

Sanctions Screening for Indirect Investments - The Buy Side's New Compliance Challenge



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Introduction

The ongoing expansion - particularly by the US - of measures targeting ownership of securities issued by sanctioned companies is increasing pressure on funds and investment managers, as well as index operators, to screen component securities of their portfolios and indices for possible breaches. As a result, buy-side firms for the first time are having to consider how to screen their portfolios to ensure issuers of securities they hold aren't subject to new global screening rules.

Many investment firms are finding this screening requirement challenging. For one thing, up-to-date sanctions data and clear entity hierarchies showing beneficial ownership are difficult to source and integrate in order to screen the growing list of securities now included in the sanctions. Furthermore, the number of securities and persons now subject to sanctions covering political situations in the Middle East, Asia and Eastern Europe is mushrooming, requiring firms to monitor vast volumes of data in order to achieve compliance with a raft of different rules and regulations globally.

Compliance is made more challenging by the complexity of many corporations and executives that are targeted by the sanctions, which can make it difficult for firms to ensure they have identified the correct entity or person. Moreover, many buy-side firms lack the resource or expertise to screen the securities they hold to ensure they aren't in breach, introducing potential reputational risk and/or regulatory penalties.

Given the experience of sell-side practitioners - which have long established KYC and compliance departments and yet had to adjust to securities screening in 2014 when the Russian sectoral sanctions were put in place - buy-side firms need to act fast if they are to avoid regulatory censure. It took their sell-side counterparts a significant amount of time to react to the new sanctions regime, and even now - seven years later - some are still implementing their response. It's unlikely regulators will be as patient this time around.

This white paper will explore how buy-side firms are responding to the challenge of sanctions screening as regulatory scrutiny of this area grows, where they can expect to find sources of data and analysis that can help them comply, and the practicalities of processing this data and providing some form of look-through to the sell side firms that market their funds and services.

The Expanding Landscape of Sanctions Targeting Share Ownership

The global political climate over the past five years has sparked a jump in the use of sanctions to attempt to influence the behaviour of players in the geopolitical landscape. The European Union, the UK and particularly the US have moved to tighten their rules imposing sanctions to address difficult situations, for example in Syria, Iran, The Crimea and Ukraine, Belarus, and in China.

As jurisdictions' sanctions rules become more onerous, so the penalties for breaches become more punitive. The industry was issued a wake-up call in 2019 when Italian bank UniCredit was fined \$1.3 billion for breaches of sanctions on Iran and other countries. The record UniCredit penalty followed a six-year investigation by US regulators. It also followed by a week a \$1.1 billion settlement by UK bank Standard Chartered over similar conduct.

For financial institutions, the stricter global sanctions regime translates into the need to tread carefully. Sell-side financial firms have long been required to monitor the securities they trade, own or recommend to clients to ensure they have not been issued by entities that are owned by, managed by or otherwise connected to sanctioned individuals. Fund and asset managers have typically relied on their sell-side service providers to screen their holdings or recommendations to ensure they avoid a potential breach of the rules.

But things have changed. Recent moves by the US have extended sanctions to cover indirect investments, such as funds that may have exposure to sanctioned securities. This move, embodied in US Executive Order 13959 in response to issues around the Chinese tech company Huawei, targets transactions in securities of entities identified by the US Treasury as 'Chinese Military-Industrial Complex Companies', as well as their subsidiaries.

In essence, EO 13959 imposes responsibility for sanctions screening on fund managers, which, as well as ensuring they themselves aren't breaching the rules, are now required to provide a 'look-through' into their funds' constituent securities for sell-side firms wanting to verify the funds they are marketing aren't in breach.

EO 13959, which came into effect in January 2021, was the culmination a busy couple of years for sanctions issuance, with Iran and China attracting new actions, and political situations such as Brexit and diverging US and EU stances on Iran adding to the complexity. As things now stand, compliance teams are faced with a myriad of sanctions regulations (see table 1, Page 4), often with conflicting requirements and definitions. For global firms, the scope of sanctions that may apply to their activities can range from sectorial sanctions on Russia and Crimea, 30 or more global sanctions on Cuba and Syria, and ongoing actions against primarily Russian politically exposed oligarchs, 86 of who remain on the US Treasury's watch-list.

	AU	CA	CH	EU	OFAC	UK	NL	UN	HK	SG	JP
AFGHANISTAN				*		*	*				
AL-QAIDA	*	*	*	*		*	*	*	*	*	*
BALKANS					*						
BELARUS			*	*		*	*				
BURMA					*						
BURUNDI			*	*	*	*	*				
CENTRAL AFRICAN REPUBLIC	*	*	*	*	*	*	*	*	*	*	*
CUBA					*						
CHINA					*						
DARFUR					*						*
DR CONGO	*	*	*	*	*	*	*	*	*	*	*
EGYPT				*		*	*				
IRAN	*	*	*	*	*	*	*	*	*	*	*
IRAQ	*	*	*	*	*	*	*	*	*	*	*
IVORY COAST			*	*	*	*	*	*	*	*	*
LEBANON					*						
LIBERIA			*								
LIBYA	*	*	*	*	*	*	*	*	*	*	*
NORTH KOREA	*	*	*	*	*	*	*	*	*	*	*
PALESTINE					*						
REPUBLIC OF GUINEA			*	*		*	*				
REPUBLIC OF GUINEA-BISSAU			*	*		*	*	*	*	*	*
SOMALIA	*	*	*	*	*	*	*	*	*	*	*
SOUTH SUDAN	*	*	*	*	*	*	*	*	*	*	*
SUDAN	*	*	*	*	*	*	*	*	*	*	*
SYRIA	*		*	*	*	*	*				*
TALIBAN	*	*						*	*	*	*
TUNESIA				*		*	*				
UKRAINE	*			*				*			*
UKRAINE/RUSSIA	*	*	*	*	*		*				
VENEZUELA			*		*						
YEMEN	*	*	*	*	*	*	*	*	*	*	*
ZIMBABWE	*	*	*	*	*	*	*				

Table 1: SIX Sanctions Matrix (provided for illustration purposes only)

The challenge for multinational regulated entities is to normalise their response as far as is feasible across multiple jurisdictions, and make the right choice for their organisations on the level of compliance to the various different sanctions measures.

Things are not likely to get any easier anytime soon. EO 13959, introduced by President Donald Trump, marked a shift away from ‘hard sanctions’ to ‘soft sanctions’, in this case the linking of close name matches to targeted Chinese military companies. While new President Joe Biden may have pulled back from this, creating significant confusion in the marketplace, the expectation is that supervisory bodies will adopt similar measures in the future, making it essential that financial institutions prepare.

The Chinese sanctions furthermore raise questions about the potential use of artificial intelligence (AI) to translate Chinese names into Western languages. Observers also wonder whether the US stance on China will be picked up by other Western countries, hugely broadening the scope of the sanctions challenge and potentially inviting reciprocal measures from China, which has already created its own Unreliable Entity List to identify sanctioned companies, in turn raising the question of whether other heavily sanctioned countries will introduce their own countermeasures. It remains to be seen, meanwhile, whether and to what extent financial institutions will seek to comply with these countermeasures.

Impact on Investment Management Community

EO 13959 marks the first instance of sanctions applied to indirect investments, thereby creating an obligation for asset and fund managers, index providers and the investment banks and brokerages that market funds. As a result, these organisations need to screen the component securities of the funds they manage, trade or market, to ensure none is connected with sanctioned people or organisations. And while other regulators haven't yet taken this step, the investment management industry largely expects them to do so, and is planning accordingly.

For fund managers and index providers, the challenge of compliance is significant, not least because they have never been subject to sanction screening requirements before. Due to the complexity of the funds business, and the need to identify and screen organisations with 'closely matched names' to those appearing on the US list of sanctioned companies, the scale of the challenge is substantial.

The Scale of the Screening Task

Industry observers have suggested that as many as 300,000 funds may need to be monitored for potential exposure to securities identified by EO 13959 alone, perhaps amounting to half a million potentially affected securities. While this number is huge, the status of each fund and its constituent securities can change at any time, requiring firms to maintain ongoing on-demand access to up-to-date sanctions data. The explosion in volumes of exchange-traded funds adds to the challenge, since each fund has many unique underlying constituent securities, each of which may be exposed to sanctioned companies or people.

“Establishing beneficial ownership is especially difficult given the complex corporate structures of many companies today.”

Identifying potentially affected funds and sourcing data on their component securities is a significant foundational step toward ensuring compliance with new and emerging sanctions measures. But it is only foundational. Once you have identified the population of potentially affected funds, the next step is to establish corporate hierarchies in order to identify beneficial ownership of any given entity, allowing identification of links with politically exposed persons (PEPs), for instance.

The opacity surrounding beneficial ownership was a contributory factor in the decision to develop and launch the global Legal Entity Identifier (LEI) standard, whose administrators aim to assign an identifier to any legal entity globally so that investors understand whose securities they hold in order to assess risk more accurately. But the LEI does not provide corporate hierarchies that link commonly owned issuers, which means investment firms themselves will need to construct their own, using data sourced from commercial providers. The complexity of corporate ownership means that the depth of data required by firms is significant, requiring an understanding not only of whose securities they are holding but also who they acquired them from and on whose behalf.

Establishing beneficial ownership is especially difficult in today's low-interest environment, wherein investors and their intermediaries are seeking investments further afield than ever before in search of superior returns. This may involve investments in funds in emerging markets or more obscure financial instruments, making an accurate ownership hierarchy extremely important in order to understand exposures to sanctioned entities.

Additional complexity comes in the form of establishing ownership of privately owned companies. While locating ownership data for public companies is relatively straightforward, with most listing authorities requiring full disclosure of significant investor holdings, this is not the case for private corporations, which may require a nontrivial element of detective work to fully understand, adding to cost and time resource.

The Integration Challenge

Given the expansive data requirement posed by the emerging screening requirements, firms will need to draw upon a range of data sources to gain the depth and breadth of coverage they need. These may include their own internal databases, which themselves may hold data derived from external sources.

“Firms need to be able to map the various identifiers and symbologies used by these disparate data sets.”

To get value from these data sets, though, firms need to integrate the various data sets required to get a comprehensive view of their potential exposures to screening rules. As such, firms need to be able to map the various identifiers and symbologies used by these disparate data sets, and may need to establish a business rules engine that identifies corporate relationships using data from multiple sources.

By definition, the tools needed to construct these rules engines and filters are sophisticated and may not be readily available. These tools will need the flexibility to deal with multiple sanctions rules, many of which have their own thresholds for corporate ownership that trigger actions or penalties. It remains a significant challenge to ensure any screening tool is accurate, includes the ability to establish corporate ownership of all targeted securities across all regimes, and is flexible enough to rapidly process updates to the relevant sanctions rules, again across multiple jurisdictions.

And finally, the tool needs to be able to identify potentially toxic instruments and be deployed in a manner that can be used to automate the monitoring of financial sanctions. This is being driven by regulatory requirements, some of which are mandating that institutions implement identification capabilities at the instrument level so they don't miss a tainted security, which requires automation to be truly effective.

As a data provider, SIX is working to help clients consume data in more automated and cost-effective ways, both through integration partnerships with third-party platform providers including Simcorp, Eagle Investment Systems and FactSet Data Systems.

The Evidence Requirement

The US Office of Foreign Assets Control (OFAC) has published its compliance requirements some years ago: https://home.treasury.gov/system/files/126/framework_ofac_cc.pdf. But now the buy side is specifically mentioned in EO 13959, and given the substantial exposure of US debt markets to China it's a question of when - not if - the OFAC will move to enforce its requirements on the buy side.

For investment management firms, the emergence of sanctions requiring screening of indirect investments brings with it the responsibility to provide transparency for impacted intermediaries. These may include fund marketers, brokerages and investment banks, and global custodians and fund administrators, all of which require evidence that the funds they are holding, marketing or otherwise exposed to, are not in breach of the widening array of global sanctions.

Firms also need to present evidence of compliance with the various regulations that require sanctions screening. These are changing rapidly as jurisdictions follow others into new areas of screening requirements, and still others retaliate against what they consider to be onerous sanctions against them.

Practical Steps for Implementing Sanctions Screening

Investment firms are still trying to understand the full extent of the response to EO 13959 and the implications and repercussions it may have for their screening obligations. They are beginning to recognize that the introduction of indirect investments into the mix has sparked a need to respond in terms of implementing a robust and comprehensive mechanism for screening potentially impacted funds and their underlying component securities.

Buy-side firms seeking to put in place a robust screening process can take a number of practical steps to ensure they have an effective and flexible framework in place. As a start, firms need to be aware of the measures that

“Firms need to be aware of the measures that may impact their holdings.”

may impact their holdings. This requires access to data relating to the funds they manage and their component securities, updates of relevant jurisdictions' measures, beneficial ownership data covering the issuers involved, identifiers and other reference data for ensuring the correct securities are being monitored, and corporate actions data that may impact companies under scrutiny.

Practitioners acknowledge the importance of data standards in helping to formulate their response. In particular, the market has accepted the need for the LEI, which has been mandated as the standard used to identify entities by several major regulations, most notably the second iteration of the EU's Markets in Financial Instruments Directive (MiFID 2). At the same time, those charged with building databases of entities and securities of interest understand that the LEI alone is not sufficient for building reliable mechanisms for establishing beneficial ownership, as required under many screening jurisdictions.

Integration Practicalities

Armed with these data sets and hierarchies, the integration and processing challenges facing practitioners is considerable. For one thing, firms need to ensure any tools or screening provider they use have fully up-to-date data, taking into account all changes in ownership and control of corporations as they occur. They need to conduct an in-depth portfolio review to ascertain which data sets are impacted by various regulations, whether those governing ownership of Chinese tech companies or corporations owned or controlled by Russian oligarchs or the Iranian, Syrian or Cuban regimes.

The screening mechanism needs to reflect the nuances of each jurisdiction's interpretation of any given sanctions measure. This requires system designers to review in-depth all documentation issued by the various regulators, since each will have a specific prescription of how to deal with given situations. The platform must be able to monitor and adjust for any changes to rules connected to any specific regime. This can be complex; the United Nations, for example, maintains separate committees for each sanctioned regime, each of which may issue updates to its position on those regimes at any time. Screening tools need to check this output on a regular basis to ensure that nothing has changed that could materially impact the firm's process for identifying problem securities.

Screening tools also need to reflect the firm's accepted level of risk, at both the local and group level. Indeed, the resource a firm puts into surveillance of potential breaches should relate to the importance of specific activities to the overall business. For many firms, this may suggest more emphasis on trading, particularly around pre-trade surveillance, with the temptation for many to adopt an attitude of minimum viable compliance for downstream systems.

But it would be dangerous to assume that your pre-trade screening process guarantees compliance throughout the trading work flow, so checks need to take place at every stage, from pre-trade and transaction, through middle-office processes, to clearing and settlement. This extends to any securities that may be held on your firm's behalf by custodians or other fund administrators; any breach in your firm's account will ultimately be your firm's responsibility. Connected with this is the firm's appetite for reputational risk. This is particularly relevant as the industry's focus turns to environmental, social and governance (ESG) investing. Exposure to sanctioned regimes may breach accepted sanctions, but it may also impact broader ESG considerations.

Overall, though, the sheer volume of data involved presents perhaps the biggest challenge. Given that each jurisdiction has its own stance on the application of multiple sanctions for each regime or situation, it's difficult for firms to ascertain which data is most pertinent to their business. Since the 2014 sanctions against Russia following its invasion of Ukraine, the volume of data firms need to apply to their screening mechanisms has grown substantially. This has raised the risk of false positives, which requires more human resource to handle checks and reconciliations.

More recently, firms have been able to implement artificial intelligence (AI) technologies, which have helped process the large volumes of data involved. To gain most benefit from AI processes like machine learning, firms need to work closely with their suppliers - of data and tools - in order to configure screening filters so that false positives are minimised, and resources can be allocated to the highest risk cases. It's worth remembering that your regulator will require evidence of a robust methodology, quality assurance testing and other elements that demonstrate that due care has been paid to complying with sanctions rules; it's not enough to blame a list provider or other vendor for noncompliance. This points to the need to dedicate resource to the screening process. Many large financial institutions are assigning responsibility for screening to dedicated technology and data science experts.

Investment firms will also need to provide evidence of compliance to their service providers. This is particularly relevant to fund managers that rely on sell-side distributors of their products. These firms require transparency around fund managers' screening capabilities; they need to be comfortable that the fund and other investment products they market on behalf of managers don't contain as constituents securities issued by entities that are subject to sanctions. What's needed is some form of 'look-through' by which sell-side firms are able to view fund components' compliance credentials, much in the way insurers required a look-through facility from their investment managers to meet the requirements of the EU's Solvency II regulation.

As it can be seen, there are many steps firms should be taking now in order to get on top of the substantial and highly dynamic sanctions screening requirement. Still at issue, though, is the degree to which investment firms immerse themselves in screening for sanctions. So far it's not clear whether firms need to take steps to comply with all global measures or just focus on domestic rules that may apply to them directly. It's unclear

what instruments they need to cover, particularly with respect to cryptocurrencies and emerging digital assets. And it's not yet clear whether fund managers will need to take sanctions into account before they make their portfolio selections, although this seems increasingly likely. But whatever the scope of the requirement, firms are facing a major challenge to meet their obligations in even the most cursory way.

As the requirement for sanctions screening becomes more entrenched - and the likelihood grows that institutions' own policies will eventually become more stringent than those of the regulators - firms are likely to implement more sophisticated and innovative technology solutions to ensure they are in compliance. As they face this growing complexity, firms need to decide whether to build their own response or use a solution from a recognized data or technology supplier.

Critical Data Sets: A Checklist for Investment Managers

Critical Data Sets Checklist
Regulatory updates
Beneficial ownership details
Company structures
Underlying securities
Core security data
Corporate actions

Table 2

What's Needed: How the Sanctioned Securities Monitoring Service (SSMS) Can Help

The Sanctioned Securities Monitoring Service (SSMS) from SIX aims to help institutions to navigate the minefield of sanctions measures globally and ensure they don't trip over new or changed measures into non-compliance.

It's essential that firms aren't fooled by the tops of the icebergs of sanctions data as there is much more below the surface. For example, sourcing lists of sanction targets from regulators is an essential requirement. But it's important to understand the degree to which these lists change over time, as well as their various data formats and taxonomies. It's essential to normalise this data into a standard format supporting a single, consistent view.

To this foundational dataset, firms need to add information on the millions of private and publicly listed companies, building ownership hierarchy trees based on the appropriate thresholds documented within different regulations. These hierarchies need then to be mapped against the global universe of active and inactive instruments, a process that can run to more than 35 million financial instruments.

Even this doesn't catch everything. Individual nuances can create gaps in your filter, making it essential to institute post-process controls. For example, a 2018 European Court of Justice ruling decreed that structured

products based on American depository receipts, which currently are not sanctioned by OFAC, are subject to sanction. This kind of arrangement can create a lot of complexity, with practitioners having to monitor around 1.5 million structured products, many running that process twice daily to ensure compliance, which translates into significant issues when there is a rule change.

SSMS from SIX provides an easy-to-process file of sanctioned financial instruments and links them to securities, structured products and options. It covers a range of jurisdictions, including the UN and OFAC and regulators in Australia, Hong Kong, Japan, New Zealand, Singapore, the EU, the Netherlands, Switzerland, the UK and California, with new additions in the pipeline.

The service helps firms by matching sanctions lists with sanctions directives, allowing compliance teams to drill down into domiciles, individuals and companies. The service enables practitioners to identify associated companies and securities by analysing and identifying connections between domiciles/companies/individuals, and aggregate the results into a single consolidated list.

SIX has a long history of monitoring global sanctions, having launched SSMS in 2014. It has leveraged its deep expertise in the space to deploy teams of sanctions specialists, who monitor the data for false positives, which can be difficult and expensive for financial institutions to fix. SIX's sanctions teams work with clients to address questions and concerns, and explain the methodology behind the business rules used by the SSMS service.

SSMS delivers highly granular, structured data to subscribing organisations twice a day. Reports include the following data points:

• Name Direct Issuer: Institution short name for the company identified
• Useful cross reference data links: Link to the sanctioned mother company/ organization/individual
• SSI Entity: Link between the issuer identified and the actual SSI
• Is Issuing: Flag indicating if the company is issuing instruments
• Identifiers: Various company Identifiers including LEI. Instrument identifiers ISIN, SEDOL, CUSIP, CINS, FIGI and many local ones
• Active Flag: Possible values «Not yet issued», «Inactive», «In liquidation/dissolution», «Active», «In default»
• Issue Date: Issue date of concerned instrument
• Legal Basis: On instrument level the legal basis is provided under which a security is sanctioned (e.g. EO 13959)
• Active Flag: Possible values «Not yet issued», «Inactive», «In liquidation/dissolution», «Active», «In default»

Table 3

For asset management firms, a key element is the clear legal rationale that accompanies the reason for why every single entity and instrument that is included in the file is there. This is evidenced by the underlying legislation, which also explains why it was identified and what controls were used. For buy-side institutions, the time to put in place a strategic approach to the ever more-complex sanctions monitoring requirement is now.

About SIX

SIX operates and develops infrastructure services for the Swiss and Spanish Stock Exchanges, for Securities Services, Banking Services and Financial Information with the aim of raising efficiency, quality and innovative capacity across the entire value chain of the Swiss and Spanish financial centers. The company is owned by its users (121 banks). With a workforce of some 3,500 employees and a presence in 20 countries, it generated operating income of CHF 1.38 billion and Group net profit of CHF 439.6 million in 2020.

For more than 90 years, SIX has provided the financial data and services the industry needs: high-quality data, delivered at the right time, in the right way. From our core reference data on securities, prices, corporate events, tax and regulatory data, to our flagship indices and bespoke benchmarks, SIX offers added-value services that smoothly integrate with your workflows. We free your time and attention to spend on growing your business.

With SIX, you benefit from a unique database of more than 30 million instruments, providing data aggregated directly and in real time from more than 1,800 worldwide sources, already verified, structured, interlinked and enriched. And we do it the right way, with a tireless focus on quality and innovation to serve the wealth and asset management industry as well as global financial institutions. Over the recent years, SIX has developed a renowned expertise on sanctions monitoring at the instrument level.

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