

## Mongolia Adopts the Custodial Regulations

November 2014

On 3 July 2014, the *Regulations on Custodial Licensing and Operations* (the "**Custodial Regulations**") were jointly approved by the head of the Financial Regulatory Commission (the "**FRC**") and the President of the Bank of Mongolia (the "**BoM**").

The Custodial Regulations have been much-awaited after the adoption of the amended version of the *Law of Mongolia on Securities Market* (the "**Revised Securities Law**") on 24 May 2013, which introduced the concept of custodian services to Mongolian capital markets and provides a basic regulatory framework for the same. Please see our [client alert](#) on the same.

We set out below a brief summary of the Custodian Regulations.

### 1. Scope of the Regulation

The Custodial Regulations regulate the issuance, suspension, extension and revocation of custodian service licences and set out the requirements to be observed when conducting custodian services.

Custodial services are defined as services related to the deposit of securities and the exercise of ownership rights therein.

Pursuant to the Custodial Regulations, only banks, their controlled or subsidiary companies, or the central securities depository (the "**Permitted Entities**") may conduct custodial services.

### 2. Licensing

The principal requirements which Permitted Entities are required to satisfy in order to obtain a custodial service licence are as follows:

- (a) to be registered with the Legal Entities Registration Office of Mongolia;
- (b) to satisfy the minimum share capital requirements set out by the FRC and BoM;
- (c) to have sufficient human resources with the relevant professional skills;
- (d) to have 6 or more experts having a minimum of 3 years' experience in the banking, financial or capital markets sectors and who are qualified to work in the securities market; and
- (e) to meet the requirements in terms of office space, facilities, equipment and technical/computing infrastructure to carry out custodial services.

The FRC shall decide whether to issue a licence within 30 days of receipt of a completed application.

### 3. Custodial services and its types

A legal entity licensed to conduct custodial services (the "**Custodian**") may also conduct specific securities registration activities, settlement activities and other activities approved by the FRC.

The Custodian may engage in the following activities on behalf of its clients:

- (a) those activities which it is authorised pursuant to the agreement entered into with a client;
- (b) obtain information relating to the entity in which clients have invested, to inform the client regarding the same and to carry out the client's instructions;

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- (c) notify clients of any taxes payable, transfer the same to the relevant tax authority and reclaim any excess tax paid; and
  - (d) receive notices of shareholders meetings from the central securities depository, inform clients of the date and agenda of shareholders meetings, enquire of the client's preferred method of participation in the shareholders meeting and exercise voting rights on behalf of the client.

The Custodian is required to provide relevant custodial services relating to following:

- (a) general and extraordinary shareholders meetings;
- (b) acquisitions;
- (c) capital increases;
- (d) conversion of equities and debt instruments;
- (e) coupon payment of debt instruments;
- (f) mergers;
- (g) issue of dividends;
- (h) exchange of securities;
- (i) liquidations;
- (j) proxy voting;
- (k) redemption of debt instruments;
- (l) split and consolidation of shares; and
- (m) tax rebates in relation to equity and debt instruments.

Other activities may be provided by way of agreement.

A Custodian is required to conclude a custodial services agreement with each client.

#### 4. Crosscheck of assets in the client accounts

The Custodians shall undertake a crosscheck of the assets in client accounts on weekly basis in cooperation with the central securities depository.

The Custodians are able to provide services to the clients of custodians outside of Mongolia who have concluded cooperation agreements in respect of securities registered in Mongolia by opening accounts at the central securities depository either in the client's name or in the foreign custodian's name and undertaking the same crosscheck with the foreign custodian and/or the foreign central securities depository using the international interbank transfer system.

#### 5. Types of accounts

Custodians may maintain following types of client accounts:

- (a) fully disclosed/open or direct ownership accounts (the "**Fully Disclosed Account**");
- (b) nominal/nominee account or indirect ownership accounts (the "**Nominee Account**");
- (c) mixed accounts; and
- (d) trustee accounts.

Fully Disclosed Accounts are owned by and will record information relating to a beneficial owner. The beneficial owner may appoint a professional representative who will manage the account on behalf of the beneficial owner.

Nominee Accounts are managed by the Custodian and will only record information relating to the nominal owner. The nominal owner will be appointed by the beneficial owner by way of a custodial services agreement and will undertake securities transactions based on instructions given by the beneficial owner or a representative thereof.

Mixed Accounts have terms and conditions to those for Nominee Accounts, but the account will also be

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registered in the name of beneficial owner. The mixed account is similar to the Fully Disclosed Account as it holds complete information on the beneficial owner, but is managed only by the Custodian.

Trustee accounts are managed by a representative on behalf of the beneficial owner in accordance with an agreement entered between the beneficial owner and the representative.

#### **6. Requirements for risk management**

Custodians are required to undertake 'know your client' activities in accordance with the regulations approved by the President of the BoM and the risk-based approach recommended by the Financial Action Task Force in order to prevent the financing of terrorism, money laundering and other prohibited activities and to ensure the client's ability to pay.

The Custodian is required to transfer funds from the deposited amount of securities in accordance with the percentage set by the BoM into specific accounts opened by the BoM in order to mitigate risks to the financial system.

#### **7. Suspension and revocation of licences**

The FRC may suspend a custodial service licence on the following grounds:

- (a) where the licence holder fails to submit operational reports to the FRC on more than three consecutive occasions;
- (b) where the licence holder fails to submit financial reports and relevant information to the FRC and other authorities within the time specified by law for two consecutive quarters;
- (c) where the licence holder fails to pay the relevant FRC fees within three months of the due date;
- (d) where the license holder conceals errors caused by its failure to maintain and/or cross-check its clients'

securities and asset registrations in accordance with the applicable regulations;

- (e) where the license holder repeatedly distributes misleading advertisements and false information;
- (f) where the custodial services cannot be provided in accordance with this regulation (for example, due to a force majeure event or because the Custodian no longer satisfies the minimum requirements);
- (g) where the license holder has committed a serious breach of the terms of the custodial services agreement; or
- (h) other grounds specified in law.

Licence holders may request the FRC reinstates a suspended licence after remedying breaches and returning to normal operations.

The FRC may revoke a custodial service licence on the following grounds:

- (a) the holder of the licence issues a request for revocation;
- (b) the custodian's (or its parent's) banking licence has been revoked by the BoM;
- (c) the licence holder has not paid the FRC's fees for more than a year;
- (d) licence holder has not satisfied the minimum levels of capital adequacy, operational risk fund adequacy and/or the prudential liquidity ratios in the form and amount set by the FRC and the BoM for two consecutive quarters;
- (e) the licence holder has not carried out any operations for a year following issuance of the licence;
- (f) the licence holder has not submitted the relevant reports to the FRC for two consecutive quarters;

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- (g) the licence holder has not complied with its obligations in respect of the FRC and has not remedied any such breaches during the prescribed period;
  - (h) the licence holder has been liquidated; or
  - (i) other grounds specified in law.

In the event that a Custodian becomes either insolvent, is liquidated or has issued a request to be wound-up, then the assets of the same, if it is a bank then the securities deposits of clients, shall be transferred to another entity that provides custodial services with the consent from the FRC.

## **8. Inspection and liabilities**

The FRC shall conduct both on and off-site, scheduled and unscheduled inspections in accordance with relevant laws and procedures and shall hold the relevant entity liable for any breaches identified.

Custodians are not responsible for any liabilities arising as a result of investment decisions made by their clients.

Those found to be in breach of the Custodial Regulations may also be subject to penalties in accordance with the Revised Securities Law, the Law on Banking, the Law on Combatting Money Laundering and Terrorism Financing and other laws and regulations.

## **CONCLUSION**

The Custodial Regulations provide a regulatory framework in respect of licensing, types of custodial services, the general obligations of the entities engaged in custodial services, risk management and reporting obligations.

Those investors who, for various reasons were unable to be involved in the day-to-day management of their investments, are now able to delegate these management functions to Custodians.

The adoption of the Custodial Regulations is a positive step towards an enhanced investment environment and strengthened Mongolian capital market.

The FRC and the BoM as regulators will play an important role in ensuring the efficient implementation of the Custodial Regulations. We understand that the FRC has already issued custodial licences to two banks, being the Trade and Development Bank and Golomt Bank, and that these two banks currently undertaking preparations to provide custodial services.

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