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talks to

Philippe Seyll



It is time to settle fund shares the same way as securities

The settlement of transactions in investment funds is notoriously inefficient, but the reliance of fund managers on fund distributors to raise capital for them to manage means the industry has a high tolerance threshold when it comes to manual processing. Philippe Seyll, head of investment fund services and a member of the executive board of Clearstream, has argued since the turn of the century that applying the settlement institutions and techniques used in the securities industry is the ideal solution. With the coming of TARGET2- Securities, the single securities settlement system for Europe, his vision is now close to realisation.

Superficially, funds are not a natural business for Clearstream to be in. As a provider of domestic and international central securities depository services, its natural territory lies in the settlement of securities transactions and the safekeeping and servicing of the stocks and bonds it holds in custody. In addition, funds are managed by the clients of its clients, placing them on the one boundary which Clearstream insists it must never cross: servicing the buy-side clients of its sell-side customers. So it takes closer analysis to understand why it makes sense for Clearstream to service fund transactions and take shares or units in funds into custody at all. “What we are really doing is servicing the fund distribution process with the techniques we have used in the fixed income and equities markets for the last 30 years,” explains Philippe Seyll, head of investment fund services and a member of the executive board of Clearstream. “Instead of fund distributors having to hold shares in funds with a network of multiple transfer agents, they hold them in a

single account with us. We stand between the transfer agent and the distributors, and act as a central place of settlement for subscriptions to and redemptions of shares in the funds.”

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In other words, the fund services Clearstream has branded as Vestima aim to bring to transactions the same settlement efficiencies that Clearstream as an international central securities depository (ICSD) delivers to securities transactions. Its primary clients are neither fund managers nor their transfer agents, though they benefit from more efficient settlement of subscriptions and redemptions, but the fund distributors whose settlement costs are reduced. Certainly, it is hard to disagree that the fund distribution process, from order placement to final cash settlement, is inefficient. Since managers are concerned principally to distribute their funds to as many investors as possible, they tolerate low levels of automation on the part of distributors, many of which continue to instruct purchases and sales by fax. Vestima offers all Clearstream customers acting as fund distributors a single process through which to route orders to buy and sell up to 125,000 share classes in funds managed by over 1,000

fund managers across 37 jurisdictions. Most are UCITS funds distributed across borders in Europe, but the service also covers Hong Kong and Singapore, which are the major fund markets in Asia. Vestima also settles transactions by delivery of fund units against cash payment in either commercial or central bank money between the account of the investor and the account of the fund manager or its transfer agent at Clearstream Banking Luxembourg. Since it launched the service in 2000, average daily traffic volumes have grown at an annual compound rate of 15-20 per cent to over 8 million transactions in 2013. Vestima is now the largest cross-border order-routing network available. Once the latest acquisition is finalised, international fund units or shares in client custody accounts at Clearstream will have reached €700 billion, excluding the €1.5 trillion of German domestic funds held by Clearstream Banking Frankfurt.

That acquisition, announced in April this year, was the purchase of Citco Global Securities Services (CGSS), the hedge fund custody processing unit of Citco, a hedge fund administrator. It addressed a longstanding complaint of fund distributors that use Vestima and other order-routing services: buying and selling shares in hedge funds is much less efficient than buying shares in mutual funds. “The customers asked us to do it,” explains Seyll. “The fund distributors that use Vestima appreciated efficient access to 125,000 mutual fund share classes, and they wanted the same access to alternative funds, and we could not do it. We were like a restaurant serving only meat when the customers were asking for fish as well.” Although it opened an operation in Ireland in November 2012 to service distributors buying hedge funds, Clearstream found it difficult to gain the scale it needed to reproduce the level of automation it was already achieving in mutual funds. The CGSS acquisition, by bringing an established book of business on behalf of 60 major banks distributing 25,000 hedge funds, has accelerated

progress. It also brought tried and tested technology and 300 experienced staff to operate. “The idea is to give our clients the broadest possible reach,” says Seyll. “If clients want to invest in mutual funds they can do so via Vestima. If they want to invest in ETFs, they can do so via Vestima. Hedge funds are the latest addition to our funds business range.”

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Seyll says that the CGSS acquisition has raised the profile of Vestima among the custodian banks that need to service investors in alternative funds, creating a cross-selling opportunity. A number of large custodian banks that are currently processing orders in-house on behalf of clients to which they provide middle and back office services have approached Clearstream with a view to outsourcing their subscription and redemption order routing, and to appointing Vestima as a sub-custodian to the funds. Seyll says they see outsourcing as a better option than continuing to invest in a sub-scale operation delivering a service that is complex (it requires separate links to multiple fund managers or their transfer agents) yet increasingly commoditised in terms of price. “We never sell Vestima this way, but we are really in the business process outsourcing (BPO) business,” he explains. “We in-source subscriptions and redemptions and the subsequent settlement from distributors and transfer agents. If they want to do it themselves, they can, but if they want to outsource it, we have a solution. We have invested a lot of money in making

the fund settlement process more efficient, and we seek to recoup that money by selling a settlement service to as many fund distributors and custodians as we can.”

The crucial element of that service is what Seyll calls “transparency into the fund distribution chain.” Which distributors are selling which funds, where, and who to, is data highly prized by fund managers. The information is valuable not only in its own right, but as the key to calculating the trail commissions paid to fund distributors, who for that reason regard it as even more important. On the face of it, centralised settlement of fund transactions through a single account at Clearstream makes it hard to obtain that data, because positions and transactions are bundled and cash payments are netted. However, Seyll says Vestima has always included functionality that allows fund distributors to store data in ways that make it easy for them to calculate and share trail commission calculations with fund managers or their transfer agents. Regulatory attempts to suppress the use of trail commissions – such as the Retail Distribution Review (RDR) in the United Kingdom and, potentially, the second version of the Markets in Financial Instruments Directive (MiFID II) – have the potential to reduce the importance of trail commissions. But Seyll points to a compliance obligation which makes detailed sales information even more important. Know Your Client (KYC) and Anti-Money Laundering (AML) regulations are putting pressure on fund managers to force their fund distributors to disclose the names of their clients. “Within Vestima, fund shares belonging to different beneficial owners can be commingled, or segregated by type, region or even individual names,” says Seyll. “Users can see the number of shares in the name of the distributor, or further broken down in terms of the clients of the distributor. The distributors can set their own level of granularity.”

KYC and AML regulations are not the only measures arguing for greater disclosure of beneficial owners. The fifth version of the Undertakings for Collective Investments in Transferable Securities directive (UCITS V) and the Alternative Investment Fund Managers Directive (AIFMD) puts depository banks under direct pressure to segregate assets in collective investment vehicles at the level of the sub-custodian. Seyll acknowledges that segregation could reduce operational efficiency in funds in exactly the same way that it decreases efficiency in the securities markets if it was imposed on individual client accounts and down to the level of the central securities depository (CSD) and the transfer agent. For example, the regulatory pressure on custodians to desist from holding client securities in omnibus accounts, in which assets belonging to different clients are commingled, is likely to increase transaction costs and decrease liquidity. Something similar applies to mutual fund shares and units if they are held by thousands of transfer agents in a decentralised way, and settled between bank accounts in commercial bank money.

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“For the funds market, the name of the game is to find a way of complying with regulatory demands for segregation while preserving the benefits of centralisation and automation,” explains Seyll. “Having Vestima standing in the middle means fund distributors do not have to establish hundreds, if not thousands, of links to different fund managers and transfer agents to identify assets held by

their clients. By coming through Vestima, they can access details of client holdings in 125,000 different mutual fund share classes through a single account. Fortunately, we believe this model can accommodate the latest interpretations of the regulatory request to segregate assets.” Seyll adds that, unlike mutual funds, hedge funds are by their nature not fungible, and that this imposes full segregation at each stage along the custody chain anyway. “Moreover, investors in hedge funds have often pressed since the 2008 crisis for their holdings to be segregated in their own name,” he says. “They want to be known to the fund. Investors in hedge funds that were gated or closed in 2008-09 had great difficulty in making themselves and their views known to the managers of the fund. That reality is embedded into the specific hedge fund offering of Vestima.”

Seyll also insists that a centralised service benefits fund managers and their transfer agents as well as fund distributors, in terms of efficiency as well as compliance. “They do not have to establish thousands of links to fund distributors, some of which still transmit orders by fax,” he says. “We have roughly 1,000 distributors around the world which send hundreds of thousands of transactions a day to fund managers and transfer agents through our system. Without us, the transfer agents would receive subscription and redemption orders in a wide variety of different formats, which would make it impossible to automate the processing of the transactions.” Seyll rejects the idea that this role threatens to disintermediate transfer agents. He distinguishes between the role of transfer agents as registration agents (fund share issuance and creation, in which they interface with the fund and its manager) and the role of Clearstream as settlement agent (delivering cash against shares, or vice-versa, as investors subscribe to or redeem shares in the fund, ultimately on the books of the transfer agent). Although Vestima offers a tracking service designed to automate the process of re-registering fund holdings when investors move their assets between distributors,

Seyll says it is merely another service offered to fund distributors. “We have no intention whatsoever of getting into the registration business,” he says. “We are in the settlement business.”

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In executing that business, Vestima offers distributors a choice of settlement in central bank money via the Luxembourg CSD (LuxCSD), which is jointly owned by Clearstream International and the Banque centrale du Luxembourg (BCL), or commercial bank money, via the cash correspondent banks of the fund managers or their transfer agents and the fund distributors. Of course, netted settlement via Clearstream deprives transfer agents of the fees they earn for settling individual transactions, but Seyll says the savings on processing costs more than outweigh the loss of revenue. “Transfer agents do not make money out of settlement,” he explains. “The real value they add is in maintaining the register of investors, and keeping managers informed of who is buying their funds and where. Our work with the fund distributors helps them to do that.”

It is no secret that the European Central Bank (ECB) believes T2S, scheduled to go live across 23 CSDs in four phases between June 2015 and February 2017, should also settle international mutual fund transactions.

Seyll adds that more efficient settlement ensures fund managers and transfer agents reduce their own operational costs. By

centralising settlement on its own books, Vestima is able to translate orders into settlement instructions automatically, and settle transactions with a rate of success (99.9 per cent) that cuts operational risk to nugatory levels. “That is very efficient for a transfer agent, because they have the certainty of receiving cash for immediate value, and can be confident that the number of shares in the fund that they have created are delivered to the account of the distributor, without needing to do anything themselves,” explains Seyll. “We automate the whole process. Instead of having to deal with thousands of subscriptions from dozens of distributors, and make thousands of payments to dozens of distributors every time they have redemptions, the settlement of the cash and the movement of the shares happen automatically. It creates tremendous value for the transfer agents.”

Seyll believes settlement of international fund transactions in T2S will happen de facto, as there are already large volumes of international funds settling in domestic CSDs that will be enrolled.

He adds that Vestima will also insulate its existing users from the disruption occasioned by the TARGET2-Securities (T2S) single settlement platform for securities. It is no secret that the European Central Bank (ECB) believes T2S, scheduled to go live across 23 CSDs in four phases between June 2015 and February 2017, should also settle international mutual fund transactions. “I believe it will happen and the ECB is probably interested in it because additional transaction volumes will contribute to covering the costs of the T2S project,” says Seyll. “Fund managers are not opposed to it.” It is certainly

not an absurd idea. Fund transactions already settle on a centralised basis in central securities depositories (CSDs) in France and Germany (where Clearstream Banking Frankfurt is the CSD for funds). Seyll believes settlement of international fund transactions in T2S will happen de facto, as there are already large volumes of international funds settling in domestic CSDs that will be enrolled automatically into T2S. “For the transfer agents already connected to Vestima, nothing will have to change,” he says. “They already have the option to settle in commercial bank money in the international central securities depositories (ICSDs) and will be able to leverage this to reach distributors settling in T2S. This is possible through the inter-operability of our ICSD platform with LuxCSD, which will become a conduit into T2S. The transfer agents also have the option to use Vestima to issue directly via LuxCSD to benefit from settlement in central bank money.”

If Seyll is right, fund managers and their transfer agents will have to adapt to the fact that, for banks active in Europe, the settlement of fund transactions in CSDs and in central rather than commercial bank money is the norm.

Once T2S is in place, fund distributors will be able to settle securities transactions in central bank money through their domestic connections to T2S, and it would be surprising if that did not whet their appetite for settling mutual fund transactions in the same way. “We anticipate that regulators will favour fund transactions settling in central bank money wherever possible,” says Seyll. “After all, the ECB is one of the most influential opinion-formers, decision-makers

and regulatory enforcement agents in the world. It will make practical sense too, since the distributors will already be wiring money to the ECB every day to settle their securities transactions.” If Seyll is right, fund managers and their transfer agents will have to adapt to the fact that, for banks active in Europe, the settlement of fund transactions in CSDs and in central rather than commercial bank money is the norm. That means they will have to make more of their funds eligible for settlement in T2S, and find a way to settle transactions in those funds within T2S. For Seyll, the settlement of mutual fund transactions on a centralised basis in central bank money will mark the fulfilment of a prediction he first made 15 years ago. Now, scarcely anybody disputes that fund settlement is ripe for the increased operational efficiency the securities markets have enjoyed for nearly 20 years. As Seyll points out, fund subscriptions and redemptions are simple by comparison with, say, a corporate action. Cash is exchanged for shares by a process that in principle scarcely varies at all. The problem is the practice, not the principle. Vestima, which was set up in 2000 to streamline fund settlement, may be close to finally fulfilling its purpose.

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