is involved has been generally disclosed and the bank is in possession of, or may obtain, material, non-public information concerning the securities issuer (thus putting it in the position of someone capable of insider trading), or
- the bank is engaged with the company in non-public activity, such as mergers and acquisitions work, affiliate ownership, or underwriting activities or other distribution of the issuer's (the company's) securities.

This could impact corporate action processing in certain circumstances.

For example, in the event of a merger or takeover, a firm could be merged or taken over by a security that is on the restricted list. In this event, it is important to escalate this matter to the compliance and/or legal teams for advice and guidance.

7.2 Sanctions (and Embargoes)

Sanctions (and Embargoes) are political trade restrictions put in place against target countries to maintain or restore international peace and security.

An example of a recent high-profile sanction being introduced was that against Russia (restrictive measures in view of Russia's actions in destabilising the situation in Ukraine), whereby a first set of sanctions was imposed on 31 July 2014 by the EU, essentially in line with those also set by the US government.

The level of sanctions can be specific and unique to each scenario, they can apply to both goods and services (such as banking), and can be against individuals, companies or sovereign states. Sanctions mean that accounts of sanctioned individuals or entities may be frozen so that the account holder will not be able to access the assets, or transactions such as wire transfers to sanctioned individuals or entities will be blocked. This is to prevent the sanctions target from benefitting from the financial system.

Due to the nature of asset servicing, there must be specific checks in place within the process. Procedures and protocols should be developed, subsequent to the

interpretation of specific sanctions, to determine whether any underlying clients or assets are subject to sanctions upon which a corporate action event has been announced. Subsequent action is likely to be specific and will require engagement with business compliance and control officers to ensure appropriate action is taken.

7.3 Different Market Regulators

Italy

Regulatory Legislation

There are several Acts of Parliament that provide the legal framework for the Italian securities market.

The main Acts are:

- the Legislative Decree of 24 February 1998, which is the consolidated law on financial instruments and financial intermediaries (TUF), and
- the Bank of Italy Regulations of 8 September 2000 concerning the management of settlement services for transactions of non-derivative financial instruments.

Regulatory Organisations

The authorities primarily responsible for regulating and supervising the Italian securities market are the Bank of Italy and the Commissione Nazionale per le Società e la Borsa (CONSOB).

The Italian central bank, the Bank of Italy, is in charge of the following tasks:

- Supervision of banks, brokers, investment firms and funds. The Bank of Italy's responsibilities in this field extend to risk limitation and the stability of intermediaries, whereas the market regulator (CONSOB) is responsible for supervising compliance with the rules for transparency and proper conduct.
- Together with CONSOB, supervision of MTS Italy, which is the electronic market for the trading of debt securities.
- Cooperation with the Italian Antitrust Authority (AGCM) to promote and protect competition on the credit sector and prevent mergers and acquisitions from creating a dominant position in the market.
- Combating money laundering together with the Italian Foreign Exchange Office (UIC).

CONSOB was established in 1974 and reports to the Ministry of Treasury. CONSOB is the supervisory body overseeing the stock exchange; its remit includes monitoring market operating practices and regulating the activities of brokers. CONSOB is the authority for ensuring transparency and correct behaviour by securities markets participants, and the disclosure of complete and accurate information to the investing public by listed companies. Evidence suggesting acts of insider trading, manipulation

or rigging must be reported to CONSOB, which is the body responsible for investigating potential market violations; CONSOB has the legal power to enforce regulations.

The AGCM is the competition authority. It has powers to control and report to parliament and the government on areas such as agreements restricting freedom of competition, abuse of dominant position and mergers or acquisitions.

Japan

Regulatory Legislation

There are several Acts of Parliament that provide the legal framework for the Japanese securities market. The main Acts are as follows:

- Securities Exchange Act 1948.
- First Commercial Code 1890.
- Law Concerning Central Securities Depository and Book-Entry Transfer (the CSD Law) 1984.
- Law Concerning Book-Entry Transfer of Corporate Debt Securities (2001).

Regulatory Organisations

The major organisations responsible for the market regulations and developments in Japan are the Ministry of Finance, the Bank of Japan, the Financial Supervisory Agency and the Securities and Exchange Surveillance Commission:

- **Ministry of Finance** – the Ministry of Finance works closely with the Financial Supervisory Agency to plan and establish the policies relating to the bankruptcies of financial institutions and financial risk management.
- **Bank of Japan** – as the central bank, the Bank of Japan, together with the Ministry of Finance, is jointly responsible for supervising banks and regulating the money and foreign exchange markets.
- **Financial Services Agency** – the Financial Supervisory Agency was established in June 1998 as an independent entity of the prime minister's office. The FSA took over the supervisory and inspections functions of the financial services sector.
- **Securities and Exchange Surveillance Commission** – the Ministry of Finance introduced the Securities and Exchange Surveillance Commission on 20 July 1992 to ensure the smooth and regular operation of the stock exchanges and the fairness of securities and financial futures trading.

US

Regulatory Legislation

The main focus of securities regulations is on the market for [common stocks](#). Both federal and state laws regulate securities. The first of the laws to be ratified was the Federal Securities Act of 1933 (as amended), which regulates the public offering and sale of securities in interstate commerce. The 1933 Act prohibits the offer or sale of a security not registered with the SEC. It requires the disclosure of information to the prospective security's purchaser. The objective of these requirements is to enable

purchasers to make fully informed and reasoned decisions based on reliable information.

Issuers of securities registered under the Securities Exchange 1934 Act must file various reports with the SEC to provide the public with adequate information. The 1934 Act also regulates proxy solicitation and requires certain information to be given to a corporation's shareholders as a prerequisite to soliciting votes. It permits the SEC to create rules and regulations to protect the investing public by prohibiting manipulative or deceptive devices via mail or other means of interstate commerce.

Regulatory Organisations

The major organisations responsible for the market regulations and developments in the United States are the SEC, the Commodity Futures Trading Commission, the Financial Industry Regulatory Authority (FINRA) and the Federal Reserve System.

The SEC, which was created by the Securities Exchange Act of 1934, is the principal regulator and supervisory body with responsibility for all securities issuance and trading, securities firms, investment companies, including mutual funds, investment advisers and all self-regulatory organisations (SROs), including the NASD, the NYSE, NASDAQ and all of the regional exchanges. The NASD, which operates within SEC oversight, is the largest SRO in the US, with a membership that includes virtually every broker/ dealer in the nation that is involved in a securities business with the public. Through its subsidiaries, the NASD develops rules and regulations, conducts regulatory reviews of members' business activities, and designs and operates marketplace services and facilities. The NASD helps to establish and coordinate the policy agendas of its subsidiaries and oversees their effectiveness.

8. Shareholder Rights Directive II (SRD II)

7.3.5 Know the concept, purpose and reporting requirements for SRD II

The Shareholder Rights Directive II (SRD II) is a European Union (EU) directive, which sets out to strengthen the position of shareholders and to reduce the short-termism and excessive risk taken by companies. It builds upon SRD I which came into effect in 2007.

SRD II came into effect on 3 September 2020 and was implemented in two phases:

- 10 June 2019 for the initial transposition into member state national laws.
- 3 September 2020 for core operational changes.

The requirements are as follows:

- There is significant change to Article 3, which now gives companies the right to identify their shareholders. This means that intermediaries (such as fund managers) need to report the required information to ensure the company knows who their shareholders are.
- Intermediaries also have to (a) send relevant information from the company to the shareholder to allow them to exercise their rights as a shareholder and (b) publicly disclose what they charge for these services; and these charges or costs must be non-discriminatory and proportionate.
- Furthermore, all institutional investors and asset managers have additional demands when publishing an engagement policy and to publish annually how their investment strategy contributes to the medium- and long-term performance of their assets under management.
- Proxy voters must follow a code of conduct as well as disclosing information to demonstrate how their voting recommendations are accurate and reliable.
- Finally, all shareholders have the right to vote on remuneration.

A good example of how SRD II has benefited society is AstraZeneca's Executive Pay Rejection (2020).

In 2020, AstraZeneca, listed in the UK and subject to SRD II transparency rules, proposed a significant increase to CEO Pascal Soriot's potential long-term incentive payout. Because SRD II requires listed companies to provide clear, detailed remuneration reports and give shareholders a stronger voice, institutional investors had far more information and influence than before.

Major asset managers (including Legal & General Investment Management (LGIM)) and several European pension funds used; SRD II-enhanced disclosures to analyse the proposal and expressed concerns that the pay rise was not aligned with long-term shareholder value. At the AGM, over 40% of shareholders voted against the remuneration report, an unusually high level of dissent for a FTSE 100 company.

Although the proposal narrowly passed, the size of the revolt forced AstraZeneca to engage with investors, revise aspects of its pay structure, and provide clearer justification in future reports; exactly the type of governance improvement SRD II is intended to deliver.

9. Documentation

7.4.1 Know the purpose and content of customer documentation

7.4.2 Know relevant record keeping requirements for asset servicing; contractual obligations; tax implications of main investment products

7.4.3 Know considerations for client or customer relationships with regard to: enforceability of the contract; interest calculations; custody arrangements; client reporting requirements; ongoing due diligence; arrangements for changing a contractual relationship

9.1 The Purpose and Content of Customer Documentation (or Agreements)

For both professional and retail clients, regulation requires investment firms to provide a basic written agreement, setting out the essential rights and obligations of the firm and the client (unless the service is one-off investment advice with no regular review). Client agreements need to be in place before providing services.

The content should include:

- information about the firm and its services
- instruments and strategies
- execution venues (best execution)
- tax implications for the products they hold
- enforceability details (such as start date, termination clauses)
- ongoing or regular due diligence requirements
- costs and associated charges
- order handling
- client money and assets
- conflicts of interest
- custodial requirement such as settlement and safe keepings, and
- bank requirements (including interest payments especially noting whether the client or manager receives it; and the calculation method, frequency of payment, and the rate applied).

Any changes to this agreement need to be mutually agreed upon by both the financial institution and the investor.

Finally, as part of any client agreement, firms must provide a client report per below:

- It must be provided in a durable medium.
- The report must include (a) periodic communications to the client, taking into account the type and the complexity of the financial instruments or investment

products involved and the nature of the service provided to the client; and (b), where applicable, the costs associated with the transactions and services undertaken on behalf of the client.

9.2 Record Keeping Requirements

The FCA has detailed record keeping rules to ensure transparency, compliance and accountability in financial services.

These rules are part of the regulatory framework to protect consumers, promote market integrity and support effective supervision.

The aspects are as follows:

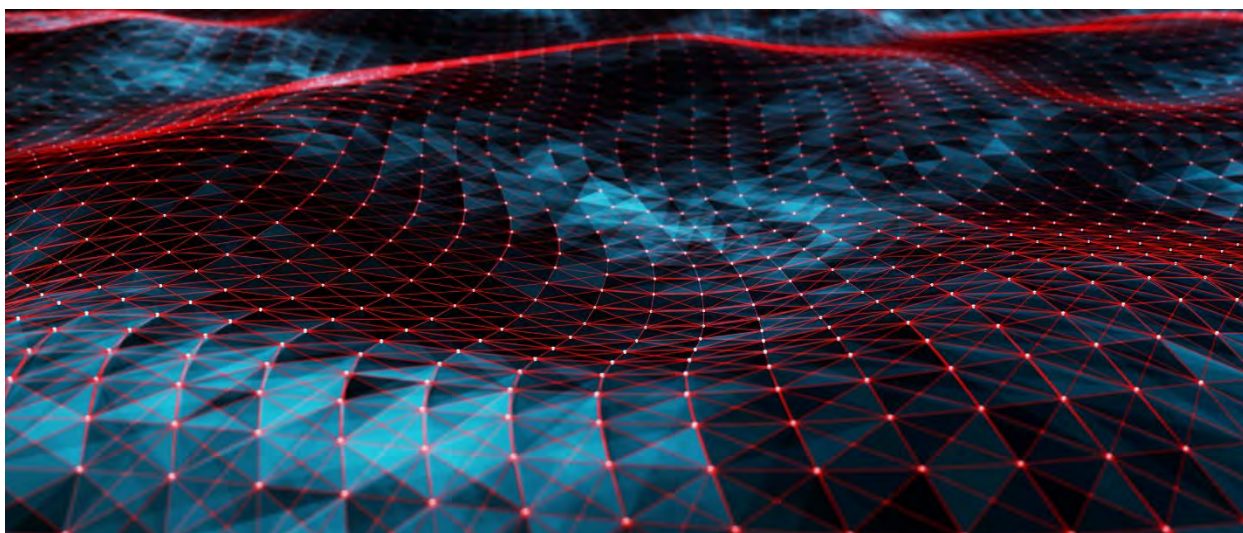
- Firms must retain records to demonstrate compliance with FCA rules and other regulatory obligations. Records should be sufficient to provide an audit trail of activities and decisions. Documentation must be stored in a way that is secure, accessible, and tamper proof.
- There are specific retention rules that are dependent on the types of documents:
 - **Client Records** – At least five years.
 - **Transaction Records** – Five years for investment services under MiFID II.
 - **Anti-Money Laundering (AML)** – Five years after the end of the client relationship or the completion of the transaction.
 - (Also note that retention periods might be longer if required by other legislation eg, GDPR or local tax laws.
- Firms must retain recordings or transcripts of telephone conversations and electronic communications related to transactions. These include emails, messages, and any electronic trading systems. Such records must be kept for five years or, if requested by the FCA, up to seven years.
- Records must be readily accessible to the FCA upon request and structured in such a way to allow easy retrieval and review.
- Senior management must ensure that record keeping processes comply with FCA standards.
- Record keeping policies and procedures must be in place and reviewed periodically.

Non compliance can result in regulatory penalties, enforcement actions, or reputational damage.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. **Why has the financial services sector developed global lending agreements?**
Answer reference: Section 3
2. **What does GMSLA stand for?**
Answer reference: Section 3
3. **What are the main actions covered by the Global Master Repurchase Agreement (GMRA)?**
Answer reference: Section 3.2
4. **Which US Act seeks to protect the public from the fraudulent issue and distribution of securities?**
Answer reference: Section 4.1
5. **What are the requirements for disclosure under the US 1933 Act (as amended)?**
Answer reference: Section 4.1
6. **What are the rules around the resale of restricted securities?**
Answer reference: Section 4.2
7. **What does SIL stand for and what is its purpose?**
Answer reference: Section 4.3
8. **How can a corporate action be impacted by a restricted trading list?**
Answer reference: Section 7
9. **What are the names of the main regulators in the US?**
Answer reference: Section 7.3
10. **What is the purpose of the Shareholder Rights Directive II (SRD II)?**
Answer reference: Section 8
11. **What is the purpose and content of customer document?**
Answer reference: Section 9.1



Chapter Eight

Risks and Controls

Section 1	Risk
Section 2	Credit Risk and Market Risk
Section 3	Operational Risk
Section 4	Reconciliation and Segregation of Duties
Section 5	Senior Managers & Certification Regime (SM&CR)

This syllabus area will provide approximately 3 of the 50 examination questions

1. Risk

One of the major issues facing any institution such as a custodian that is appointed by a client to service a portfolio of assets, is to allow for the transference of risk. How the asset servicer then manages this risk is absolutely key to the success of the whole operation. This issue has become more prevalent in recent years and a far greater focus has been placed on the mitigation and management of risk. Virtually all institutions and all custodians have risk management departments and control functions whose sole role is to negate and limit the exposure the company may have to risk.

A greater appreciation within the financial services sector of the effects of risk has been brought about by many factors:

- **Greater and more efficient regulation by the market regulators** – examples such as the Sarbanes-Oxley Act (SOX), the New Capital Accord from Basel and the Basel Sound Practices for the Management and Supervision of Operational Risk have led to a greater focus on the mitigation of risk.
- **Major corporate scandals and major loss-making events** – some extremely high-profile financial scandals dating back to the mid-1980s, such as the Maxwell case, Barings in the 1990s and more recent events such as Enron, AIG and Lehman Brothers.
- **Increased competition in the marketplace** – asset servicing has seen the growth of much greater competition in recent years. This has squeezed income streams. This reduction in income and profit has seen a greater focus on the elimination of risk.

There are many risks associated with asset servicing. The three common categories of financial risk are:

- **Credit** – the risk of loss caused by the failure of a counterparty to pay its obligations.
- **Market** – the risk of loss of earnings or capital arising from changes in the value of financial instruments and exchange rates.
- **Operational** – the risk of direct or indirect loss (which can be a loss of reputation) resulting from inadequate or failed internal processes, people and systems or from external events.

It is this third risk which this chapter will look at in detail, after some background information on credit and [market risk](#).

2. Credit Risk and Market Risk

2.1 Credit Risk

Credit risk is most simply defined as the potential that a counterparty will fail to meet its obligations in relation to agreed terms.

Securities firms need to manage the credit risk inherent in their entire portfolio, as well as the risk inherent in individual credits or transactions. For most banks, loans are the largest and most obvious source of credit risk. However, other sources of credit risk extend throughout the activities of a bank, including in the banking book and trading book, and both on and off the balance sheet. There is credit risk in various business lines other than lending, including trade financing, foreign exchange transactions, financial futures and options and settling transactions.

The term 'credit risk' may embrace a range of risk elements:

- **Issuer risk** – the risk that an issuer may default on its obligations. In the case of a debt instrument, for example, this will be the risk that the issuer fails to meet interest payments and to redeem principal on the instrument on redemption date.
- **Counterparty risk** – the risk that an institution defaults on obligations outstanding to a trade counterparty prior to trade settlement.
- **Settlement risk** – occurs when there is a non-simultaneous exchange of value (eg, cash and securities).

2.2 Market Risk

Market risk is the risk of loss of earnings or capital arising as a result of movements in market prices, including interest rates, exchange rates and equity values.

Financial institutions have always faced the risk of losses on- and off-balance sheet arising from undesirable market movements. However, the sharp increase in proprietary trading in many banks has heightened the need among regulators to ensure that these institutions have the management systems to control, and the capital to absorb, the risks posed by market-related exposures.

That said, the primary focus in the 1988 Basel Accord was on credit risk, and market risk only gained a high profile when the Basel Committee on Banking Supervision published a policy document on the supervisory treatment of market risk in April 1993. This proposed that firms should set aside capital to cover the price risks inherent in their trading activities. This document put forward a standardised measurement framework to calculate market risk for interest rates, equities and currencies.

Market risk can become an issue in securities operations in several ways:

- If a settlement is delayed or a trade fails, there is the possibility that the value of the instrument will fall during this period until settlement has been finally achieved.
- If the custodian misses a corporate action (eg, a rights issue), it may be required to compensate the investor for lost entitlements. If the price of the securities moves against the custodian before this exposure is closed, this can result in major financial losses for the custodian concerned.
- If a trade confirmation remains unmatched and it is discovered, for example, that both parties have reported a sale, instead of one a sale and the other a purchase, one may have to reverse the transaction in the market and incur a loss because the market price has changed.
- Late or failed transactions or a missed rights issue, in illiquid markets can be difficult to rectify as additional stock may not be available to borrow or buy.

3. Operational Risk

3.1 The Causes of Operational Risk

Operational risk is defined by the Basel Committee on Banking Supervision as *‘the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events’*.

All types of operational risk can be traced back to:

- processes that are involved in executing the business
- people or staff employed by the institution
- technology that is developed to support the processes and the people, and
- the environment within which the people, processes and technology operate. The environment has both internal and external influences, such as economics, law, tax policy, a change of government, the labour market, the pace of change, war and natural disasters.

3.1.1 Process Causes

Processes are activities designed to perform certain functions such as the disbursement of dividends or interest payments to clients. They are designed to be efficient and to prevent errors. If there are flaws in the design and/or controls of the process, then mistakes are made and losses result.

Some common generic examples of process issues that create operational risk are:

- lack of effective procedures and/or procedural documentation

- lack of capacity – that is, the ability of a firm to cope with business demand
- volume sensitivity – this means that staff workload increases in proportion to increasing volumes; it becomes an issue if there is a high degree of manual processes, such as in withholding tax (WHT) reclamation, and
- lack of effective controls.

3.1.2 People Causes

In the financial services sector, people are often thought of as an organisation's greatest asset. This is reflected by the high proportion of a firm's costs being attributed to staff compensation. However, the operational risks due to people-related issues are difficult to assess. This is partly because of the difficulty in measuring their effects. As the visibility of the human factor has improved, it has become even more apparent how damaging losses due to people issues can be.

In asset servicing, some of the common human causes of operational risk include:

- human error, an example being trade inputting or checking client instructions
- staff acting in an unauthorised manner or with a lack of supervision
- lack of integrity and honesty, which could lead to fraud
- lack of customer care
- lack of skills and/or insufficient training
- poor communication
- concentration of expertise, and
- in peak times, tiredness.

3.1.3 Technology Causes

All firms use technology in order to improve the effectiveness and efficiency of their processes, especially repetitive tasks. Its use is accepted as improving controls and reducing cost and, in the age of e-commerce, its importance to asset servicing is greater than ever before. However, it is also a cause of operational risk.

Some technology causes are:

- lack of system availability due to operational failure, inadequate security or power failure
- lack of system integrity – if systems do not automatically pass information between themselves, there is a need for manual re-keying between systems, and inter-system reconciliations are required to ensure the integrity of data
- inadequate testing of systems in their development stage leading to later production problems, and
- lack of flexibility if a new issue or an amendment to previous issues arises.

More and more often, we are seeing corporate actions, more so in emerging markets, which do not follow a logical or formulaic sequence, thus preventing automation in any way.

3.1.4 Environmental Causes

The three causes of process, people and technology are inherent in the internal structure of an organisation. The environmental causes have an impact by exacerbating the risks that already exist in these areas, and the other causes of risk cannot be adequately understood without taking these environmental issues into account.

Some examples of environmental causes are:

- changes in the regulatory or tax environment
- the accelerating increase in trade volumes as a result of increased market activity, resulting in greater pressure on staff, their processes and technology, and
- the increasing pace of change. The management of change is a major area that is becoming an ever-greater issue for financial institutions as the environment in which they operate becomes more and more complex.

3.2 Key Risks in Asset Servicing

8.1.1 Know the key risks of corporate action processing: inaccurate/incomplete information; incorrect or misapplied instructions; missed deadlines; updates on entitlement; payment handling; reduced settlement periods; risks around late returned stocks and its importance

Provided below are examples of asset servicing risks and their implications:

- **Providing/receiving inaccurate information** – if asset servicing institutions provide incorrect or inadequate information to fund managers then the fund managers will not be best placed to make a sound decision. Through basing a decision on the information provided, they may choose unwisely and lose value on their investments (such as missing a rights issue). The asset servicing team may be required to compensate the fund manager to rectify the position if incorrect information has altered its decision and negatively impacted it. If, on the other hand, asset servicing receives incorrect information from a fund manager in terms of a decision taken, this is the fund manager's responsibility and, as such, corrective action would be taken as a relationship issue and on a reasonable endeavours basis.
- **Providing/receiving incomplete information (such as provided incorrect take over details)**– as per the above, asset servicing/custodians would be responsible for any costs/losses incurred. However, if full information is not available because of market conditions, the asset service department would not be held liable or responsible.
- **Failing to provide any information** – as a result, the fund manager may not be aware of the event and will be unable to take a decision.

- **Applying incorrect instructions** – the asset servicing department would be duty-bound to rectify the situation to reflect the fund manager’s decision for the event. For example, selling nil-paid rights when they should have been exercised. As a consequence, it may incur unlimited losses/costs depending on market conditions. Any profit made by the team may be passed on to the client, although, depending on the status of the fund, some clients may decline due to undue enrichment rules.
- **Failing to apply instructions** – again, asset servicing would be forced to make the client good to reflect the fund manager’s decision for the event. As a consequence, it may incur unlimited losses/ costs depending on market conditions.
- **Missed deadlines** – if the fund manager is responsible for missing the deadline by not submitting the instruction, this is not an asset servicing risk. The fund manager may miss the internally set deadline and will then be advised that the response will be dealt with on a ‘reasonable endeavours’ basis. Alternatively, the fund manager may miss the custodian deadline and, if applicable, the default action will be applied. If asset servicing misses the custodian deadline, it then becomes responsible for reimbursing the fund manager with any losses incurred, and these are unlimited and dependent on market conditions.
- **Updates of entitlement** – the correct and timely updating of in-house systems to reflect client positions is vitally important, both for trading and fund accounting. Erroneous trades posted on to a system can lead to missed entitlement. For example, if the trade capture section within a custodian had neglected to input a transaction on the in-house custody system, this could have severe implications for the asset servicing team, who would not be able to reconcile the position to the market. A situation could develop whereby a protection might be required with a market counterparty. This will be subject to a deadline if it is a voluntary corporate action. If this deadline is missed and results in a monetary loss, the custodian may have to make the client good.
- **Reduced settlement periods** – There is a global movement to reduce settlement periods on trades. This will provide some key benefits for market participants such as lower counterparty risk, quicker access to funds/securities, efficiency and a possible liquidity boost. While this will also provide more accurate corporate action entitlement, it does create a number of operational risks. Firms will have more operational pressure which could result in a higher risk of processing errors and reduce time window for resolve disputes and address late settlements. Therefore, will create pressure for reconciling and processing corporate actions.
- **Late returned stocks and its importance** – When firms lend (or repo) out securities they are expected to be returned by a specific date. But if these assets are returned late, it can affect settlement which can then have a knock on impact on dividends, rights, and corporate action processing such as missed/incorrect entitlements which can then result in processing errors which cause financial losses as well as additional effort to unwind.

3.3 Implications of Inaccurate Information

Asset servicing departments are only as good as the information received from their subcustodians. If this is inaccurate, the fund manager may be provided with incorrect information and thereby make a decision that is not fully informed. In such an event, the custodian may be required to make good any claims made by the fund manager.

- **Poor or wrong investment decision** – if a fund manager makes a poor investment decision, the fund may suffer a loss. Only if it can be determined that a manager has acted against the fund mandate (for weighting/exposure, etc) will the client be compensated.
- **Missing deadlines** – if inaccurate information is passed on, this could lead to missing a deadline. The entity who passed on the information would then be held liable. As most asset servicing voluntary events have a strict deadline, this would again lead to the custodian making the client's position good. An example of this would be a missed deadline relating to a rights issue. As the issue would be backed by an underwriting, once the deadline for acceptance has been reached then no further call monies can be accepted. In this scenario, the custodian may be required to buy shares in the open market and credit them to their client's account, debiting the client for what the original call money would have been. If there was a premium on these shares in relation to the call price, then this would lead to a monetary loss.
- **Providing inaccurate terms, valuations and pricing** – this could lead a fund manager to make a decision it would not otherwise make. For example, the fund manager may choose to lapse instead of take up rights. Asset servicing may be required to rectify this, post-event, by buying in or selling stock and suffering any associated loss.
- **Pricing is vitally important to unit trust managers** – one of the major risks they face relating to the incorrect pricing of a unit trust would be reputational risk. Regulatory requirements are very strict in relation to the rules on pricing and, therefore, the guilty company may receive a fine and bad press; this can severely affect reputation.

4. Reconciliation and Segregation of Duties

8.1.2 Understand the importance of reconciliation and segregation of duties

8.1.3 Know breach reporting obligations

8.1.4 Understand the risks of not complying with regulations: CASS; SM&CR

The FCA uses the Client Assets Sourcebook (CASS) rules to protect clients' money and assets when they are held by an investment firm, ensuring they remain, safe, identifiable, and returnable even if the firm becomes insolvent.

CASS sets out strict requirements for segregation, record-keeping, reconciliations, custody controls, and oversight, so that client assets are never mixed with firm assets, never used for the firm's own purposes, and can be quickly traced and returned if anything goes wrong.

The regime is designed to maintain market integrity, reduce the risk of loss to investors, and ensure that firms have clear systems, controls, governance, and accountability (including under SM&CR) for safeguarding client assets at all times.

There are a number of major risks that firms could face for noncompliance – namely:

- **Client money loss or misuse** – incorrect segregation or reconciliation can result in loss of client funds, especially in an insolvency event.
- **Regulatory penalties** – significant fines, public censures, or enforcement actions can occur (eg, firms historically fined millions for CASS failures).
- **Operational disruption** – CASS breaches often trigger immediate FCA intervention, remediation projects, and skilled person reports.
- **Insolvency complications** – Poor CASS compliance can cause major delays and losses for clients during firm failure, which the FCA heavily focuses on.
- **Reputational damage** – loss of client assets severely undermines trust and can lead to client departures, difficulties attracting new business, and long-term brand harm.

4.1 Reconciliation of Clients' Securities

What are the key rules?

CASS 6.6.8 through to 6.6.58 is a group of rules that deal specifically with reconciliations of customer assets. These rules include:

- permissible reconciliation methods
- frequency of reconciliation
- separation of duties
- problem resolution, and
- reporting problems to the regulator.

What reconciliation methods are allowed?

- There are a number of allowed or permissible reconciliation methods.

Rules 6.6.10 through to 6.6.32 define the following reconciliation methods:

- An **Internal Custody Record Check** – a check as to whether the firm’s records and accounts of the safe custody assets held by the firm (including, for example, those deposited with third parties) correspond with the firm’s obligations to its clients. This means that if the firm’s records show that it is holding 1,000 units of a particular asset for each of ten clients, then it must hold 10,000 units in total. These assets may be held by the firm’s custodian, or they may be held physically by the firm, or there might be some combination of the two.
- A **Physical Asset Reconciliation** – the name the regulator gives to the process of reconciling any assets that are held physically. The rules permit two possible methods of performing this reconciliation:
 - the **Total Count Method**, whereby all the customer assets held by the firm are counted and reconciled on the same day, and
 - the **Rolling Stock Method**, whereby one group of assets is counted and reconciled on one day, and other groups are counted and reconciled on other days.
 - An **External Custody Reconciliation** – the process of agreeing the firm’s records of custody assets with the records of its custodians.

How frequently should reconciliations be done?

Rule 6.6.44 requires firms to decide how often to perform these reconciliations. It does not prescribe a ‘one size fits all’ rule. But, when making the decision; firms must take account of:

1. frequency, number and value of transactions which the firm undertakes in respect of clients’ safe custody assets, and
2. any risks to which clients’ safe custody assets are exposed, such as the nature, volume and complexity of the firm’s business, and where and with whom safe custody assets are held.

To ensure that there is no misunderstanding, rule 6.6.45 requires that firms keep a written record of the decision process that they used to choose a certain reconciliation frequency, and Rule 6.6.46 orders them to review such decisions regularly in the light of changing business activities, processes or volumes.

How should firms investigate issues and/or problems?

CASS 6.6.49 and CASS 6.6.50 require firms to promptly investigate discrepancies and Rule 6.6.54 requires them to make good any shortfall from their own resources if the discrepancies cannot be resolved in any other way.

When should firms report problems to the FCA?

CASS 6.6.57 requires a firm to notify the Financial Conduct Authority (FCA), in writing and without delay, if it discovers:

1. its internal records and accounts of the safe custody assets held by the firm for clients are materially out of date or materially inaccurate or invalid
2. it will be unable, or materially fail, to take the steps required under CASS 6.6.54 for the treatment of shortfalls, or
3. it will be unable, or materially fail, to conduct an internal custody record check in compliance with CASS 6.6.11 to CASS 6.6.19 , or
4. it will be unable, or materially fail, to conduct a physical asset reconciliation in compliance with CASS 6.6.2 to CASS 6.6.30, or
5. it will be unable, or materially fail, to conduct an external custody reconciliation in compliance with CASS 6.6.34 to CASS 6.6.37.

The FCA takes breaches of the CASS rules very seriously (especially if the FCA either discover the issues themselves or are not made aware of them by the firm in a timely manner). Therefore, by not complying with the rules, firms are taking a significant risk. There are a number of highly publicised and large fines for firms who did not comply with the CASS rules.

4.2 Client Money Reconciliations

The rules concerning the reconciliation of client money are covered by section 7.15 of the Client Money Rules.

Client Money is cash that belongs to a firm's clients.

- CASS 7.15.12 requires firms to carry out a client money reconciliation. This is a reconciliation of its internal records and accounts of the amount of client money that the firm holds for each client with its internal records and accounts of the client money the firm should hold in client bank accounts or has placed in client transaction accounts.
- CASS 7.15.13 stipulates that when carrying out an internal client money reconciliation, a firm must use the values contained in its internal records and ledgers (for example, its cash book or other internal accounting records) rather than the values contained in the records it has obtained from banks and other

third parties with whom it has placed client money (for example, bank statements).

- CASS 7.15.14 stipulates that an internal client money reconciliation should be one of the steps a firm takes to arrange adequate protection for clients' assets when the firm is responsible for them.
- CASS 7.15.27 and 7.15.28 deal with reconciliation frequencies, and CASS 7.15.29 through to 7.15.32 deal with what actions firms must take when discrepancies are revealed. These rules are broadly the same as CASS 6.6.49 through to 6.6.54 which were explained in the previous section of this workbook.
- CASS 7.15.33 requires firms to notify the FCA 'in writing without delay' if it discovers:
 1. its internal records and accounts of the client money held by the firm for clients are materially out of date, or materially inaccurate or invalid, or
 2. it will be unable or materially fail to take the steps required under CASS 7.15.29 through to 7.15.32 for the treatment of shortfalls.

As with any type of payment, there is a risk of some type of problem or issue. This can cover a wide range of activities. For example, fraudsters directing funds to their accounts (as opposed to the intended recipient), fraudsters impersonating clients to obtain their funds or operational errors being made where monies are accidentally paid to the wrong accounts.

Therefore, firms need to have a number of capabilities in place to mitigate these problems, including the following:

- Strong governance with good high-level sponsorship at the executive level (for example the CEO). Typically, most firms will have some sort of payment oversight committee that oversees all the controls in place, investigates problems and ensures that remediation actions take place.
- Strong business staff engagement supported by (a) strong systems/controls to manage against issues and fraud with (b) clear roles and responsibilities regarding 'who does what' especially in the event of problems.
- This engagement and responsibility will need to cover all staff. It will range from frontline staff to second/third lines of defence (such as risk, compliance, and internal audit functions). It will also need to include the relevant senior management.
- Regular reporting of any errors to assess what has taken place, where the risks exist and, therefore, what remediation activity is required.
- Clear definition of risk appetite in terms of budgets for 'expected' losses.

4.3 Breach Reporting Obligations

While the above focuses on CASS and what to report to the regulator in case of problems, there is a wider point here in that firms need to be aware that they have to follow the FCA's Conduct Rules and if they are breached, then the regulator needs to be informed.

Firms are required under the FCA's rules (particularly SUP 15) to report any breach or incident that could have a significant regulatory, operational, or client impact. This is to ensure transparency, protect consumers, and also maintain confidence in financial systems. Specifically:

- This means notifying the FCA immediately or as soon as reasonably practicable when an event occurs that could compromise compliance, harm clients, affect market integrity, or indicate weaknesses in systems and controls. Examples include CASS breaches, significant valuation or pricing errors, failures in trade execution or corporate actions, financial crime or AML issues, cyber or data breaches with client impact, and any misconduct or control breakdown relevant to SM&CR.
- The FCA expects firms to report material issues promptly, without waiting for a full internal investigation, and to provide follow-up updates as more information becomes available.
- Senior Managers (especially SMF16 (Compliance), SMF17 (MLRO), and SMF24 (Operations)) are accountable for ensuring that breaches are properly identified, escalated, assessed for materiality, and reported where required.
- Firms must also maintain comprehensive breach logs, root-cause analyses, remediation plans, and documentation supporting their decision-making on whether a breach was reportable.
- Failure to report a material breach can lead to regulatory scrutiny, enforcement action, or personal accountability for Senior Managers.

However, there is an overlap with SM&CR (which is discussed in more detail in section 5 below).

Any Senior Management Functions (SMFs), which are controlled functions carried out by approved persons, need to note four further items; namely:

- They must be pre-approved by the FCA or PRA.
- They must have a Statement of Responsibilities (SoR) that clearly states what they are responsible and accountable for.
- They will have a Duty of Responsibility under the Financial Services and Markets Act 2000 (FSMA). This means that if a firm breaches one of the requirements, the SMF responsible for that area could be held accountable if they did not take reasonable steps to prevent or stop the breach.
- They must be fit and proper to carry out their jobs, and firms need to assess their ongoing fitness and propriety at least annually.

This has implications for reporting breaches.

For non-SMF staff subject to the Conduct Rules, firms must annually report the number of Conduct Rule breaches resulting in disciplinary action using form REP008 in RegData. If there are no breaches, a nil return must be submitted.

For SMFs, the regulator requires that firms notify them within seven business days of concluding disciplinary action for a Conduct using a Form D (or Form C if the SMF will be leaving the firm) on Connect.

Disciplinary action means the issuing of a formal written warning, suspension or dismissal, or the reduction or recovery of remuneration. A breach of the Conduct Rules that is not significant enough to warrant one of these outcomes should not be reported.

If a firm takes disciplinary action for a Conduct Rule breach but the employee appeals, or plans to appeal, this should still be reported to the regulator and the notification should include the appeal. The firm should update the regulator on the outcome of an appeal in the next REP008 submission or using Form D (for an SMF).

4.4 Separation of Duties

At a general level the segregation of duties is an internal control principle that involves dividing tasks and responsibilities among multiple individuals to reduce the risk of errors, fraud and unauthorised actions.

However, specifically from a firm point of view, rule 6.6.47 requires firms, whenever possible, to ensure that checks and reconciliations are carried out by a person who is independent of the production or maintenance of the records to be checked and/or reconciled.

5. Senior Managers & Certification Regime (SM&CR)

8.1.4 Understand the risks of not complying with regulations: CASS; SM&CR

The background to the [Senior Managers & Certification Regime \(SM&CR\)](#) regulation is that the FCA and PRA implemented new rules on increasing individual accountability to improve professional standards and the culture within the UK financial services sector by making it easier for firms and regulators to be clear about who is responsible for what. Therefore, if things go wrong, then it will allow senior managers to be held personally accountable when they are at fault for issues within their area of responsibility.

SM&CR came into force on 7 March 2016, for UK banks, building societies, credit unions and PRA- regulated investment firms. The regime was rolled out to cover all FSMA-regulated firms (including asset managers) in 2018.

Non-compliance with SM&CR exposes firms and individuals to serious regulatory, financial, and reputational consequences:

- **Regulatory enforcement** – the FCA can take action against both the firm and individual senior managers, including fines, bans, or withdrawal of approvals.
- **Personal liability** – senior managers may be held personally accountable for failures in their areas of responsibility under the 'Duty of Responsibility.'
- **Increased supervision** – firms may face FCA scrutiny, skilled person reviews (s166), or restrictions on business activities.
- **Operational failures** – weak governance can lead to poor controls, misconduct, culture issues, or customer harm.
- **Reputational damage** – failures can harm client trust and impact ability to win business or hire talent.

The regulation consists of the following two main sections:

The first part is the Senior Managers Regime (SMR) which focuses on the most senior individuals in firms who hold key roles or have overall responsibility for whole areas of relevant firms. Firms need to:

- ensure each senior manager has a statement of responsibilities setting out the areas for which they are personally accountable
- produce a firm responsibilities map that joins these individual responsibilities together, and
- ensure that all senior managers are pre-approved by the regulators before carrying out their roles.

A 'duty of responsibility' has also been implemented which means that senior managers are required to take the steps that are reasonable for a person in that position to take, to prevent a regulatory breach from occurring.

The second part is the Certification Regime which applies to 'material risk-takers' (staff who are subject to the dual-regulated firms' remuneration code and other staff who pose a risk of significant harm to the firm or any of its customers). Accordingly, firms need to:

- have identified all certified individuals
- have assessed them as fit and proper, and
- have procedures in place to reassess the fitness and propriety of certified staff on an annual basis.

The publicly available Financial Services Register now reflects the Senior Managers and Certification Regime (SM&CR) information for relevant firms.

The above discussing SM&CR from a general point of view but it would be good to discuss SM&CR through an Asset Servicing lens.

See below:

- SMFs relate to corporate actions through their responsibility for governance, oversight, and systems/controls, even though they do not usually execute

corporate actions themselves. Under the SM&CR regime, certain SMFs (particularly the SMF1 (CEO), SMF3 (Executive Director), SMF16/17 (Compliance/MLRO), and SMF24 (Chief Operations Function)) must ensure that the firm has robust processes for handling corporate actions such as dividends, mergers, rights issues, and proxy voting. This includes making sure that operational teams follow correct procedures, client entitlements are accurately processed, deadlines are met, and communications to clients are clear and compliant.

- If a failure occurs (such as missed elections, incorrect processing of dividends or takeovers, or failures to notify client) then SMFs can be held accountable if the root cause is inadequate oversight, poor systems/controls, weak governance, or insufficient resources.
- In short, while corporate actions are processed by operations teams or custodians, SMFs are responsible for ensuring the framework, controls, oversight, and accountability that keep those processes accurate, timely, and compliant.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. **What is the definition of credit risk?**

Answer reference: Section 2.1

2. **What is the definition of market risk?**

Answer reference: Section 2.2

3. **What are the four main causes of operational risk?**

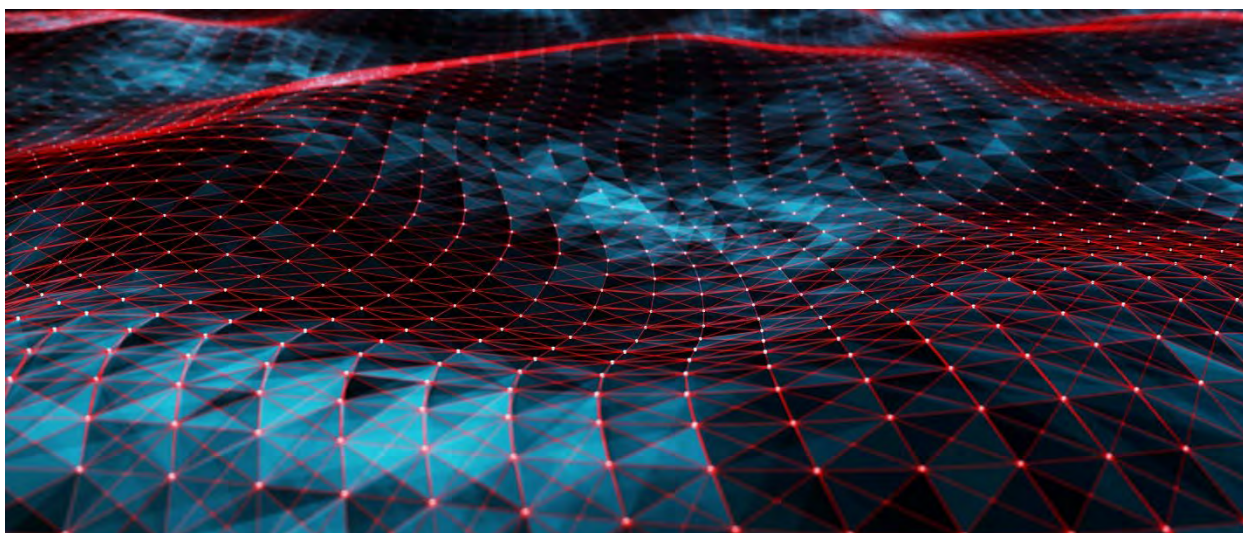
Answer reference: Section 3.1

4. **List three of the key risks in asset servicing and explain the consequences to the client and to the asset servicing company.**

Answer reference: Sections 3.2 and 3.3

5. **What must a regulated firm do if it finds that its internal records and accounts of the safe custody assets held by the firm for clients are materially out of date?**

Answer reference: Section 4.1



Glossary

1933 Securities Act (as amended)

In the US, the 1933 Securities Act (as amended) was enacted in the wake of the Great Depression (when a large number of small private investors lost everything they owned). Its two basic objectives are (a) to provide the greater transparency and (b) reduce fraud in the securities market. It is also called the Full Disclosure Act. It requires issuers to register a detailed and truthful statement with the SEC describing any new offering.

Acceptance Date

The date specified by company registrars/agents by which client instructions need to be lodged.

Accrual

A method of accounting in which each item of income or expense is entered as it is earned or incurred, regardless of when actual payments are received or made.

Accrued Interest

The amount of interest that has been earned on a bond but not yet paid to the bondholder (because payment is made only on set dates).

Administrator

The person assigned by the courts who takes over executive responsibility of a company in liquidation in order to ensure that creditors are protected.

Agent Deadline

A deadline set by an agent by which time it must receive responses to voluntary corporate actions in order that it can collate them and meet the market deadline.

American Depositary Receipt (ADR)

Depositary receipts are instruments which simplify the international buying, selling and holding of securities. Depositary receipts represent equities but may also represent preferred shares, convertibles and debt, with or without warrants. All depositary receipts are based upon the same principle: they create a substitute instrument for international ownership of shares in a company when use of the original instrument (share certificate) would entail inconvenience, delay, added expense and unnecessary risk. Originally designed for overseas companies to gain US listings where access to the local market was difficult for US clients. Less important now due to global relocation of major US trading houses.

Annual General Meeting (AGM)

Meeting held annually to discuss and vote on the three mandatory resolutions, and those recommended by a company's board.

Asset Stripping

When a firm mounts a takeover on a target firm with the intent of breaking it up and selling its assets for profit, rather than running it as a going concern.

Association for Financial Markets in Europe (AFME)

AFME is the voice of Europe's wholesale financial markets, representing the leading global and European banks and other significant capital market players. It focuses on a wide range of market, business and prudential issues and offers a pan-European perspective, bringing to bear deep policy and technical expertise and constructive influence on European and global policymakers.

At-the-Money

A warrant or other derivative that will return neither a profit nor loss if it is exercised.

Authorised Share Capital

The maximum amount of share capital that a company can issue without the need to change the memorandum.

Auto-Depositary Compensation

A depositary automatically reclaims a corporate- actions-related benefit on behalf of the party holding stock if for any reason (eg, late booking or failed trade) the benefit was not paid to the correct party.

Bearer Security

A type of security where physical possession of the certificate is proof of ownership.

Beneficial Owner

The ultimate entity that exercises controls over, and receives the entitlements from, a particular asset. In the modern context this entity is seldom the name registered on the company register. A fund manager may well hold private client assets. There is normally a chain of custodianship of the asset. A global custodian will hold these in turn as part of the fund manager's holdings. In the case of overseas holdings, a subcustodian to the order of the global custodian may in turn hold these. The registered holder on the books of the company will be the subcustodian, but the beneficial owner will still be the private client. Ultimate ownership must be tracked back through the books of several custodians and a fund manager.

Blockchain

Blockchain is a distributed and shared database that maintains a continually growing list of records called 'blocks' (or digital tokens). Each block contains a timestamp and a link to its previous block. The contents of each block cannot be altered retrospectively. Its main and most well-known use is providing the ledger that underpins the Bitcoin cryptocurrency.

Board Lot

Standard tradeable unit of shares in the market.

Bond

Fundamentally a bond is an acknowledgement in paper or book entry form of a loan made to a company that is redeemable under conditions specified at the time that the loan was made. Most bonds (but not all) will pay income at any agreed rate at specified periods. Most bonds specify the final date when the capital sum lent to the company must be repaid. Some bonds allow the holding to be converted into shares or other instruments issued by the company.

Bonus Issue

An issue of fully paid new shares from a company's reserve, free of payment, to the existing shareholders in proportion to the existing holdings at a specified date (the Record Date). The object of such an issue may be to make the market in the shares more 'liquid' by increasing the number in circulation. Companies do not always issue the same type of shares for a bonus.

Bullet Redemption

The redemption of a bond by a single lump sum payment.

Calculation/Paying Agent

The agent bank responsible for telling the paying agent how much is being paid on an issue based on its terms and conditions.

Call Date

The date specified by a company for which the payment of new shares is required.

Call Option (on shares)

A call option provides the investor with the right to buy a pre-agreed number of shares of stock at a specific strike price up until a specified expiration date.

Call Option (on a bond)

A clause in a bond's issue giving the issuer the right to ask for early redemption.

Call Payment

The cash a shareholder sends to a receiving agent as payment for additional shares in a rights issue.

Capital Gains Tax (CGT)

A tax on the increase in the value of an asset, ie, the difference between its sale and purchase price.

Capital Repayments

A payment made by a company to its shareholders to repay some of its issued share capital.

Central Counterparty (CCP)

An entity that sits between the buyer and seller of an exchange-traded security and acts as a guarantor of contracts. By this means, the exchange assumes the credit risk, thereby limiting the exposure of its members by protecting them from the impact of default.

Central Securities Depository (CSD)

An institution that holds all the securities for a particular market. By doing so, it centralises the securities of a particular market, making settlement easier.

Class Action

Globally, but mainly in the US, minority shareholders who are not satisfied with the actions taken by a company and take the view that this may have materially affected the share price in the market. This results in a class action for compensation. Other purchasers of the stock over the same period are invited to join the action.

Clean Price

The price of a bond excluding accrued interest.

Clearing

The process whereby the two parties to a trade assume responsibility for it.

Clearing Agent

An agent that manages the process of clearing on its clients' behalf. This includes matching the settlement details of seller and buyer.

Commercial Paper (CP)

Unsecured, short-term bearer security. It is usually issued by a company in the same way that a bank issues a certificate of deposit (CD), except that it is not usually interest-bearing (ie, priced at a discount to the face value).

Compulsory Redemption

A compulsory redemption (or a compulsory purchase, compulsory acquisition or squeeze-out) is when minority shareholders are forced to sell their shares to a majority shareholder (or bidder) who has acquired enough control in a company. It is normally triggered in a takeover or merger situation, where the acquirer wants to gain 100% ownership of the target company to take it private and/or de-list it.

Common Stock

The US term for Ordinary Shares.

Consideration

The entity paid or received for a trade.

Consolidation

When a company consolidates its existing share capital into fewer shares of a higher par value. This change will alter (decrease) the number of shares authorised within the company and will therefore affect the market price per share. Also known as a Reverse Split.

Consumer Duty

This is a regulatory framework that requires financial firms (including banks, insurers, investment firms, and advisers) to act in the best interests of their customers, ensuring products and services deliver good outcomes. This is to ensure that customers are protected, market fairness is improved and to reduce harm caused by poor products and/or services.

Contingent Value Right (CVR)

A CVR is a derivative which is based on some future event by a specified date and if this event happens then the CVR distributes a pre-agreed payment typically in cash. If the event does not happen then the CVR expires and is worthless.

Conversion Agent

The agent bank appointed by the bond issuer to manage the mechanics of a conversion.

Conversion Event

An event when the characteristics of a financial instrument are changed.

Corporate Action

Any activity instigated by a company which may affect its capital shares and/or cash.

Counterparty

One party of a trade legally bound to make good delivery or a good payment.

Counterparty Risk

The risk that a counterparty will default on its obligations.

Coupon

The periodic interest rate declared on a bond or bearer security. Owing to the bearer nature, these are paid usually by sending a removable part of the certificate (the coupon) to the registrar.

Credit Rating

A measure of the quality of a bond and a reflection of the creditworthiness of the issuer, determined by external rating agencies such as Moody's and Standard & Poor's.

Credit Risk

The risk of loss caused by the failure of a counterparty to pay its obligations.

Cum-dividend

Term used to indicate that shares are being transferred with (cum) the right to receive the dividend.

Custodian

Organisation which holds clients' assets in safe custody, ensuring that they are not released without proper authorisation and ensures the timely and accurate collection of dividends and other benefits.

Data/Information Vendors

Companies which provide securities-related information to the investment management community for a fee.

Debenture

A type of bond that in the US is unsecured and in the UK is secured on specified assets of the company.

Default

Failure of a debtor to pay interest or to repay principal when payment is due.

Defence

During a takeover, the target company may not wish to be taken over. It may, therefore, adopt a strategy called defence to prevent the takeover going through.

Deferred Shares

A class of share where the holder is only entitled to a dividend if ordinary shareholders have been paid a specified minimum dividend. Deferred shares carry negligible rights. They do not usually carry voting rights or entitle the holder to any dividends or a return of capital on a winding-up except in very limited circumstances.

Dematerialised

Securities where certificates or documents of title have been eliminated and replaced by book entry records.

Demerger

An issue of shares free of payment to existing shareholders, similar to a Bonus Issue, but entitlements received are shares to be quoted separately from the parent company. The action turns the subsidiary into an independent company, which has its own shares and listing on the market. It effectively demerges the subsidiary from its parent.

Depository Receipt (DR)

Negotiable certificates that represent a fraction or multiple of a number of foreign shares. They allow investors to invest in foreign securities using their local exchange.

Depository

A centralised body which typically enables members to hold book entry accounts for dematerialised securities, settles transactions between members on a delivery-versus-payment (DvP) basis, and provides basic custody services. May also hold certificated securities in secure storage.

Derivative

An instrument whose value is derived from an underlying instrument such as a share or the price of a commodity, rather than having intrinsic value. Examples are options, swaps and warrants.

Digital Tokens

A digital token is a specific type of digital asset that represents a unit of value, right, or ownership. For example, a non-digital asset could be a paper share certificate but a digital token could represent this electronically.

Dirty Price

The price of a bond including accrued interest.

Dissenting Shareholders

Shareholders in a company which has met the criteria of being taken over, who for their own reasons do not wish to receive the takeover consideration and, thereby, remain nominally shareholders of the old company. Dissent is not allowed in all markets worldwide.

Dividend

Allocation, in the form of cash, of a portion of company profits to a shareholder on a pro rata basis. Dividends may also be paid in the equivalent amount of shares (stock dividend).

Dividend Reinvestment Plan (DRIP)/Bonus Share Plan (BSP)

When a company offers its shareholders the option to enrol in a dividend reinvestment or bonus share plan. Once enrolled in the plan, it is like a standing instruction until cancelled. Certain companies also give investors the option to enrol in the plan at time of purchase.

Double Taxation Agreement (DTA)

A bilateral agreement between two states that exists in order to encourage and maintain an international consensus on cross-border economic activity and to promote international trade. From an investor's perspective, it contains clauses that prevent double taxation if the same income is taxable in two states. Also called a Double Taxation Treaty (DTT).

Drawings

Drawings and partial redemptions are similar. The company makes repayment at various stages of the life of the security, usually with reduction in the nominal value. The holdings are placed in a pool and the bonds to be redeemed are selected by lottery.

Dutch Auction

Similar to a tender except that the company offers to purchase its common shares at an amount between two prices to be determined by the company. Shareholders are invited to tender their shares at a price they are prepared to accept.

EasyWay (Deadlines and Corporate Event) Notices

Notification of corporate actions produced by Euroclear and distributed electronically to their members. This system was originally called DACE.

Escrow

An account held by the registrar in CREST which is a pool of all the accepted shares in relation to a takeover. Once in escrow, these shares are not normally tradeable.

Eurobond

Bonds issued outside the country of the borrower, denominated in a currency which is generally not that of the issuer's country. Settlement takes place through the international clearing system (Euroclear and Clearstream). This market is regulated by ICMA (formally known as ISMA).

Ex-Date

A cut-off date designated to identify trades which are entitled to the issue. Purchases up to this date will qualify as will any sales traded after this specific date.

Ex-Dividend

Term used to indicate that shares are being transferred without (ex) the right to receive the next dividend.

Expiry Date

The last day for which an offer can be accepted.

Extraordinary General Meeting (EGM)

A meeting of shareholders called at any time for a special purpose.

Financial Conduct Authority (FCA)

The Financial Conduct Authority replaced the Financial Services Authority as the body responsible for regulating conduct in retail and wholesale markets, supervising the trading infrastructure that supports those markets and for the prudential regulation of firms not prudentially regulated by the Prudential Regulation Authority (PRA).

Financial Services and Markets Act 2000 (FSMA 2000)

FSMA 2000 which came into force on 1 December 2001 replaced and consolidated a variety of previous legislation surrounding the financial services sector in the UK.

Foreign Account Tax Compliance Act (FATCA)

FATCA is a piece of regulation developed by the US tax authorities in their efforts to combat tax evasion by US persons holding investments in offshore accounts. It was enacted in March 2010 and came into force in January 2013.

Foreign Ownership Restrictions

Limits and restrictions of various kinds imposed by countries on individuals, firms and financial institutions in order to control ownership of shares, thereby protecting the national interest and/or to protect investors.

Free of Payment

- a. The movement of assets for which there is no associated (cash) countervalue.
- b. The movement of assets, which is not dependent on the simultaneous payment of the cash countervalue.

Fully Paid Rights

Once a call payment has been made during a rights issue, the shareholder then holds fully paid rights rather than nil-paid rights.

Global Agreements

Standard legal documents covering securities lending designed to standardise terms and conditions for lending and borrowing in order to reduce the legal risk and improve the efficiency of the practice.

Global Master Repurchase Agreement (GMRA)

The accepted industry contractual template for performing repo and buy/sell back transactions.

Global Master Securities Lending Agreement (GMSLA)

The accepted industry contractual template for performing stock lending transactions.

Government Bonds

Long-term, interest-bearing securities. They are issued by governments to finance fiscal deficits or capital spending.

In-the-Money

A warrant or other derivative that will return a positive value if it is exercised. It may not make a profit, as it will depend on the price paid for the derivative.

Initial Margin

A means employed by an exchange of receiving collateral when a position is first opened. Initial margin is collected at the start of each day's trading.

Initial Public Offering (IPO)

The initial sale of a company's shares to the public. This will involve publishing a prospectus which sets out the details of the company to be floated, setting an offer price for the shares and receiving applications.

Interest Rate Convention

A method of calculating the interest payable on interest-bearing bonds.

Investment Management Company

An institution that provides its clients with a full range of investment management and custody services.

ISO 15022

A message standard introduced in 2002 which, as one of its benefits, was designed to allow for better automation of corporate action messages.

ISO 20022

A more comprehensive message standard developed in 2005 which is based on the use of a standard data dictionary and XML message rules.

Issued Share Capital

The total value of share capital that has been issued by the company. Note that this may be different to the Authorised Share Capital.

Issuer

A company or government entity that chooses to raise money in the capital markets through the issue of securities.

Issuer Risk

The risk of default when one institution holds debt securities issued by another institution.

Lapsed Rights Proceeds

Lapsed rights proceeds are sometimes paid on allotments for which the call has not been paid.

Lazy Money

The value lost when a warrant that is in-the-money is either (a) not exercised prior to expiry date or (b) auto expires. The term 'lazy' reflects the lack of effort on the investor's part.

Lead Manager

The principal investment house in a syndicate handling a new issue of securities. It will be appointed by the issuing company. The lead manager is said to 'run the book' on behalf of the issuer.

Liquidation

A company goes into liquidation when the business objectives can no longer be applied owing to factors such as debt default by the company. The company assets are realised and creditors and holders of capital paid out according to their priority, if adequate funds are available. Also the reduction of the number of units in issue in an authorised unit trust.

Long Coupon

The amount paid on the second coupon date of a bond that is equivalent to something more than the whole coupon. This results from a bond being issued between two coupon dates.

Mandatory Corporate Action

A corporate action that does not require a decision on the part of the investor.

Margin

Collateral on open positions to insure against the risk of default.

Market Deadline

A deadline set by the firm whose shares are subject of the voluntary corporate action. All responses must be received at the firm or its agent by this date and time for the response to be acted upon.

Market Risk

The risk of loss of earnings or capital arising from changes in the value of financial instruments.

Maturity

The time period to the redemption of a bond.

Merger

When two or more companies combine capital and operate their business as one company.

Mini-Tender

An offer is made to purchase no more than 5% of the stock of a company. The 5% threshold is critical because any offer to purchase more than 5% of the stock would trigger a variety of regulatory requirements. By staying under the 5% ceiling mini-tender offers can avoid regulatory scrutiny. Therefore, this means that (a) they are treated nervously by investors and (b) if made by an outside party without the company's management approval, could be seen as the start of a hostile takeover.

Multilateral Trading Facility (MTF)

A facility that brings together multiple parties (eg, retail investors or other investment firms) that are interested in buying and selling financial instruments, and enables them to do so.

Netting

Settlement of cash or securities by summing up credits and debits and delivering or claiming the resulting amount in one movement. Netting can be bilateral, multilateral or continuous net settlement.

New Issue

Also called a placement or initial public offering (IPO). Issue of new shares to the general public as part of the process of obtaining a stock market listing or the creation of a new company.

Nil-Paid Security

An entitlement to buy additional shares in a company at a discount to market price, given as part of a rights issue. The security is nil-paid as the shareholder does not need to transfer any cash to receive it.

Non-Renounceable

Ownership cannot be transferred to another beneficiary and entitlements are not tradeable.

Nostro

The account with a settlement agent which is used to record transactions and balances in cash amounts. Nostro means 'our account with you'.

Odd Lot

A quantity of shares which is less than the normal trading unit, not an exact multiple of a board lot. Will often be traded at a disadvantageous price to a board lot.

Operational Risk

The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.

Orderly Default

A process whereby a debtor state or company that is financially distressed renegotiates the terms of its debt issues with creditors.

Ordinary Shares

Shares in a company which are entitled to the balance of profits and assets after all prior charges. Also known as equity shares or common stock.

Organised Trading Facilities (OTFs)

OTFs are multilateral trading venues in the European Union enabling third parties to trade bonds, derivatives, structured finance products and emission allowances but not equities. In contrast to multilateral trading facilities, the operator of an OTF exercises discretion in the order-matching process.

Out-of-the-Money

A warrant or other derivative that will return a negative value if it is exercised.

Par Value

Equal to the nominal or face value of a security.

Pari Passu

Ranking in all respects equal to existing shares.

Partial Redemption

Similar to redemption, the difference being repayment is made by the company at various stages of the life of the security, usually without reduction in the nominal value. The holding will remain the same but the value per unit will fall until the final payment at maturity.

Paying Agent

The agent bank collects monies for disbursement from the issuer, advises clearing agents of the monies due and makes the appropriate payment to the clearing agent.

Payment Date

During the dividend cycle, the date at which the dividend is paid to the party who held the shares on record date.

Placing

A public offer to purchase stock at a set price. When there is a floating of a company on the stock exchange or an issue of new stock, certain institutions may underwrite or agree to a placement of the issue.

Poison Pill

A strategy that is employed by a company that is the subject of a takeover bid or merger approach that is designed to increase the likelihood of negative results over positive ones for the company that has made the takeover approach.

Poison Pill Rights

A selective rights issue which allows additional shares to be issued to some shareholders. Used to deter aggressive takeovers by diluting the shareholding of the bidding company.

Position Monitoring

The daily analysis of an individual exchange member's exposure risk in relation to their ability to cover their margin liabilities and delivery obligations.

Predator

A company which is attempting to take over another company (the target company).

Pre-emptive Rights

When a company proposes to issue new shares, existing shareholders may have the right to be offered a pro rata part of the new shares before they are offered to a new shareholder. The rights are contained either in the Articles of Association or imposed by Section 89 of the Companies Act 1985.

Preference Shares

Preference shares normally rank in priority for dividend and, in a winding-up or other repayment of capital, for return of paid up capital together with any arrears of dividend but do not participate in any further distribution of assets. Preference shareholders are usually only entitled to vote at a general meeting of the company where rights are directly involved if their dividend is in arrears.

Primary Market

The capital marketplace where a bond, equity or loan is initially issued.

Priority Offer

Right to apply for new shares by existing shareholders in proportion to their existing holding.

Private Placement

The sale of bonds to a hand-picked group of institutional investors (ie, not into the public marketplace). As a result, the sale is not governed by the same regulations as a normal issue and the bonds are restricted.

Proxy Voting

Voting on company issues by a representative (the proxy) of the shareholder. Note all UK companies must hold an annual general meeting every 15 months and a minimum of 21 days' notice of the annual general meeting (AGM) must be given to shareholders. Only 14 days' notice need be given of an extraordinary general meeting unless a special resolution is being proposed.

Proxy Voting Agent or Voting Service Provider

A specialist firm which performs some or all of the corporate governance functions on behalf of investors.

Prudential Regulation Authority (PRA)

The Prudential Regulatory Authority (PRA), a subsidiary of the Bank of England (BoE), is responsible for the prudential regulation of financial firms, including banks, investment banks, building societies and insurance companies.

Put Option (on shares)

A put option provides the investor with the right to sell a pre-agreed number of shares of stock at a specific price or the strike price up until a specified date or the expiration date.

Put Option (on a bond)

A clause in a bond's issue giving the bondholder the right to ask for early redemption.

Qualified Institutional Buyer (QIB)

A sophisticated investor who invests (on behalf of themselves or other QIBs) at least \$100 million worth of securities.

Reasonable Endeavours

The term used when a custodian or broker receives an instruction that it cannot guarantee to execute because of deadline, local market practices, or factors beyond the custodian's or broker's control.

Receiving Agent

The agent bank that receives corporate action payments from the clearing agent on behalf of its client.

Record Date

The date that determines the eligibility of a shareholder to receive the current declared dividend.

Redemption/Repayments

Redemption and repayments are basically similar operations whereby either loan stock is repaid or redeemable securities are redeemed on a specific date. These securities have a limited lifespan at the end of which stock is usually redeemed at par.

Register

The records detailing, for example, owners and transfers.

Registrar

A company charged with the responsibility of keeping a record of the owners of corporations' securities and preventing the issue of more than the authorised amount.

Repurchase Agreement (Repo)

An arrangement whereby one party (the repo seller) sells a security to another party (the repo buyer) and simultaneously agrees to repurchase the same security at a subsequent date at an agreed price.

Restrictions

A special feature of a bond whereby unregistered bonds are acquired from the issuer in private sales (called a Private Placement). As a result, they have restricted transferability for a certain time period.

Rights Issue

Offering of ordinary shares to investors who currently hold shares which entitle them to buy subsequent issues at a discount from the offering price.

Sanctions (and embargoes)

Political trade restrictions put in place against target countries with the aim of maintaining or restoring international peace and security.

Schemes of Arrangement

A Scheme of Arrangement is a legally binding process used in corporate finance to restructure a company, create a compromise with creditors, and/or reorganise ownership. It is widely used in mergers, acquisitions, takeovers, or debt restructuring.

Scrip Dividend

This is a choice of payment of a dividend in shares rather than cash.

SEC Rule 144a

An amendment to the 1933 Securities Act (as amended), issued in April 1990 to address the specific requirements of participating in private placements by non-US domiciled entities in the US market.

Security Identification Number

This is a unique security reference number and must conform with an internationally recognised standard such as the International Securities Identification Number (ISIN) code or Committee on Uniform Securities Identification Procedures (CUSIP) number.

Senior Managers & Certification Regime (SM&CR)

A piece of regulation from the Financial Conduct Authority (FCA) that improves personal accountability by naming individuals, and making them personally responsible for key aspects of a firm's activity.

Settlement Risk

The risk that occurs when there is a non- simultaneous exchange of value and one of the parties defaults.

Shareholder Rights Directive II (SRD II)

The Shareholder Rights Directive II (SRD II) is a European Union (EU) directive, which sets out to strengthen the position of shareholders and to reduce short-termism and excessive risk taking by companies. It builds upon SRD I which came into effect in 2007 and was implemented in two phases; namely (a) 10 June 2019 for the initial transposition into Member State national laws and (b) 3 September 2020 for core operational changes.

Short Coupon

The amount paid on the first coupon date of a bond that is equivalent to something less than the whole coupon. This results from a bond being issued between two coupon dates.

Sophisticated Investor

Certain issues carry restrictions, whereby US shareholders are not eligible to participate in issues, as entitlements received are not registered under the United States Social Security Act of 1933 (as amended). This restriction can at times be waived upon production of a Sophisticated Investor Letter (SIL) which exempts the company from any legal responsibilities for the ownership of these shares.

Sophisticated Investor Letter (SIL)

A letter that certifies to the issuer that a purchase made under a private placement is for investment purposes only and that there is no intention to immediately re-offer the securities publicly.

SRD II

See Shareholder Rights Directive II.

Stamp Duty

A UK tax levied on the transfer of chargeable securities in physical form.

Stamp Duty Reserve Tax (SDRT)

A UK tax levied as the transfer of chargeable securities in dematerialised form.

Stock Borrowing

A method by which market makers are able to borrow securities in order to make up a shortage in those securities and in exchange for a fee.

Stock Dividend

A dividend paid in stock rather than cash in proportion to their original holding as at a specified date.

Stock Lending

Authorised institutions lend their assets and, when permitted, those of their clients to market makers through a network of intermediaries in exchange for a fee.

Stock Situation Notice (SSN)

A notice issued by the London Stock Exchange (LSE) to advise of the details of an event and dates.

Straight-Through Processing (STP)

Process whereby an instruction or information received is processed without manual intervention.

Street Name

A brokerage account where the customer's securities and assets are held under the name of the brokerage firm, rather than the name of the individual who purchased the securities or assets. Although the name on the certificate is not that of the individual, they are still listed as the real and beneficial owner and would usually have the rights associated with the security. However, the beneficial owner may not have these rights if the reason that the stock is registered in street name is because of a breach of a foreign ownership limit.

Strike Price

For a warrant or option, the predetermined price at which the holder can buy the underlying share.

Stripping

The action of removing the coupons from a normal bond and selling them separately with a face value and maturity equal to each interest payment. Both the coupons and the original bond become zero coupon bonds.

Subdivision

When a company multiplies its existing shares into new shares of a lower par value. This occurs when the number of outstanding shares is changed as a result of a vote approved by shareholders and authorised by the company's board of directors. There is no change in the market value of the company, hence the total value of all shares prior to the split must equal the total value of all shares after the subdivision. A subdivision is also known as a split, stock split, split-up or forward split.

Society for Worldwide Interbank Financial Telecommunications (SWIFT)

Society for Worldwide Interbank Financial Telecommunications. It runs a secure electronic communications network between banks. It has introduced the MT56 series of messages under ISO 15022 that are a standardised way of sending corporate action notifications.

Systematic Internaliser (SI)

A firm that executes orders from its clients on its own account.

Takeover

A voluntary event when a bidding company attempts to acquire a controlling interest (50% plus one share) in a target company.

Target2-Securities (T2S)

A European securities settlement engine which aims to offer centralised delivery-versus-payment (DvP) settlement in central bank funds across all European securities markets.

Tender Agent

The agent bank that manages the tender process on behalf of the issuer.

Tender Offer

An offer to purchase outstanding shares of a security at a specified price. The company can make the offer itself, or through a subsidiary of the company or another company.

Tokenisation

See Digital Tokens.

Trade Date

The date a trade was dealt.

Trustee

A person who administers a trust. The trustee will be the holder of legal title to the investments that make up the trust and will act in a fiduciary capacity to its clients.

Underwriter

A company, usually an investment bank, that supports a new issue of shares by agreeing, for a fee, to purchase any shares from the company which are not taken up by existing shareholders or the marketplace.

Underwriting

An agreement to take up any residual shares left over from an offer for a commission.

Value-Added Services

Related to custody, value-added services is a general term for services over and above the core services that in some way provide an enhancement to the client's portfolio.

Value Date

A date attached to a particular entry of funds posted to a bank account. Intended to reflect the date on which such funds are deemed to cease to be available to the bank in the case of a debit entry, or to become available to the bank in the case of a credit entry.

Variation Margin

A means employed by an exchange of receiving collateral on an open position that is paid or received at the end of each day, reflecting the daily profit or loss on the open position.

Warrant

A security attached to a company's debt or equity issue or, in certain cases, on a stand-alone basis. Each warrant unit allows the holder to purchase a predetermined number of shares of the company's common stock at a predetermined price within a certain time frame (usually less than 15 years).

Warrant/Options Exercise

Periodically, holders of warrants (or, in the case of Australia, options) have the right/option to subscribe for ordinary shares in the company at a set price per share. This option usually occurs on a six-monthly or annual basis with a stipulated lifespan. A warrant is issued by a company. An option is issued by a broker.

Withholding Tax (WHT)

A tax levied by local tax authorities on the income earned by non-residents on their foreign investments.

XML

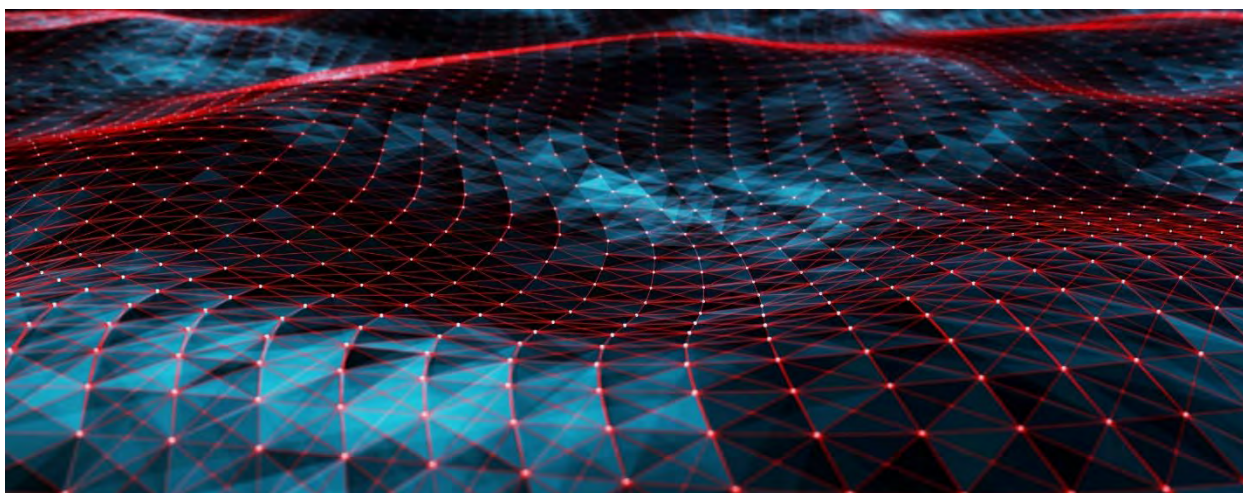
A flexible way to create common information formats and share both the format and the data on the worldwide web, intranets, and elsewhere. XML is a formal recommendation from the World Wide Web Consortium (W3C) similar to the language of today's web pages, the Hypertext Markup Language (HTML).

Yield

A bond's yield is its return on capital, expressed as a percentage.

Zero Coupon Bond (ZCB)

A bond which matures at a premium to the offer price, but does not pay a coupon in its lifetime.



Multiple Choice Questions

The following questions have been compiled to reflect as closely as possible the standard you will experience in your examination. Please note, however, that they are not actual CISI examination questions.

Please note that, as part of exam security, hand-held calculators are not allowed in CISI exam venues. Candidates must use the onscreen calculator for all CISI CBT exams in all languages in the UK and internationally.

- 1. In the UK, shareholder meetings must be announced a minimum of how many days before the meeting?**
 - A. 14
 - B. 21
 - C. 28
 - D. 42

- 2. When two companies issue bonds otherwise on the same basis, a difference in the coupon offered will typically reflect a difference in:**
 - A. corporate structure
 - B. credit risk
 - C. international representations
 - D. recent profitability

- 3. What type of event is a priority offer?**
 - A. Voluntary event
 - B. Tax event
 - C. Mandatory event
 - D. Regulatory event

4. **What risk is defined as the risk of loss of earnings or capital arising as a result of movements in prices?**
- A. Credit
 - B. Market
 - C. Trading
 - D. Operational
5. **Why is the domicile of a person important?**
- A. It controls where a person can live
 - B. It controls the rules for client money
 - C. It controls the jurisdiction for tax
 - D. It controls the amount of investment compensation
6. **What are the Financial Services Compensation Scheme's (FSCS's) compensation limits for insurance businesses?**
- A. 85% of the claim with a £1 million upper limit
 - B. 90% of the claim with no upper limit
 - C. 95% of the claim with no upper limit
 - D. 100% of the claim with a £1 million upper limit
7. **Under the Global Master Securities Lending Agreement (GMSLA), how are the rights relating to conversions dealt with while a security is on loan?**
- A. The borrower can exercise the right to convert
 - B. The lender can exercise the right to convert
 - C. The right to convert automatically lapses
 - D. The borrower and lender must agree jointly to convert
8. **Why would an investor wish to convert securities traded under Regulation S to those traded under Rule 144a?**
- A. They wish to create an American depositary receipt (ADR)
 - B. They wish to deal in the securities in Japan
 - C. They wish to take advantage of an early redemption date
 - D. They wish to trade in the US without Securities Exchange Commission (SEC) registration

9. An investor buys 100 call warrants for a premium of £0.40 each and a strike price of £1.00. What will the share price have to reach for the investor to make a profit of £50?
- A. £51.00
 - B. £1.90
 - C. £1.40
 - D. £0.90
10. Who are UK's statutory compensation scheme for customers of authorised financial services firms?
- A. Financial Conduct Authority (FCA)
 - B. Prudential Regulation Authority (PRA)
 - C. Bank of England (BoE)
 - D. Financial Services Compensation Scheme (FSCS)
11. What is a stock situation notice (SSN)?
- A. A market notification published by a listed company about its own shares
 - B. An investment bank analyst's view of the potential performance of a share
 - C. A market notification published by the London Stock Exchange (LSE)
 - D. Euroclear's view of the potential performance of a bond
12. Which of the following is eligible to appoint a proxy?
- A. Proxy agent
 - B. Shareholder
 - C. Nominee company
 - D. Issuing company
13. An investor holds 5,000 shares in a company priced at £8.50 per share. The company subsequently makes a 1-for-5 share rights issue at £6.50. Nil-paid rights on the share issue will, therefore, be worth:
- A. £1.67
 - B. £2.00
 - C. £6.50
 - D. £8.17

14. **Lazy money** is an expression usually used in relation to which type of corporate action?
- A. Warrants
 - B. Rights
 - C. Priority offers
 - D. Takeovers
15. Which of the following will assist a company that might require funds for research and development?
- A. Rights
 - B. Scrip
 - C. Consolidation
 - D. Bonus
16. On which of the following dates will stock movement normally take place?
- A. Record date
 - B. Effective date
 - C. Ex-date
 - D. Expiry date
17. People are a contributor to which type of risk?
- A. Operational
 - B. Market
 - C. Credit
 - D. Consumer
18. **MT568 – Corporate Action Narrative** – will be used specifically when:
- A. cash is to be credited to client accounts only
 - B. cash has been debited from client accounts only
 - C. there is a change in the status of a corporate action event
 - D. complex instructions or details need to be provided
19. **A lead manager** is primarily responsible for:
- A. safekeeping of the securities issued and asset servicing
 - B. handling security purchase payments and stock movement
 - C. taking on the credit risk in new security transactions
 - D. overseeing syndicate activities in the issue of new securities

- 20. When a corporate letter of representation is issued, the investor concerned:**
- A. is legally obliged to attend the company meeting in person
 - B. has nominated a specific person to attend the company meeting and register a vote
 - C. has expressed an intention to vote by post by a specified date
 - D. has given the company authority to vote on their behalf
- 21. Which of the following is a recognised asset servicing risk when there is failure to inform the customer of the existence of a forthcoming event?**
- A. The fund manager may miss the opportunity to take part in a particular event
 - B. The asset servicer will have breached the client money rules
 - C. The fund manager will have to rely on other information sources
 - D. The asset servicing department may be unable to reconcile the position to the market
- 22. The purpose of the Foreign Accounts Tax Compliance Act (FATCA) is to:**
- A. require account holders to obtain tax advice prior to investing in global markets
 - B. mitigate double taxation between two nations
 - C. identify US persons who may be evading tax through the use of offshore investment accounts
 - D. gather and exchange information about account holders between many global jurisdictions
- 23. A significant difference between scrip dividends and dividend reinvestment schemes is that:**
- A. scrip dividends require compulsory share purchase
 - B. scrip dividends require payment of broker's commission
 - C. dividend reinvestment plans primarily benefit major shareholders
 - D. dividend reinvestment plans are offered without a reference price
- 24. The primary role of a central counterparty is to:**
- A. guarantee the performance of contracts to trade in securities
 - B. administer securities settlement and provide asset servicing
 - C. hold all securities within a particular market centrally
 - D. ensure securities are properly safeguarded

- 25. What is the main difference between the clean price and the dirty price of a bond?**
- A. The dirty price includes accrued interest
 - B. The dirty price is net of taxation
 - C. The clean price includes broker fees
 - D. The clean price is for companies with high credit ratings
- 26. Withholding tax (WHT) is:**
- A. levied by national tax authorities on investment income earned by non-residents on their foreign investments in that country
 - B. levied by the UK on investment income earned by UK nationals
 - C. only levied when there is a double taxation agreement (DTA) in place
 - D. only levied when the investor is a higher rate taxpayer
- 27. In order to be classed as a US qualified institutional buyer (QIB), what MINIMUM value of securities must be invested?**
- A. \$25 million
 - B. \$100 million
 - C. \$250 million
 - D. \$500 million
- 28. Shareholders have been offered pre-emption rights. This means that:**
- A. taking up the option will dilute the value of their holdings
 - B. their holdings will be transferred to another company following a takeover
 - C. the value of the new rights offered will be sufficient to compensate for the reduction in share price
 - D. the number of shares held following the issue will be at least three times the number originally held

- 29. To convert a UK share to an American depositary receipt (ADR), the investor needs to send which two instructions to its custodian?**
- A. The first instruction is to deliver the UK share free of payment to the UK depository account of the American bank and the second is to receive the ADR free of payment into the depository account
 - B. The first instruction is to receive the UK share free of payment to the UK depository account of the American bank and the second is to deliver the ADR free of payment into the depository account
 - C. The first instruction is to deliver the UK share against payment in GBP to the UK depository account of the American bank and the second is to receive the ADR against payment in USD into the depository account
 - D. The first instruction is to receive the UK share against payment in GBP to the UK depository account of the American bank and the second is to deliver the ADR against payment in USD into the depository account
- 30. In a Dutch auction, the company offers to reimburse its ordinary shares at an amount between two prices to be determined by the company. The takeover process for a company in the UK has reached day 39. This is the last day on which the:**
- A. target company announcement can be made
 - B. predator company can revise its offer
 - C. shareholders can withdraw acceptance of the offer
 - D. shareholders of the target company can respond
- 31. What is the purpose of a dividend access plan?**
- A. To enable investors to take advantage of the dividend tax credit paid by a UK company
 - B. To enable UK investors to take advantage of the dividend tax credit paid by a UK company
 - C. To enable investors to receive dividends at a time of their choosing
 - D. To enable UK investors to receive dividends tax-free
- 32. 'B' share bonus issues are attractive to UK investors because:**
- A. there is no tax to pay at the time of the bonus issue
 - B. there is no tax to pay at the time of the bonus issue and no tax to pay when the resulting securities are sold
 - C. there is no tax to pay at the time of the bonus issue, although when the shares are sold there may be a liability to capital gains tax (CGT)
 - D. they are free of tax

- 33. In order to set up an open market share buy-back scheme the issuer must:**
- A. obtain approval in principle at an annual general meeting (AGM) or an extraordinary general meeting (EGM)
 - B. advertise the fact to each investor
 - C. offer a price higher than that of the market to interested investors
 - D. advertise the fact to each investor and offer a price higher than that of the market to interested investors
- 34. If two counterparties have a number of claims against each other for the same corporate action, they:**
- A. must settle each claim individually
 - B. may make a net settlement of the total value of the claims
 - C. must consider any netting that the exchange/clearing house has already carried out
 - D. should take the matter up with the clearing house concerned
- 35. A shareholder is entitled to lapsed rights proceeds when they:**
- A. have not taken up some or all their rights, and the new shares have been sold by the underwriters
 - B. have not taken up any of their rights
 - C. have not taken up some or all their rights, and the new shares have been sold by the underwriters at a profit
 - D. have sold some or all of their rights
- 36. What is an MT599 SWIFT message?**
- A. Corporate Action Narrative
 - B. Corporate Action Status and Processing Advice
 - C. Corporate Action Free Format
 - D. Corporate Action Notification
- 37. Which of the following is a mandatory event?**
- A. Rights issue
 - B. Bonus issue
 - C. Class action
 - D. Tender offer

- 38. Which regulation's purpose is to strengthen the position of shareholders and to reduce short termism and excessive risk taking by companies?**
- A. SRD II
 - B. MiFID II
 - C. GDPR
 - D. CSDR
- 39. What vendor is the market leader for proxy-voting agent services?**
- A. IHS Markit
 - B. SWIFT
 - C. Broadridge
 - D. Bloomberg
- 40. Which of the following data standards is typically used for information and data gathering?**
- A. SWIFT
 - B. FIX
 - C. BACS
 - D. CHAPS
- 41. Who is responsible for producing stock situation notices (SSNs)?**
- A. FCA
 - B. LSE
 - C. Proxy voter
 - D. Custodian(s)
- 42. How often are dividends paid?**
- A. Periodically
 - B. Annually
 - C. Half-yearly
 - D. Monthly
- 43. How much does a bonus issue cost an investor?**
- A. Price at XD (Ex-Date)
 - B. The closing price on PD (Pay Date)
 - C. It is free
 - D. Average for previous six months

- 44. A consolidation can also be known as a:**
- A. bonus issue
 - B. reverse split
 - C. split
 - D. scrip Dividend
- 45. Where is WHT deducted?**
- A. At source
 - B. At receipt
 - C. At payment
 - D. At settlement
- 46. What type of agreements are double taxation agreements (DTAs), or double taxation treaties (DTTs)?**
- A. Bilateral agreements between two countries
 - B. Unilateral agreements between two countries
 - C. Bilateral agreements between two or more countries
 - D. Bilateral agreements between two trade bodies
- 47. Who developed the Common Reporting Standard (CRS)?**
- A. European Union (EU)
 - B. US
 - C. UK
 - D. Organisation for Economic Co-operation and Development (OECD)
- 48. Which of these is NOT a core service of a custodian?**
- A. Safekeeping
 - B. Trade matching
 - C. Cross-border transaction processing
 - D. Cash management
- 49. What is the role of a receiving agent?**
- A. To handle payments and stock movement in respect of certain corporate events
 - B. To handle voting in respect of certain corporate actions
 - C. To handle tenders in respect of certain corporate events
 - D. To handle data scrubbing in respect of certain corporate actions

- 50. Which body has responsibility for 'macro-prudential' regulation, or regulation of the stability and resilience of the financial system as a whole?**
- A. Financial Policy Committee (FPC)
 - B. Prudential Regulation Authority (PRA)
 - C. Financial Conduct Authority (FCA)
 - D. Investment Association (IA)
- 51. The FSCS's compensation limits on deposits are as follows:**
- A. 100% of the first £75,000 per person per authorised firm
 - B. 100% of the first £80,000 per person per authorised firm
 - C. 100% of the first £85,000 per person per authorised firm
 - D. 100% of the first £90,000 per person per authorised firm
- 52. SEC Rule 144a was established in April 1990 to address what specific requirements?**
- A. Definition of sophisticated investors
 - B. Stock lending and repurchase agreements
 - C. Foreign ownership restrictions
 - D. Participating in private placements

Answers to Multiple Choice Questions

1. B Chapter 4, Section 2

In the UK, shareholder meetings must be announced at least 21 days prior to the meeting.

2. B Chapter 2, Section 7

The difference in coupon usually represents the extra credit risk (ie, the risk of the issuer defaulting on its payments).

3. A Chapter 3, Section 2.4.4

A priority offer is deemed a voluntary event.

4. B Chapter 8, Section 2.2

Market risk is the risk of loss of earnings or capital arising as a result of movements in market prices, including interest rates, exchange rates and equity values.

5. C Chapter 5, Section 2

The legal domicile of a person is important, since it, rather than the actual residence, often controls the jurisdiction of the taxing authorities.

6. B Chapter 7, Section 2

90% of the claim with no upper limit.

7. B Chapter 7, Section 3.1

Under the GMSLA, when a security is on loan, any rights relating to corporate action events such as conversions, subdivisions, consolidations and takeovers may be exercised by the lender.

8. D Chapter 3, Section 3.2

In the US, securities must be registered with the SEC except under Rule 144a, which allows qualified institutional buyers (QIBs) to trade privately placed securities without restrictions; and Regulation S, which clarifies offers and sales of securities outside the US that are exempt from SEC registration requirements.

9. B Chapter 3, Section 4

Premium already paid for 100 warrants = (100 x £0.40)	=	£40.00
Amount to be paid when warrants exercised	=	£100.00
Profit required	=	£50.00
Total	=	£190.00 (equivalent to £1.90 per share)

10. D Chapter 7, Section 2

The Financial Services Compensation Scheme (FSCS) is the UK's statutory compensation scheme for customers of authorised financial services firms. The FSCS's rules are set by the FCA.

11. C Chapter 1, Section 2.3.1

Stock situation notices (SSNs) are produced by an analytical team at the LSE.

12. B Chapter 4, Section 3.1

A shareholder has the legal power to appoint a person to act for them in 'proxy'.

13. A Chapter 3, Section 2

Total value of investor's shares prior to the corporate event:

$5,000 \times 8.50 = £42,500$. After taking up the issue, the investor will have 6,000 shares in total.

Adjusted price per share: $(£42,500 + (1,000 \times 6.50)) \div 6,000 = 8.17$. Nil-paid rights will be worth $= 8.17 - 6.50 = £1.67$ per share.

14. A Chapter 3, Section 4

The payment on a lapsed warrant is referred to as lazy money.

15. A Chapter 3, Section 2

The shareholder exercises rights by buying new shares which provides funds to the company.

16. B Chapter 1, Section 4.1

Following corporate actions, movement of stock takes place on the effective date.

17. A Chapter 8, Section 3.1.2

In the financial services sector, people are often thought of as an organisation's greatest asset. This is reflected by the high proportion of a firm's costs being attributed to staff compensation. However, the operational risks due to people-related issues are difficult to assess. This is partly because of the difficulty in measuring their effects. As the visibility of the human factor has improved, it has become even more apparent how damaging losses due to people issues can be.

18. D Chapter 1, Section 2.3.6

MT568 – Corporate Action Narrative – is used when complex instructions are needed regarding a corporate action event.

19. D Chapter 6, Section 2.4.5

The lead manager coordinates syndicate activities in placing a new securities issue in the primary market.

20. B Chapter 4, Section 4.1

A corporate letter of representation specifies that an individual can attend the meeting and vote on the investor's behalf.

21. A Chapter 8, Section 3.2

Failure of the asset servicing department to provide any information to the fund manager may mean that the fund manager misses the opportunity to take part in an event, and the fund manager may lose confidence in the asset servicing team.

22. C Chapter 5, Section 4.2

Identify US persons who may be evading tax through the use of offshore investment accounts.

23. D Chapter 2, Sections 2.2

Scrip dividend options are offered with a known monetary value. Dividend reinvestment schemes do not allow the shareholder to know the value of their entitlement before making the election.

24. A Chapter 6, Section 2.6.2

The central counterparty acts as a guarantor of contracts.

25. A Chapter 2, Section 7.2

The clean price excludes accrued interest, which is then included in the dirty price which is the final price paid by the buyer.

26. A Chapter 5, Section 3

Withholding tax (WHT) is levied by local tax authorities on income earned by non-residents on their foreign investments.

27. B Chapter 7, Section 4.2

QIBs are sophisticated investors who must invest at least \$100 million worth of securities for themselves, their client and other QIBs.

28. C Chapter 3, Section 2

If pre-emption rights exist, the shareholders will be offered new rights in proportion to their existing holdings, so that the original investments are not diluted.

29. A Chapter 3, Section 3.4

The mechanism is as follows (in this example, the conversion is from a UK share to an ADR):

1. An instruction is sent to a conversion agent who will cancel the local equities and reissue them as depositary receipts (DRs). In the case of ADRs, this is usually a US bank.
2. Two instruction messages need to be sent to the custodian. One is to deliver the equities free of payment to the UK depository account of the American bank, and the second is to receive the ADRs into the depository account free of payment.
3. The American bank will normally charge a fee for this, and stamp duty reserve tax (SDRT) will also be payable at the higher rate of 0.5% (only on creation of the ADR) as shares are entering a clearing system.

30. A Chapter 3, Section 5.2

Day 39 in the takeover process signifies the last date for the target company announcement.

31. B Chapter 2, Section 2.3

UK-based investors who receive dividend income from UK-domiciled companies are entitled to a 'tax credit' of (currently) 10% of the amount declared, which they may offset against their other tax liabilities.

However, UK investors are not entitled to a tax credit on dividends paid by a non-resident company, and in recent years a number of large companies have changed the domicile of their parent company from the UK to another country with a more favourable corporate tax regime.

A dividend access plan is one way of remedying this situation.

Under such a plan, shareholders may choose whether they receive their dividends from a company resident for tax purposes in the UK, or from the company that issued the shares, which is resident for tax purposes outside the UK.

32. C Chapter 2, Section 3.2

Such bonus issues may be attractive to investors because they are an alternative to dividends, which are taxed differently. If there is a bonus issue, there is no immediate liability to CGT when the shareholder receives the bonus shares, but there may be a CGT liability when the shares are sold.

33. A Chapter 3, Section 6.2

Unlike a tender offer, which has a fixed timetable, open market repurchases can span months or even years. Before the firm can take this action, it should seek shareholder approval in principle at an AGM or EGM, but once it has this approval, it has a great deal of flexibility.

34. C Chapter 1, Section 4.2

If two counterparties have a number of claims against each other, they may be able to net them to reduce the overall movement of cash or stock and the risk. If the claim is processed via an exchange, the exchange may do this automatically. In other cases, it is up to the two parties to agree bilaterally to net.

35. C Chapter 3, Section 2

The investor is only entitled to lapsed rights proceeds if the underwriter sold the new shares for a profit.

36. C Chapter 1, Section 2.3.6

This is a free format message and technically it can be used to communicate anything. These messages are fortunately not that common. However, because of their unstructured nature, care should be taken if one is received.

37. B Chapter 2, Section 3

A bonus issue is a mandatory event.

38. A Chapter 7, Section 8

SRD II (Shareholder Rights Directive II).

39. C Chapter 4, Section 3.2

As of 2022, Broadridge is the market leader for proxy-voting agent services.

40. A Chapter 1, Section 2

SWIFT is the most common standard.

41. B Chapter 1, Section 2.3.1

SSNs are produced by an analytical team at the London Stock Exchange (LSE) and cover corporate actions on stock listed on the LSE, including AIM (the Alternative Investment Market).

42. A Chapter 2, Section 2.1

Dividends are paid on a periodic basis.

43. C Chapter 2, Section 3

A bonus issue, which is a benefit distribution, is a free issue of new shares to existing shareholders.

44. D Chapter 2, Section 4.3

A consolidation, which can be known as a reverse split.

45. A Chapter 5, Section 3.1

WHT is deducted at source. In other words, the custodian in the country that is levying the tax will receive the payments gross. Then it must deduct WHT from any payments that it is making to overseas investors, and account for the deduction to both the investors and the tax authorities.

46. A Chapter 5, Section 3.2

Double taxation agreements (DTAs), or double taxation treaties (DTTs), are bilateral agreements between two countries. They are negotiated and ratified at ministerial level and exist in order to encourage and maintain an international consensus on cross-border economic activity, and to promote international trade and investment.

47. D Chapter 5, Section 4.3

The European Union (EU) adopted the CRS, which was developed by the OECD (Organisation for Economic Co-operation and Development), which calls on participating jurisdictions to automatically exchange certain information with other jurisdictions on an annual basis, to combat tax evasion. The EU adopted the standard on 1 January 2016. The CRS was modelled after FATCA, but the US did not sign up to the CRS reporting standards.

48. B Chapter 6, Section 2.1.1

Core services are those that are considered to be standard across the industry and are provided by all custodians. They are closely related to the basic processes of managing clients' securities and include:

- safekeeping
- settlement
- cross-border transaction processing
- asset servicing, and
- cash management.

49. A Chapter 6, Section 2.4.2

A receiving agent is appointed by an issuer to handle payments and stock movement in respect of certain corporate events.

50. A Chapter 7, Section 1

This Financial Policy Committee (FPC), established in the Bank of England (BoE), has responsibility for 'macro-prudential' regulation, or regulation of the stability and resilience of the financial system as a whole. Its role is:

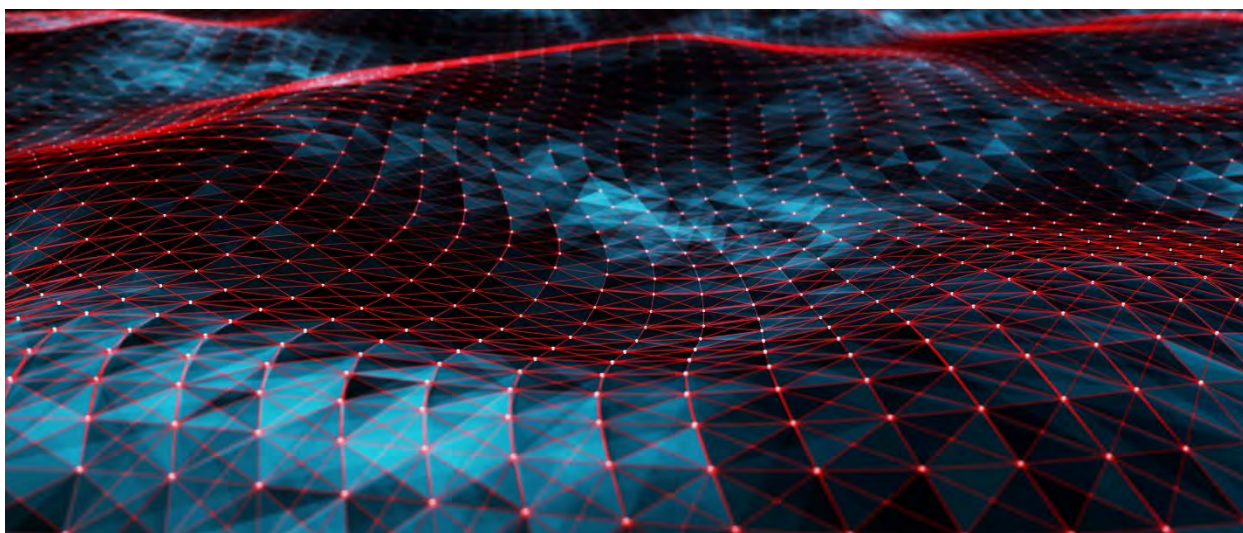
'Contributing to the Bank's objective to protect and enhance financial stability, through identifying and taking action to remove or reduce systemic risks, with a view to protecting and enhancing the resilience of the UK financial system'.

51. C Chapter 7, Section 2

The FSCS's compensation limits on deposits is 100% of the first £85,000 per person per authorised firm.

52. D Chapter 7, Section 4.2

SEC Rule 144a was established in April 1990 to address the specific requirements of participating in private placements.



Syllabus Learning Map

Syllabus Unit/ Element		Chapter/ Section
Element 1	The Life Cycle of an Event	Chapter 1
1.1	The Life Cycle of an Asset Servicing Event On completion, the candidate should:	
1.1.1	Know event types: • voluntary events • mandatory events • mandatory events with options	1
1.1.2	Know the key stages of the life cycle of an asset servicing event: • market announcement • event data collection and validation • notification • election processing • payment/settlement of entitlement • reconciliation • continuous safeguarding • fiduciary responsibilities	1

1.2	Information Gathering and Data Scrubbing On completion, the candidate should:	
1.2.1	Know the SWIFT and other standards in relation to corporate events: • MT564/Corporate Action Notification • MT565/Corporate Action Instruction • MT566/Corporate Action Confirmation • MT567/Corporate Action Status and Processing Advice • MT568/Corporate Action Narrative • MT599/Free-Format Message • Disclosure messages (SIDR, SIDC, SIRE, SIRC, SIRS) • Proxy messages (MENO, MECN, MENT, MEIN, MEIC, MEIS, MECO, MERD) • ISO15002 and ISO 20022	2
1.2.2	Know: • the purpose of information gathering • the purpose of data scrubbing • the impact of distributed ledger technology • tokenisation	2
1.3	Event Entitlement On completion, the candidate should:	
1.3.1	Know the significance of: • record-date • ex-date • cum-entitlement • ex-entitlement • special-ex • special-cum • pay date	3
1.3.2	Be able to calculate an entitlement: • amended for a late booked or cancelled trade for loaned stock	3

	when there is special ex/special cum trading	
1.3.3	Know significant deadlines in relation to an event	3
1.4	Payment, Claims and Post-Payment Reconciliation On completion, the candidate should:	
1.4.1	Know how to validate a claim for the following transactions: - repo - buy/sellback - sell/buyback - stock loan - failed trade	4
1.4.2	Know: - the implication of pay/effective date in relation to an event - the implication of failing to settle a claim for nil-paid rights prior to the deadline for acceptance in the UK market - how the transformation process may generate claims	3 and 4
Element 2	Mandatory Events	Chapter 2
2.1	Dividends On completion, the candidate should:	
2.1.1	Know the frequency of the payment timetable for the UK, US, Japan and Italy: - ex-dividend date - record dates - special-ex - special-cum - pay date	2.1

2.1.2	Know the impact of a dividend on the share price	2.1
2.1.3	Know the distinction between scrip dividends and dividend reinvestment schemes	2.2
2.1.4	Be able to calculate a scrip dividend entitlement given a cash dividend, a reference price for the shares and a record holding date	2.2
2.1.5	Know the concept of dividend access plans and the implications of tax on the dividend	2.3
2.2	Bonus Issues On completion, the candidate should:	
2.2.1	Know the following types of bonus issue: • bonus issue • bonus issue with rights • B share bonus issues	3
2.3	Subdivisions (Splits) and Consolidations (Reverse Splits) On completion, the candidate should:	
2.3.1	Know the difference between a subdivision and a bonus issue	4
2.3.2	Be able to calculate the impact of subdivisions and consolidations on the share price of: • subdivisions • consolidations	4
2.4	Demergers (Spin-Offs) On completion, the candidate should:	
2.4.1	Be able to calculate the effect on book value of a demerger	5
2.5	Capital Repayments On completion, the candidate should:	
2.5.1	Know the following methods of achieving a capital repayment: • redeemable bonus issue • renominalisation	6

	• repayment	
2.6	Bond Coupons On completion, the candidate should:	
2.6.1	Be able to calculate bond interest using the following methods: (30/360 – actual/360 – actual/365 – actual/actual)	7
2.6.2	Be able to calculate ‘clean’ and ‘dirty’ prices	7.2
2.7	Delayed/Defaulting Securities On completion, the candidate should:	
2.7.1	Know the effect of issuer default on the servicing of interest and principal payments on: • corporate debt • sovereign debt	8
2.8	Compulsory Redemption On completion, the candidate should:	
2.8.1	Know what a compulsory redemptions is	9
2.9	Scheme of Arrangement On completion, the candidate should:	
2.9.1	Know what a scheme of arrangement is	10
Element 3	Voluntary Events	Chapter 3
3.1	Rights Issues On completion, the candidate should:	

3.1.1	Know: - the stages involved in a rights issue - the reasons for rights issues and the options available to the shareholder - the difference between renounceable and non-renounceable rights - Priority Offers in the UK - lapsed rights proceeds - poison pill rights in the US	2 and 5
3.1.2	Be able to calculate a theoretical ex-rights price and a nil-paid rights price given a cum-rights price, a nil-paid rights issue ratio, and a subscription price	2
3.1.3	Be able to calculate a split rights entitlement	2
3.2	Conversions On completion, the candidate should:	
3.2.1	Know the following types of conversion: - convertible bonds $\Leftrightarrow$ equities 144a $\Leftrightarrow$ Reg S (and how they differ) 144a $\Leftrightarrow$ Unrestricted (registered) line - preference $\Leftrightarrow$ ordinary	3
3.2.2	Know the process for converting underlying local shares to ADRs/GDRs or vice versa	3
3.3	Warrants On completion, the candidate should:	
3.3.1	Know how to exercise warrants	4
3.4	Takeovers and Exchanges On completion, the candidate should:	
3.4.1	Know the following aspects of takeovers: - acceptance - no action - Section 979 notices - buyer protection and trade transformation - key dates - dissenting shareholders	5

	the role of the Panel on Takeovers and Mergers (PTM)	
3.5	Tenders On completion, the candidate should:	
3.5.1	Know the following aspects of tender offers: - Tender offer - Dutch auction - Odd lot/mini tender offers - Acceptance and no action - Oversubscription - Scale-back	6
3.6	Debt Exchange Offers On completion, the candidate should:	
3.6.1	Know: - the stages of a debt exchange - the process involved for 'acceptance' and 'no action' - the concept of scale back	7
3.7	Debt Repurchase On completion, the candidate should:	
3.7.1	Know: - the stages of a debt repurchase - the process involved for 'acceptance' and 'no action' - the concept of a tender cap	8
Element 4	Corporate Governance	Chapter 4

4.1	Types and Dates of Company Meetings On completion, the candidate should:	
4.1.1	Know: - the timescales for a company calling a meeting - the rights of shareholders to request an EGM and the timescales - the difference between ‘abstaining’ and ‘taking no action’ - the difference between an ordinary resolution and a special resolution	2
4.1.2	Know the implications of consent solicitations	2
4.1.3	Understand the reasons for calling a bondholders meeting	2
4.2	Appointing a Proxy On completion, the candidate should:	
4.2.1	Know: - the purpose of using a proxy - who is entitled to appoint a proxy - who is eligible to be a proxy for the selected markets - the different methods of appointing a proxy in selected markets	3
4.2.2	Know the role played by the proxy voting agent also in relation to voting service providers (VSPs)	3
4.3	Voting On completion, the candidate should:	
4.3.1	Know the instruction process for a proxy vote: - corporate letter of representation - implications for asset servicing	4
4.4	Share Ownership On completion, the candidate should:	

4.4.1	Know: - the purpose of Section 793 of the Companies Act 2006 - the purpose of SRD II disclosures relevant data protection issues	5
Element 5	Tax	Chapter 5
5.1	Tax On completion, the candidate should:	
5.1.1	Know the life cycle of a tax reclaim	2
5.1.2	Understand the term 'deduction at source' and its implications	3
5.1.3	Understand the role of a qualified intermediary	4
5.1.4	Know the implications of the US Foreign Account Tax Compliance Act (FATCA)	4
5.1.5	Know the implications of the Common Reporting Standard (CRS)	4
5.1.6	Know the implications of the US 302 tax	4
5.1.7	Know the need to provide proof of residency to the fiscal authorities for the purpose of reclaiming tax and obtaining relief at source	2
Element 6	Participants	Chapter 6
6.1	Participants On completion, the candidate should:	
6.1.1	Know the role played by the custodian/subcustodian	2.1
6.1.2	Know the role played by the transfer agent/registrar	2.2
6.1.3	Know the role played by the trustee	2.3

6.1.4	Know the role played by the: - tender agent - receiving agent - calculation agent - paying agent - conversion agent	2.4
6.1.5	Know the roles of trade associations, infrastructure and industry- led working groups	2.6
6.1.6	Know transfer and settlement systems - cash - assets	2.7
6.1.7	Data Providers	2.8
Element 7	Legal and Compliance	Chapter 7
7.1	Legal and Compliance On completion, the candidate should:	
7.1.1	Know how residency and tax domicile can affect eligibility to receive a benefit or participate in an event	2.1
7.1.2	Know the implications of consumer duty and how it impacts Asset Servicing	2.2
7.2	Global Agreements On completion, the candidate should:	
7.2.1	Know how the: - GMSLA master agreement deals with income distributions and events in respect of securities out on loan - GMRA master agreement deals with income distributions and stock events in respect of bonds out on repo	3

7.3	Sophisticated Investors On completion, the candidate should:	
7.3.1	Know: - the two basic objectives of the 1933 Securities Acts (as amended): - implications of SEC rule 144a - the use of sophisticated investor letters (SILs)	4
7.3.2	Understand the impact of Client Asset Rules on asset servicing functions	5
7.3.3	Know the implications of foreign ownership limits	6
7.3.4	Know how a restricted list may impact a corporate action	7
7.3.5	Know the concept, purpose and reporting requirements of SRD II	8
7.4	Documentation On completion, the candidate should:	
7.4.1	Know the purpose and content of customer documentation	9
7.4.2	Know relevant record-keeping requirements for asset servicing - contractual obligations - tax implications of main investment products	9
7.4.3	Know considerations for client or customer relationships with regard to: - enforceability of the contract - interest calculations - custody arrangements - client reporting requirements - ongoing due diligence - arrangements for changing a contractual relationship	9

Element 8	Risk and Controls	Chapter 8
8.1	Types of Risk On completion, the candidate should:	
8.1.1	Know the key risks of corporate action processing • inaccurate/incomplete information • incorrect or misapplied instructions • missed deadlines • updates on entitlement • payment handling • reduced settlement periods • late returned stocks and its importance	3.2
8.1.2	Understand the importance of reconciliation and segregation of duties	4
8.1.3	Know breach reporting obligations	4
8.1.4	Understand the risks of not complying with regulations: • CASS • SM&CR	4

Examination Specification

Each examination paper is constructed from a specification that determines the weightings that will be given to each element. The specification is given below.

It is important to note that the numbers quoted may vary slightly from examination to examination as there is some flexibility to ensure that each examination has a consistent level of difficulty. However, the number of questions tested in each element should not change by more than plus or minus 2.

Element Number	Element	Questions
1	Life Cycle of an Event	7
2	Mandatory Events	10
3	Voluntary Events	8
4	Corporate Governance	5
5	Tax	5
6	Participants	4
7	Legal and Compliance	8
8	Risk and Controls	3
Total		50

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