TRANSPARENCY IN SECURITIES TRANSACTIONS AND CUSTODY CHAINS

Study on the Benefits and Costs of Securities Accounting Systems

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Executive Summary

A review of transparency in securities transaction and custody chains with a focus on the benefits and costs of securities accounting systems finds that omnibus and segregated account systems as well as hybrid systems that bridge the two offer benefits to their respective users as well as disadvantages. While there has been increased United States (US) regulatory scrutiny of the omnibus account in terms of the potential for it to be subject to misuse by persons subjects to sanctions or individuals wishing to access the US securities markets in an illicit manner, issues with effective cross-border operation of the segregated account in an intermediated chain and economies of scale mitigate against their wider use in capital markets. In either case, it has not been demonstrated conclusively that absent robust anti-money laundering (AML) and sanctions screening on the part of financial institutions either the omnibus account or segregated account or a hybrid version thereof is no longer fit for purpose.

Without regard to what type of account structure is being used to comply with know your customer (KYC), the industry is very conscious of the need to ascertain as much customer information as is possible on transactions while respecting data protection and privacy rules and to effectuate somehow the ability to "know your customer's customer", although with respect to this latter point more progress needs to be made. In conjunction with this review, a May 2015 survey of the ISSA membership (32% response rate) undertaken by Coventry University reveals that there is significant interest in the issue of transparency in securities transactions and custody chains. For details of the survey results see Appendix A.

Introduction

In the post Global Financial Crisis environment, participants in global capital markets take it for granted that their securities transactions will be supported by operational systems that offer a robust clearing and settlement process. Global custodians and the systems which they use operate in an electronic, intermediated and cross-border environment whereby physical assets have been replaced by electronic records.[1] It is undisputed that banks are operating in an environment characterised by ever-increasing regulatory pressure.

The adaption of the Financial Action Task Force (FATF)[2] Recommendations[3] (1 and 26, especially) and the banking sector's risk-based approach (RBA)[4] to global anti-money laundering (AML) and counter-terrorist financing (CTF) standards have placed heightened scrutiny on the need for transparency in the financial sector. Closely related to these efforts is the need for financial institutions to incorporate customer due diligence (CDD), such as know your customer (KYC), to establish why such customers are engaged in certain financial transactions and to extend CDD to politically exposed persons (PEPs) and family members and associates of such PEPs.[5] FATF is particularly concerned with setting appropriate standards on transparency and beneficial ownership[6] so as to prevent the misuse of corporate vehicles for money laundering or terrorist financing but they also support the efforts to prevent and detect other designated categories of offences such as tax crimes and corruption.[7] However, FATF's guidance has been focused exclusively on payments and trade based money laundering and terrorist financing and not on securities settlement and custody.[8]

In respect of securities settlement, regulators and enforcement authorities until recently themselves thought reliance on the first gatekeeper in the chain was sufficient, provided it was a regulated entity.[9] The question now raised in light of

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[1] Madeleine Yates & Gerald Montagu, "The Law of Global Custody", 4th ed., Bloomsbury Professional, Ltd., 2013, at p. 4.

[2] The independent inter-government body that develops and promotes policies to protect the global financial system against money laundering, terrorism and the proliferation of weapons of mass destruction.

[3] FATF International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation (2012) http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf (accessed 17 April 2015).

[4] FATF Guidance for a Risk-Based Approach - The Banking Sector (2014) http://www.fatf-gafi.org/media/fatf/documents/reports/Risk-Based-Approach-Banking-Sector.pdf (accessed 17 April 2015).

[5] FATF International Standards (2012), op cit..

[6] FATF Guidance Transparency and Beneficial Ownership (2014) http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-transparency-beneficial-ownership.pdf (accessed 18 April 2015).

[7] FATF Money Laundering (ML) and Terrorist Financing (TF) in the Securities Sector (2009), paragraph 126: "An omnibus account is an account established for an entity that is acting as an intermediary on behalf of multiple individuals or entities. For example, a bank in jurisdiction X could open an omnibus account with a securities intermediary in jurisdiction Y through which the bank in jurisdiction X manages a Portfolio for its clients. In this scenario, the ML/TF vulnerability is that the securities intermediary may not know who the beneficial owners of the investment portfolio are." http://www.fatf-gafi.org/media/fatf/documents/reports/ML%20and%20TF%20in%20the%20Securities%20Sector.pdf (accessed 20 April 2015).

[8] See for instance FATF Guidance Document, Best Practices on Trade Based Money Laundering (2008) http://www.fatf-gafi.org/media/fatf/documents/recommendations/BPP%20Trade%20Based%20Money%20Laundering%202012%20COVER.pdf (accessed 16 August 2015).

[9] Dominic Hobson, "Dominic Hobson Talks to Mark Gem: The future of the omnibus account", http://cooconnect.com/sites/default/files/online-magazine/pdf/Gem_article.pdf, 2014, (accessed 18 April 2015).

recent regulatory scrutiny is whether the common perception that "every entity standing behind such a regulated entity in a securities transaction chain can still be deemed to be okay."[10] While it is clear that the securities settlement and custody industry must examine whether such reliance remains best practice as an industry standard, there is no clear legal authority that explicitly states that such reliance is invalid. This is a distinction with a difference: the former might be advisable to follow, while to ignore the latter would be to engage in conduct that is proscribed.

The securities settlement and custody industry is particularly vulnerable to margin pressure from its customer base, namely, financial institutions that are keen to reduce costs on what are viewed as a "back-office operation."[11] In Europe, this margin pressure is compounded by the arrival of T2S (Target 2 Securities - the new European wide settlement platform) which eliminates the incumbent market advantage formerly enjoyed by local central securities depositories (CSDs) in respect of settlement services in their local markets.[12] Regulatory authorities addressing "systemic risk" in the post-Global Financial Crisis environment have imposed "an army of regulations"[13] on the wider securities services industry as a whole, e.g., EMIR[14], Dodd-Frank[15], etc., with the result that the cost and staffing resources required for compliance has increased exponentially.[16]

Ensuring the right regulatory approach for the securities settlement and custody industry is critical. There is concern that an overly-prescriptive rules based approach such as one that can be found in the high value payments arena would impose avoidable costs and disruption. For instance, mandating disclosure by downstream respondents of the identities of those involved in securities transactions and custody chains adds a layer of complexity that could result in externalities and an unavoidable choosing of "winners and losers" among various activities. As such, policy makers must be careful to incorporate the right incentives in their rulemaking so that the regulations they promulgate better align incentives with goals.[17]

Compounding this problem are issues of regulatory governance, e.g., whose rules apply in a cross-border context. Regulatory definitions are neither globally consistent nor prescriptive, thus financial institutions face the risk of being held to differing standards dependent upon the jurisdictions in which they operate

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[10] Ibid

[11] AT Kearney, Inc. ,"Expect Revolution, Not Evolution, in Securities and Financial Services", 2014, http://www.atkearney.co.uk/documents/10192/4571933/Expect+Revolution-+Not+Evolution+in+Securities+and+Financial+Services.pdf/a5a088f7-1cd7-4a2b-9fa9-a341d7607d9b (accessed 17 August 2015), p.2

[12] Ibid

[13] Ibid

[14] European Market Infrastructure Regulation (EU) 648/2012, entered into force on 16 August 2012.

[15] Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111–203, H.R. 4173) (2010)

[16] For instance, HSBC Bank now has 24,300 staff specialising in risk and compliance, almost 10 per cent of its entire workforce, which has increased about a sixth from 2011 (Martin Arnold, "HSBC wrestles with soaring costs of compliance", 4 August 2014, Financial Times, available at: http://www.ft.com/cms/s/0/0e3f0760-1bef-11e4-9666-00144feabdc0.html#axzz3j6B8PZeA (accessed 17 August 2015)).

[17] Stijn Classens and Laura Kodres, "The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions", IMF Working Paper WP/14/46, March 2014, (available at: http://www.imf.org/external/pubs/ft/wp/2014/wp1446.pdf) (accessed 17 August 2015).

and the transnational regulatory environment overall. Moreover, regulators stand (both domestically and internationally) in different institutional positions and relationships *vis a vis* other actors in a regulatory regime.[18] An example illustrating this point is the conflict between US Department of the Treasury's Office of Foreign Assets Control (OFAC) economic and trade sanctions against foreign targets based on national security rules and German foreign trade law which prohibits boycott measures.[19]

The Issue: Transparency in Securities Transactions and Custody Chains

The securities settlement industry faces intensive regulatory pressure to establish with greater certainty transparency in securities transactions and custody chains. The requirements of KYC, AML and sanctions screening place greater importance on the need for custodian banks to have a clearer understanding of "who lies behind cash payments, securities transactions and assets in custody."[20] The omnibus account which is seen as a "primary source of operational efficiency"[21] has regulators concerned because it can be difficult to identify who the ultimate beneficiaries might be:

> The days of the omnibus account appear to be numbered. Regulators are zeroing in on them for three powerful reasons: investor protection; tax transparency and geopolitical policing. Any one of these reasons would be enough to make it difficult to see how this industry-standard account structure is to remain untouched.[22]

The use of omnibus accounts in the US mutual fund industry creates certain operational difficulties when it comes to compliance with SEC prospectus requirements:

> While the omnibus accounting process may be efficient for transacting in fund shares, the identities of individual investors and necessary information about their transactions are typically hidden from mutual fund compliance personnel. This lack of transparency at the individual account level makes it difficult, if not impossible, for mutual funds to

[18] Julia Black, "The Rise, Fall and Fate of Principles Based Regulation", London School of Economics Working Papers, 17/2010 available at: http://www.lse.ac.uk/collections/law/wps/WPS2010-17_Black.pdf (accessed 17 August 2015).

[19] Katherine Meloni, "Arms to Iran or a Cuban Cigar? A risk sensitive approach to sanctions for the loan market", Butterworths Journal of International Banking and Financial Law, September 2014, pp. 501-505, available at: http://blogs.lexisnexis.co.uk/loanranger/wp-content/uploads/sites/9/2014/09/jibfl_sept14.pdf (accessed 18 August 2015). This issue raises broader ethical questions for the US Government because OFAC itself runs a special licencing scheme which allows American companies to do business in countries subject to sanctions. See Jo Becker, "US Approved Business With Blacklisted Nations", New York Times, 23 December 2010, available at: http://www.nytimes.com/2010/12/24/world/24sanctions.html?hp (accessed 18 August 2015).

[20] Hobson, op cit.

[21] Bethel, op cit.

[22] Safane, J, & DeLuca, A 2014, "The omnibus dilemma", Global Custodian, p. 4. http://search.ebscohost.com/login.aspx (accessed 26 April 2015).

uniformly apply the policies and procedures contained in their prospectuses filed with the SEC.[23]

This point – namely that an omnibus account, which substitutes intermediaries for beneficial owners and commingles fungible interests in securities, allows for the assets of a number of clients to be pooled – brings considerable efficiency to institutional investor servicing and is the basis of the custody industry in many jurisdictions.[24]

Intermediaries, e.g. broker-dealers, fund supermarkets and financial advisers, have by and large begun to shift away from individual accounts held on the books of a mutual funds complex toward aggregated ("omnibus") accounts which leave fund complexes with less information about the accounts and activities of beneficial shareholders of the fund.[25] While this is operationally efficient, it leaves fund management with little control of transaction processing and less detail regarding the investor or beneficial owner of the fund.[26]

For instance, omnibus accounts allow for functions to be undertaken once by security, rather than many times by individual clients. The very fungible nature of the securities held in an omnibus account allows for shorter settlement timetables, e.g., T+2, as envisioned under T2S, enables increased competition between CSDs and allows for reduced settlement costs in financial markets.

Network managers place a good deal of emphasis on the ability of their sub-custodians to persuade local regulators to authorise the use of omnibus accounts in their local market. The magazine Global Custodian notes that: "The omnibus option routinely ranked at the top of their list of what to demand of the authorities in markets as various as Poland, Bulgaria, Ukraine and the United Arab Emirates (UAE)."[27]

OFAC and Clearstream: Fear That Omnibus Accounts Can Be Used Wrongly

OFAC's 22 January 2014 $152 million settlement with Clearstream Banking, S.A. (Clearstream) concerning Clearstream's alleged use of its omnibus account with a US financial institution as a conduit to hold securities on behalf of the Central Bank of Iran (CBI) was a game changer.[28]

Securities entitlements allegedly held in CBI's account at Clearstream in late 2007 and early 2008 related to securities held in the US.[29] In total, there were 26 corporate and sovereign bonds in Clearstream's omnibus account at a US

[23] Coalition of Mutual Fund Investors, "Hidden Omnibus Accounts", http://investorscoalition.com/regulatory-tracker/hidden_omnibus_accounts, 23 March 2015 (accessed 18 April 2015)
[24] International Organization of Securities Commissions (IOSCO), Regulation of Nominee Accounts In Emerging Markets Final Report, Emerging Markets Committee, FR 11/11, October 2011, p.6, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD362.pdf (accessed 4 May 2015).
[25] Investment Company Institute, "Navigating Intermediary Relationships", p. 1. September 2009, http://www.ici.org/pdf/ppr_09_nav_relationships.pdf (accessed 18 April 2015).
[26] Ibid, p. 9.
[27] Safane & DeLuca, op cit.
[28] Settlement Agreement between US Department of the Treasury's Office of Foreign Asset Control and Clearstream Banking, S.A. (IA-673090) dated 22 January 2014, http://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20140123_clearstream_settle.pdf (accessed 19 April 2015).
[29] Ibid

financial institution in which the CBI had a beneficial ownership interest, with a total nominal value of $2.813 billion.[30] In short, CSDs in the US served as the ultimate place of safekeeping for these securities.[31]

Although Clearstream did not admit or deny any allegation made or implied by OFAC in connection with the matter and OFAC did not make a final agency determination that a violation had occurred, the settlement reached according to OFAC "highlights the need for vigilance in the securities industry, where vehicles such as omnibus accounts - as well as the intermediated nature of the securities custody industry itself - can serve to obscure the beneficial ownership interests of sanctioned parties."[32]

OFAC Director Adam J. Szubin[33] said at the time of the settlement that "Clearstream provided the Government of Iran with substantial and unauthorized access to the US financial system."[34] Szubin noted that "[OFAC's] action should serve as a clear alert to firms operating in the securities industry that they need to be vigilant with respect to dealings with sanctioned parties, and that omnibus and custody accounts require scrutiny to ensure compliance with relevant sanctions laws."[35]

Director Szubin Elaborates OFAC's Position on Transparency (September 2014)

Speaking hypothetically at SIBOS in Boston in September 2014, Director Szubin addressed situations where OFAC would find sanctions violations: "[u]nder the regulations, if one is processing a transaction in violation of [OFAC] sanctions, be it in Iran or with respect to Ukraine, it is a violation."[36] Szubin said that "when you have that constellation of repeated activity going on over a number of years with the knowledge of senior members of an institution, then you see the headline-grabbing enforcement cases. This is conduct that not only ought to have a sanctions enforcement response, but a visible response, so that it can serve as a learning case for the rest of the industry."[37]

Szubin further elaborated:

> We are not looking for a scalp or to raise up a victory flag, but violations must have a meaningful response. The message is out there that we know that most institutions that are regulated are doing the right thing because it is the right thing to do…..[38]

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[30] Ibid
[31] Ibid
[32] Press Release, Treasury Department Reaches Landmark $152 Million Settlement with Clearstream Banking, S.A., 23 January 2014, http://www.treasury.gov/press-center/press-releases/Pages/jl2264.aspx (accessed 19 April 2015).
[33] President Barack Obama on 16 April 2015 nominated Adam Szubin to be Treasury Undersecretary for Terrorism and Financial Intelligence. He is currently Acting Under Secretary for Terrorism and Financial Intelligence.
[34] Department of the Treasury Press Release, op cit.
[35] Ibid
[36] Remarks of Adam Szubin, Director, Office of Foreign Asset Control, US Department of the Treasury, 30 September 2014, SIBOS Compliance Forum, Reported in Sibos Issues, 1 October 2014, https://www.sibos.com/sites/default/files/Sibos_Issues_2014_Wednesday3.pdf (accessed 19 April 2015).
[37] Ibid
[38] Ibid

Szubin stressed that "willfulness" was a key issue when considering cases: "Was this an example of benign or innocent neglect, or much worse, gross negligence or recklessness? All of those questions are the mostly intensely debated when we are sitting around at OFAC." [39] Further elaborating on this point: "We know that without aggressive and careful compliance by people like you in this audience [SIBOS Compliance Forum] our regulations would only be words on paper…. I can only tell you we are very careful, very thoughtful when going out with any enforcement case and there is no desire to be aggressive for the sake of looking aggressive."[40]

OFAC's approach requires financial institutions to undertake a risk-based analysis based on identified factors and allocate mitigation and compliance appropriately. Thus, the Risk Factors for OFAC Compliance in the Security Industry (updated 5 November 2008) identifies "omnibus accounts/use of intermediaries" as one of several possible risk factors for the securities industry in a non-comprehensive list and warns of the potential for the use of code names to invest funds in the US on behalf of sanctions targets, concealing the identities of the beneficial owners.[41] Cross-border relationships are particularly problematic because they create situations in which a US financial institution will be handling funds from a foreign financial institution whose customers are not transparent to the US financial institution.[42] For any relationship, or for any given transaction, firms should know: (1) who is actually undertaking OFAC screening and other monitoring with respect to a transaction; and (2) who owns the customer relationship.[43]

While it must be noted that Szubin stopped short of suggesting that omnibus accounts were unworkable, there is concern that intermediaries may find themselves forced to undertake the cumbersome task of maintaining a "warehouse of names" of approved intermediated individuals and entities "good to go" with the resulting difficulties that creating such a list entails. The idea of a "warehouse of names" is inherently problematic because financial services organisations are loathe to store too much information that they do not use regularly out of concern that such data could be breached. Additionally, there is the concern that having such information on file will lead to scienter liability in that an organisation will be hard-pressed to argue "you can't un-know what you know." [44]

It is generally understood that the level of transparency sought by OFAC can be achieved in three steps of which the first two are readily achievable at the present time. The first step is KYC which banks implement by themselves across the board. It remains to be seen, however, whether the rise of a number of new "KYC registries" will allow for greater ease of sharing such information between entities.[45] The second step involves 'mining the data' that is presently available

[39] Ibid
[40] Ibid
[41] http://www.treasury.gov/resource-center/sanctions/Documents/securities_risk_11052008.pdf (accessed 19 August 2015).
[42] Ibid
[43] Ibid
[44] Bailey Reutzel, "Know Your Customer's Customer" Goes Global, American Banker, 27 April 2015, http://www.americanbanker.com/news/bank-technology/know-your-customers-customer-goes-global-1074026-1.html?zkPrintable=1&nopagination=1 (accessed 24 July 2015).
[45] Ibid

in particular in the intermediary chain including all customer information in any part of a transaction as various parties become involved. To a large extent, banks have become much more proficient at understanding customer transactions far more comprehensively than they have been in the past.[46]

However, it is the third step – "knowing a customer's customer" – that still remains most elusive for intermediaries to achieve. Differing data protection standards and privacy issues in various countries, e.g., EU and US, make this task unworkable at the present time.[47] One possible solution here would be for financial services entities to share data on an anonymised basis data about their customers, including what payment methods are generally used so that data trends can be compared. However, the cost of compiling such information could be prohibitive and would require industry-wide consensus. For the time being, when it comes to "knowing a customer's customer" one financial institution has to be able to rely upon the systems and procedures in place in another institution. A "trust, but, verify" mechanism could be adapted industrywide but this is not in place at the present time.

It is the operational efficiency of omnibus accounts that appeals most to custodians as it creates economies of scale, lowers transaction costs, and enhances liquidity, not least by allowing securities to be lent or used as collateral without having to check who owns them first.[48] At the same time, it is the creation of such extended chains of owners in which the legal ownership of interests in securities changes hands many times without regard to the claims of the original beneficial owner that creates the transparency issue.[49] As long as one substitutes a record of the identity of the custodian for the identity of the beneficial owner the transparency issues exist.[50]

Prior to Clearstream, it was generally thought that looking behind the identity of the custodian was not necessary. For instance, the May 2004 International Organization of Securities Commissions (IOSCO) Principles on Client Identification and Beneficial Ownership for the Securities Industry did not require from the perspective of securities regulators that the CDD process be carried out by authorized securities service providers (ASSPs), to fulfil client and beneficial owner identification and verification, as well as KYC to look at owners behind omnibus accounts:

> Because the other financial institution is the ASSP's client, the ASSP is not "relying" upon the other financial institution to conduct due diligence of the financial institution's clients as that term is used in Principle 5, below. Therefore, the ASSP will not be required to "drill down" through the financial institution to identify and verify all of the financial institution's clients.[51]

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[46] Ibid
[47] Nicholas Elliott, "OFAC's Desired Banking Transparency Faces Some Obstacles", The Wall Street Journal – Risk & Compliance Journal, 1 October 2014, http://blogs.wsj.com/riskandcompliance/2014/10/01/ofacs-desired-banking-transparency-faces-some-obstacles/ (accessed 19 April 2015).
[48] Hobson, op cit.
[49] Ibid
[50] Ibid
[51] IOSCO, Principles on Client Identification and Beneficial Ownership for the Securities Industry, 1 May 2004, p. 6. n. 2. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD167.pdf (accessed 19 April 2015).

In Guidance from the Staffs of the US Department of the Treasury and the US Securities and Exchange Commission (Issued: October 1, 2003) when broker-dealers engage in transactions through omnibus accounts and sub-accounts established by financial intermediaries, these broker-dealers were not required to treat the beneficial owners as "customers":

> With respect to an omnibus account established by an intermediary, a broker-dealer is not required to look through the intermediary to the underlying beneficial owners, if the intermediary is identified as the accountholder. Even if the broker-dealer has some information about a beneficial owner of assets in an omnibus account (e.g., batch execution account) or a sub-account, under the circumstances described above, the financial intermediary (not the beneficial owner) should be treated as the customer for purposes of the rule.[52]

In February 2006, the US Commodities Futures Trading Commission issued similar guidance in respect of futures commission merchants (FCMs) who engage in transactions through omnibus accounts and sub-accounts established by financial intermediaries. In these situations:

> An FCM is not required to look through the intermediary to the underlying beneficiaries. Even if the futures commission merchant has some information about a beneficial owner of assets in an omnibus account (e.g., batch execution account) or a sub-account, under the circumstances described above, the financial intermediary (not the beneficial owner) should be treated as the customer for purposes of the rule.[53]

FinCEN recently published (4 August 2014) a Notice of Proposed Rulemaking[54] that would enhance CDD requirements for financial institutions by requiring covered financial institutions to identify, and verify, the identity of beneficial owners of their customers, with certain exceptions. The Proposed Rule would become effective one year from the date a final rule is issued. Most notably, however, for intermediated account relationships (such as omnibus accounts), the Proposed Rule would apply only to a financial institution's immediate customer – the intermediary – and not the intermediary's underlying clients.[55]

FinCEN acknowledges that it is concerned about the illicit finance risks posed by underlying clients of intermediary customers due to the lack of insight a financial institution has into those clients and their activities.[56] However, FinCEN believes that this risk may be more effectively managed through other means, such as proper CDD conducted by financial institutions on their direct customers who

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[52]Financial Crimes Enforcement Network, Guidance from the Staffs of the US Department of the Treasury and the US Securities and Exchange Commission (SEC), Issued: October 1, 2003, Subject: Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (31 CFR 103.122) http://www.fincen.gov/statutes_regs/guidance/html/20031001.html (accessed 19 April 2015).

[53] Financial Crimes Enforcement Network, Commodity Futures Trading Commission, Guidance FIN-2006-G004, Issued: February 14, 2006, Subject: Frequently Asked Question regarding Customer Identification Programs for Futures Commission Merchants and Introducing Brokers (31 CFR 103.123) http://www.fincen.gov/statutes_regs/guidance/html/futures_omnibus_account_qa_final.html (accessed 19 April 2015).

[54] Federal Register, / Vol. 79, No. 149 / Monday, August 4, 2014 / Proposed Rules http://www.gpo.gov/fdsys/pkg/FR-2014-08-04/pdf/2014-18036.pdf (accessed 19 April 2015).

[55] Ibid at 45163.

[56] Ibid

serve as intermediaries, and appropriate regulation of the intermediaries themselves.[57] This feature of the Proposed Rule appears to respond to commenters who cautioned that a requirement to identify an intermediary's underlying clients or beneficial owners could have significant detrimental consequences to the efficiency of the US financial markets by requiring financial institutions to modify longstanding practices.[58]

On 4 February 2014, an $8,025,000 settlement agreement was reached between the Financial Industry Regulatory Authority (FINRA) and Brown Brothers Harriman & Co (BBH) and its Global Head of AML and Sanctions Compliance concerning BBH's alleged brokerage and/or custody of trades in low priced securities for foreign bank intermediaries located in secrecy havens, predominately Switzerland, who had omnibus accounts at BBH on behalf of their undisclosed clients who were the beneficial owners of the low priced securities. FINRA was particularly concerned that BBH's Swiss bank clients could offer their underlying clients anonymous access to US securities markets.[59] Without admitting or denying liability, BBH was cited for not requiring clients who wish to offer brokerage to their underlying customer to set up a disclosed sub account in the name of the underlying customer. Of particular note is the fact that BBH's Head of AML and Sanctions Compliance was held liable and fined.

In Europe, the Market Abuse Directive (MAD) was adopted by the European Parliament in January 2014 and is set for European Union-wide implementation by 2016. It now makes inciting, aiding and abetting of market abuse a criminal offence under the Directive. Mark Gem sees this as a wake-up call to the custodian industry to get to grips with some of the inherent complexity in policing omnibus accounts: "If as an industry we do not make that level of inquiry, then some future regulator could argue that a custodian or a market infrastructure should have known that market abuse was taking place, and could therefore face criminal charges."[60] Gem goes further painting a bleak picture going forward under MAD:

> The regulators will go for the tallest guy in the room and will not distinguish between front and back office… They have done so many investigations in payments they are only now turning their attention to securities. The securities services industry is going to have to raise its game. The huge remedial programmes banks have launched since being fined for issues in the cash and payments industry have yet to wash through to the securities industry.[61]

This view is shared by other compliance officers in the industry speaking on an anonymous basis.

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[57] Ibid
[58] Ibid
[59] FINRA Letter of Acceptance, Waiver and Consent No. 2013035821401, Re: Brown Brothers Harriman & Co., Respondent; Harold A. Crawford, Respondent. http://www.frank-cs.org/cms/pdfs/FINRA/FINRA_BBH_Action_5.2.14.pdf (accessed 20 April 2015).

[60] Hobson, op cit.
[61] Ibid

Custody Chains and Intermediation

The origin of the custody industry arose out of the need for investors to keep securities in a safe place, e.g. bank vaults. The custody industry, however, has evolved in line with the growth of sophisticated financial markets whereby it is a complex industry in its own right no longer characterised by physical safekeeping but rather by offering a range of information and banking services.[62] For instance, when securities are bought or sold, the custodian takes care of the delivery and receipt of securities against the agreed amount of cash with the exchange of securities against funds, being referred to as "settlement". Holding securities in an investor's portfolio attracts benefits, rights and obligations; the services provided by the custodian to ensure the investor receives that to which he/she is entitled are commonly called "asset services". The most common asset services centre around collection of dividends and interest; corporate actions such as rights issues, re-denominations or corporate reorganisations; payment and/or reclaim of tax; and voting at shareholders' meetings by proxy.[63] Thus, in essence, the asset servicing function of a custodian involves being an information conduit liaising between issuers and the holders of their securities.

A local market will typically have several competing banks that would offer custodian services. If a bank provides custody services internationally in multiple markets through one service agreement with customers, they are referred to as "global custodians." More frequently, assets are not directly held by the custodian but they are recorded in book entry systems or held by other parties such as Central Securities Depositories, International Central Securities Depositories (ICSDs)[64], sub-custodians, registrars or collateral agents. In addition, all other assets which by their nature cannot be held in custody (e.g., derivative instruments) are subject to the custodian's record-keeping obligation, i.e. the custodian must maintain and keep up-to-date a record of all the collective investment scheme (CIS) open positions.[65]

The investment industry is characterised by intermediation, and custody reflects this tiered structure: Securities are ultimately held in their national CSD, but there are usually a number of intermediaries between the national CSD and the investor.[66] Each layer of intermediary provides services that cater to its own customer base and that are associated with the assets held under its custody.[67] Institutional investors and investment firms, likewise hold their securities via a mixture of intermediaries.[68] A customer's securities that are held with its immediate service provider are in turn held at upper-tier intermediaries, ending at the market infrastructures, the CSDs (where the securities are in the first place).[69] The total number of intermediaries involved between the investor and

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[62] Diana Chan, Florence Fontan, Simonetta Rosati and Daniela Russo, European Central Bank, Occasional Paper Series, No. 68, August 2007, The Securities Custody Industry, https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp68.pdf (accessed 20 April 2015).
[63] Ibid
[64] Securities depositories which were originally established to settle and safekeep Eurobonds (stateless securities) and are now active in the settlement of internationally traded securities from various domestic markets, typically across currency areas. At present, there are two ICSDs located in EU countries: Clearstream Banking in Luxembourg and Euroclear Bank in Belgium.
[65] IOSCO, Principles Regarding the Custody of CIS Assets, Consultation Report, CR07/2014, October 2014, p.4 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD454.pdf (accessed 20 April 2015)
[66] Ibid
[67] Ibid
[68] Ibid
[69] Ibid

the CSD depends on the business models of both the customer and the service suppliers in each layer of intermediation.[70]

One of the criticisms with complex custody chains is that investors can find it difficult to effectively enforce rights arising out of securities held across borders. In the recent UK decision in *Eckerle v Wickeder Westfalenstahl GmbH*,[71] German investors could not exercise rights as shareholders in a UK company despite the fact that the company was registered in the UK and listed in Germany. Another criticism concerns shadow banking issues related to financial collateral in the form of book-entry securities, as defined in EU under the Financial Collateral Directive (Directive 2002/47/EC, as in force). Different legal approaches related to the activities of securities reuse or re-hypothecation that financial intermediaries, mainly as collateral takers, conduct in modern markets pose risks in financial markets.[72]

[70] Ibid
[71] *Eckerle v Wickeder Westfalenstahl GmbH, [2013] EWHC 68 (Ch)* http://cases.iclr.co.uk/Subscr/search.aspx?path=WLR%20Dailies/WLRD%202011/wlrd2013-024 (accessed 20 April 2015)
[72] Christina I Tarnanidou, "EU financial collateral arrangements and re-hypothecation in the shadow of 'shadow banking': To further regulate or not?", Journal of Banking Regulation , (11 February 2015) | doi:10.1057/jbr.2014.22 http://www.palgrave-journals.com/jbr/journal/vaop/ncurrent/full/jbr201422a.html (accessed 20 April 2015).

Segregated Accounts: Rationale and Benefit

There are a number of different rationales for the use of segregated accounts or positions at the CSD level whether by a client of a CSD participant, e.g., an end investor or an intermediary.[73] Legal and regulatory requirements in different jurisdictions will necessitate the use of segregation for concerns of asset protection and/or transparency. Segregation can ensure that the beneficiary of the account is clearly identified; this may be necessary for an end investor to be considered the legal owner of securities and will ensure against the risk of dispossession posed in the event an intermediary in a securities chain becomes insolvent. In addition to the asset protection rationale identified above, for reasons of transparency, some jurisdictions mandate single beneficiary accounts. In these circumstances, the regulatory authorities may have concerns in order to ensure appropriate capture of tax revenue or to monitor investment flows in its capital markets. As such, segregated account structures make such "command and control" regulatory functions far easier to identify who holds the securities with the CSD.

In the context of segregating accounts to ensure proper processing of tax obligations, the segregation may be made on the basis of domicile of the investor, tax status of the investment involved or the sorts of transactions that the investor engages in. One determinant of whether the segregation is at CSD level for tax purposes is whether it is the CSD or the CSD participant who is responsible for tax withholding and calculation. If, for instance, the CSD participant is responsible for reporting to the taxing authorities as opposed to the CSD for investor revenue purposes then the segregation would be at the CSD participant level as opposed to the CSD level.

Issuers can mandate through registration requirements the need to register securities in the name of the end user or impose rules that limit registration of securities in the name of an intermediary. The rationale behind this lies with shareholder identification, exercise of control over who is entitled to vote at general meetings or on other shareholder issues or the promotion of long-term share ownership. A CSD participant may for its own purposes wish to have its holdings held in a segregated account, for instance, to distinguish fungible securities from those which may not be immediately fungible. Asset protection, accessibility of securities and operational efficiency may drive these requirements. Finally, a CSD may have specific requirements to segregate certain types of holdings as well.

It must be pointed out that the term 'segregation' has no set meaning internationally, and its interpretation ranges in different jurisdictions from a mere accounting separation of book entries to a concept with legal and other

[73] For a full discussion of this, please see Association for Financial Markets in Europe, Post Trade Settlement Committee Task for on CSD Account Structure, CSD Account Structure and Principles, 19 March 2012 http://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0CCsQFjAB&url=http%3A%2F%2Fwww.afme.eu%2FWorkArea%2FDownloadAsset.aspx%3Fid%3D5897&ei=n8FJVYTxIse9UZSKgcAK&usg=AFQjCNEhqgEf8zz26cWo0bueYCufWVJnmw&sig2=W40n3NVe3QJzhe83XyMMMA&bvm=bv.92291466,d.d24 (accessed 20 July 2015).

consequences.[74] In Europe, the CSD Regulation (CSDR)[75] in the form of Article 38 places a new obligation on a CSD's participants to offer their clients at least the choice between omnibus segregation and individual client segregation; and inform them of the costs and risks associated with each option. IOSCO Principle 14 considers both portability and segregation in the context of central clearing counterparties (CCPs) recommending that CCPs should have rules and procedures that enable segregation and portability of positions of a participant's customers and the collateral provided to the CCP.[76]

Vermaas criticises IOSCO for taking a neutral stance as to type of account structure to be used:

> I would have wanted the global body for regulators to go further and have defined a 'best practice' for the different types of products and customers, taking into account the tier in the holding chain and whether the activity is cross-border or domestic.[77]

At the same time, Vermaas acknowledges that the IOSCO position is consistent with the view taken by the Geneva Securities Convention[78] which does not prescribe a harmonised rule on segregation or spell out how segregation should be accomplished[79]. While the Geneva Securities Convention adapted a default position of omnibus securities account, nothing contained therein prohibited States for opting for segregated securities or a hybrid combination of both types of accounts.[80] When discussing the advantages of segregation, one must bear in mind that there is no uniform conception of what is meant by segregation and that there is still debate as to whether segregation must happen at all levels throughout the holding chain.

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[74] Maria Vermaas, The call for proper segregations in intermediated systems, Unif. L. Rev., Vol. 18, 2013, 589-605, 599.

[75] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 Text with EEA relevance
OJ L 257, 28.8.2014, p. 1–72 (BG, ES, CS, DA, DE, ET, EL, EN, FR, GA, HR, IT, LV, LT, HU, MT, NL, PL, PT, RO, SK, SL, FI, SV) http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1410876555408&uri=CELEX:32014R0909 (accessed 21 April 2015).

[76] CPSS and IOSCO Technical Committee, Principles for Financial Market Infrastructures (April 2012) 82. http://www.bis.org/cpmi/publ/d101a.pdf (accessed 19 July 2015).

[77] Vermaas, op cit., 601.

[78] Convention on Substantive Rules for Intermediated Securities.

[79] Vermaas, op cit., 601.

[80] See UNIDROIT, Study LXXVIII, Doc 58 (2007) 83; UNIDOIT, Study LXXVIII, Doc 21 rev (2005) 137. Geneva Securities Convention (n 1).

What do we mean when we talk about an "Omnibus" Account?

It is, of course, necessary to review some of the basic concepts behind what we mean by an omnibus account and the other account structures common through the custody industry. An "omnibus" account is an account opened in the name of an account provider, the securities credited to which belong to several clients of the account provider.[81] Typically the account provider will be obliged to maintain accounts on his own books recording the interests of these clients in respect of the securities credited to the account in the account-provider's name.[82]

By contrast, a "nominee" account has two features that distinguish it from an omnibus account: first, often a nominee acts for a single client, for example an omnibus account provider (who acts for many clients). For instance, single-client nominee accounts are common when a global account provider, being foreign, is not permitted by the membership rules applicable to the local CSD to participate directly in the CSD.[83] Second, a nominee's duties and discretions will usually be much narrower than those of other account providers: as where an omnibus account provider will be granted discretionary powers by its client, a nominee is likely to be permitted only to do such acts as are strictly necessary to maintain the client's holding of securities.[84] Whether the provider of either a nominee or omnibus account is likely to know if their account-holder is acting as a nominee or holding a pool of securities for many investors depends on applicable law - although in some EU Member States the "intermediary" nature of the account-holder is disregarded.[85]

Advantages of Omnibus Accounts

The chart below identifies some of the key advantages of omnibus accounts:

Advantages of Omnibus Accounts[86]:	
Cost	• One account needed for many investors. • Reduces fees associated with maintaining account and transfers. • Facilitates offset of credit and debit entries. • Allows for internalised (or net) settlement.

[81] Dermot Turing, *Omnibus Accounts,* European Commission Legal Certainty Group, Working Document, 31 August 2005 http://ec.europa.eu/internal_market/financial-markets/docs/certainty/background/31_8_5_turing_en.pdf (accessed 20 April 2015).

[82] Ibid
[83] Ibid
[84] Ibid
[85] Ibid
[86] The advantages and disadvantages of omnibus accounts listed here are those identified by Dermot Turing in his working group study for the Legal Certainty Group. For more details, see Dermot Turing, Clearing and Settlement in Europe, (London: Bloombsury Professional, 2012).

Voting and Corporate Actions	• Collectively held securities allow for simpler processing of voting instructions and entitlements for corporate actions required on behalf of the issuer. • With corporate actions, the account provider will be responsible for processing the instructions and entitlements for all the investors reducing the burden on the issuer.
Internalised Settlement	• Investors could "settle" across the books of an account provider instead of using the CSD. • If each investor's holding is held in a separate account with an upper-tier intermediary "internalised settlement" is impossible, since an account provider acting as lower-tier intermediary needs to process a transfer from a selling investor client to a buying investor client by means of external instructions to the upper-tier intermediary. • By contrast, if an omnibus account is used, and the ordinary processing algorithms permit, an account provider would not need to issue any external instructions to settle such a transfer. • Internalised settlement can reduce the cost of transfers and improve service levels (e.g., by offering "transfer finality" at an earlier moment than if settlement occurs at a higher tier intermediary).
Reduced Burden for Issuers	• Issuers do not need to deal directly with large numbers of investors where they are required legally only to recognise the persons who hold directly securities from them. • Shifts burden of dealing directly with investors to the account providers. • Account providers may be freer to negotiate the level of service provided to their account holders, whereas issuers will generally be required to treat all holders alike.

Disadvantages of Omnibus Accounts

Some of the disadvantages of omnibus accounts are identified in the chart below:

Disadvantages of Omnibus Accounts[87]:	
Effect of Permanent Shortfalls:	• Assuming it cannot be made good by the account provider, a permanent shortfall on an omnibus account is bound to cause loss to some investors. • How will this loss be borne? E.g., all investors lose any claim to anything held by the account provider; ratable loss-sharing; forensic accounting to identify precisely "whose" securities were lost. • In some countries a clear and simple statutory solution is provided.
Forced Borrowing:	• Shortfalls are likely to arise routinely and without malpractice by the account provider, as a result of operational error (which could be an error on the part of some other person). • Provided that the account provider is required by regulatory rules to conduct reconciliations and to take action to remove imbalances and is not insolvent, permanent shortfalls are unlikely but a temporary imbalance may exist. • The consequence of a shortfall may be that the investors entitled to what remains will to some degree be making securities loans to any investor who wishes to dispose of the whole of its holding. • Lending may be beyond the capacity of some investors and would in many cases require the consent of the lender. • Regulatory rules typically require account providers to explain to investors that their securities may be utilized to satisfy other investors' instructions.

[87] The advantages and disadvantages of omnibus accounts listed here are those identified by Dermot Turing in his working group study for the Legal Certainty Group.

Distance between Issuer and Investor:	• The omnibus account structure necessarily implies that securities are held indirectly. • The issuer knows that the registered holder is not the investor, but not who the investors are. • Corporate communications are made more difficult. • Some countries have established rules which empower issuers to stay in touch with investors where an omnibus account is used. • Distance between issuers and investors also engenders delay: by the time an investor at the end of a chain of intermediaries receives notice of a vote or other corporate action, it may be very close to the last practical moment for action or even too late. • *TELUS Corporation v. CDS Clearing and Depository Services Inc*.[88] confirms that for corporate governance purposes it is only a registered shareholder and not his/her nominee who can requisition a shareholder's meeting.
Corporate Actions:	• If securities are consolidated or rights issues relate to holdings of specific numbers of securities (e.g., a 2-for-5 issue) the account provider will typically receive replacement or additional assets which do not divide perfectly among the investors in precisely the ratio in which the investors held the original securities. • Some rounding and cash-settlement of differences is necessary, which may affect investors differentially. • The outcome for many investors is likely to be different (though not necessarily worse) from that if their securities were held in accounts segregated at the higher-tier intermediary. • Investors typically confer discretion on account providers to handle this kind of situation.

[88] 2012 BCSC 1350, Supreme Court, British Columbia, Canada

Conflicting Votes:	• Where an account provider holds securities for many investors, some may wish to vote in favour of a particular matter and others may wish to vote against. • There may be a risk in theory that the relevant legal system does not permit a single investor to vote contrarily: part of his vote for, and part against.
No Title to Investment:	• If the relevant legal system does not recognise the omnibus account as valid form of co-ownership, there is in theory a risk that the investor has no property rights at all if the account provider pools his securities with those of other investors.

Holding Client Securities at Local Market Level

A study by Thomas Murray Data Services[89] reviewed the advantages and disadvantages of the three main ways of holding client securities at the local market level. While the study was primarily concerned with the issue of asset safety in the context of an insolvency, e.g., Lehman Brothers, MF Global or Bernard L. Madoff, it is instructive as it draws on the contrasts most clearly.

Omnibus Account:

Convenience for the global custodian is paramount and as such all clients' securities are held in one account at the sub-custodian. The sub-custodian who might act for several global custodians may pool all the securities it holds in its accounts into a single account at the CSD if these are fungible securities. This, of course, makes the lending of securities from a single pooled account a far simpler task than borrowing from different accounts aiding in the hypothecation of securities. Addressing one of the disadvantages of omnibus accounts identified above, *Effects of Permanent Shortfalls*, the Thomas Murray study notes that "care needs to be taken over the actual legal ownership in an omnibus account: for instance, is the ownership interest an equitable share in the interests of the account such as a fungible pool?"[90] In bearer markets such as Germany, Switzerland, Austria and the Benelux countries, shortfalls are borne pro-rata with the other owners without regard to how the shortfall arose.

Segregation - Beneficial Owner Name at the Agent Bank:

Securities can be also held in an owner's individual account at the sub-custodian to avoid the pooling issues described above. While this is less efficient from the

[89] Thomas Murray Data Services, CMI in Focus: Asset segregation in CSDs, 24 May 2013, available at: http://ds.thomasmurray.com/opinion/cmi-focus-asset-segregation-csds (accessed 19 August 2015).
[90] Ibid

perspective of a sub-custodian and it may result in both higher costs and loss of revenue from hypothecation, it does reduce some legal risk in terms of asset safety. It must be noted here, however, that the sub-custodian does not maintain beneficial owner segregated accounts at the CSD level but only maintains a client omnibus account. This client omnibus account will be separate from proprietary assets belonging to the global custodian or sub-custodian which will be segregated into other accounts at the CSD.

Designated Segregation - Beneficial Owner Name at the CSD:

Thomas Murray suggests that this approach, legally required in some jurisdiction such as the Nordic countries, offers the highest level of asset safety.[91] However, this method of entitlement also has significant costs and requires significant administrative efforts, e.g. administering thousands of individual accounts. One advantage is in the context of asset portability in the sense that there would be no need to re-register ownership if the custodian were to be changed. One disadvantage is that a custodian may miss a corporate event where securities are registered in the beneficial owner's name because the issuer contacts the beneficial owner and not the custodian. Moreover, if the securities are held in the beneficial owner's name, any proxy voting by the agent bank will require a power of attorney and this may need to be renewed on an annual basis. One problem, however, which exists in emerging markets and complicates matters is where the broker obtains control of the securities prior to placing an order in the market. This gives rise to the risk of the broker selling assets without the client knowing (a problem somewhat common in EMEA markets), which is ultimately the risk that is borne by the asset owner.

One important point, however, that must be made when speaking of the advantages of beneficial ownership systems is that while they identify a name as a beneficial owner this in and of itself does not resolve the AML, CTF or sanctions/PEP issue entirely. As one compliance expert noted, the beneficial accounts still would "have the same clients behind them as the omnibus accounts." As such, they are as prone to abuse and manipulation as omnibus accounts. Moreover, they offer global custodians no protection from the problem caused by the fact that a "client of a client" is a crooked player.

Moreover, it would take a "wholescale reboot" of the entire securities settlement industry from top to bottom to eliminate the omnibus holding structure:

> As a consequence of the export of this Anglo-Saxon model to much of the developed world, much of Europe, the developed markets of Asia Pacific and North America retain the omnibus holding model to this day. The mature markets have a historical legacy that they can't shake off due to the evolution of the legal and tax frameworks to only support this model. Because most of the global custodians built their businesses and systems during this period, they were designed around omnibus holding models with the result that even today where the global custodians operate in designated segregated markets, they still

[91] Ibid

> prefer to offer only omnibus accounts at the CSD wherever they can get away with it.[92]

Some have also suggested that the use of Legal Entity Identifiers (LEIs) such as those developed jointly by SWIFT and Depository Trust & Clearing Corporation could facilitate the harmonisation of data collection and reporting across the value chain. However, at the present time LEIs only used publicly available data collected on financial entities and for data protection and privacy concerns does not collect information on individuals.

An omnibus account structure offers ease of data control in that the key player is the last intermediary in the chain who holds all relevant information about the end investor, keeps the appropriate documentation, and will – in its own records – provide and maintain securities accounts for each end investor.[93] This principle of "one account, with one account name, one set of static data, one set of securities balances, and one set of securities movements"[94] is in sharp contrast to the operation of multiple segregated accounts:

> If there were an obligation to segregate by end investor at the level of a CSD, then there will be hundreds of thousands, if not millions, of securities accounts opened and maintained at that CSD. One inevitable consequence is that this segregation at the CSD level is necessarily reflected in the account structure of each intermediary in the custody chain, all the way down to the last intermediary. This has the effect of multiplying the number of accounts to be opened, maintained and reconciled across the chain of intermediaries.[95]

Some of the potential sources of cost, inefficiency and risk associated with segregated account structures include:

Segregated Account Structure Problems[96]:	
Account Opening:	• Necessary to pass relevant information (including in many cases information about the end beneficiary) from the last intermediary in the chain through all the intermediaries in the chain to the CSD to open the account. • Such information will be necessary not only for investors that do invest in that country but also – most

[92] Ibid
[93] Association for Financial Markets in Europe, Post Trade Settlement Committee Task for on CSD Account Structure, CSD Account Structure and Principles, 19 March 2012 http://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0CCsQFjAB&url=http%3A%2F%2Fwww.afme.eu%2FWorkArea%2FDownloadAsset.aspx%3Fid%3D5897&ei=n8FJVYTxIse9UZSKgcAK&usg=AFQjCNEhqgEf8zz26cWo0bueYCufWVJnmw&sig2=W40n3NVe3QJzhe83XyMMMA&bvm=bv.92291466,d.d24 (accessed 6 May 2015).
[94] Ibid
[95] Ibid
[96] As identified in the AFME Report (2012).

	probably - for investors that have not yet decided to invest, but may so decide. • If this were not done, then there may be the risk of settlement fails once the investor decides to invest, given that a securities account at the CSD would not yet be open.
Account Maintenance: (Processing and Reconciliation)	• Increased communication and processing costs, as, for example, each account provider in the chain will send daily statements of holding to its account holder for multiple accounts (rather than one), and each account holder will have to reconcile with its own records. • A corporate action will be processed and reconciled on multiple accounts rather than one account. • Change of status of end investor: Any relevant change to the end investor (change of name, address, legal status etc.) may well have to be passed through the chain to the CSD, introducing considerable administrative burden at each level.
Allocation of Securities Trades:	• In the event of block securities trades being executed on behalf of multiple end investors, the trades will need to be allocated to individual securities accounts at the CSD for settlement purposes. • In consequence, the possibilities for netting at the CCP will be reduced.
Securities Lending:	• Securities loans on behalf of multiple lenders will be more complex and liable to mismatches, as securities will have to be transferred from, and later returned to, multiple securities accounts at the CSD.
Matching Requirements:	• In the event that a CSD uses securities account numbers or identifiers as a criterion for the matching of settlement instructions, under some circumstances there is a greater potential for mismatches and failed settlements.

Internalisation of Settlement:	• In the event that a buyer and a seller of securities hold securities accounts at the same intermediary, then there is the possibility - if the intermediary operates an omnibus account higher up the chain - that the transaction can settle in the books of the intermediary without any requirement for any securities movement higher up in the chain of custody. • If the intermediary operates segregated accounts, there is a requirement for a duplicate movement higher up the chain. • This point is specifically relevant for so-called investor CSDs (i.e. CSDs acting as intermediaries and operating accounts in other CSDs), and for cross-CSD settlement on the T2S platform. • This point is rarely relevant for custodians, as they do not operate securities settlement systems, and do not usually have the mix of clients that would allow for significant internalisation of settlement.
Cross-border Difficulties:	• A model of mandatory segregation by end investor at the level of the CSD may function adequately in an environment of national investors investing in national securities, but it is not a model that can be generalised in a broader cross-border environment. • First, mandatory segregation by end beneficiary at all CSDs across the world would be unsustainable (given that there would be hundreds of millions, if not billions, of end investors, over one hundred CSDs, in many cases three intermediaries in a custody chain). • Second, for most markets and most CSDs there is no specific obligation for any particular segregation, but for some markets there is a requirement to segregate by end investor. • In such a case, a decision by a

	custodian bank, especially a custodian bank in a different country, and at the end of a custody chain, to offer its clients access to securities in a market or CSD with mandatory segregation will imply very significant extra costs in account structure and maintenance for potentially all the securities that it holds in custody. • A typical consequence may be that a custodian bank decides to restrict its service offering for retail clients.
Financial Inclusion:	• The costs, risks and limitations of end investor mandatory segregation at the CSD level not only are a burden on intermediaries, and a burden that is passed on to the end investor; they also may well have the effect of preventing certain categories of end investor from accessing securities markets.
Asset Protection:	• In contrast to the viewpoint asserted by Thomas Murray Data Services, AFME suggests that the omnibus account structure protects end investors' assets better than segregated accounts at the CSD level.

Conclusion

The financial services industry is dependent on omnibus, segregated and designated segregated accounts to effect settlement and support custody globally.

Whilst there are differences amongst the various account structures dependent upon market practice and legal requirements in different jurisdictions, no one type of account structure (be it omnibus, segregated or a designated segregated accounts in and of itself) offers a "magic bullet" that can prevent money laundering, the financing of terrorist activities or the screening for sanctioned parties and PEPs in the absence of significant vigilance on the part of banks to prevent misuse.

Regulators need to have a clearer understanding of how the different sorts of accounts operate in order to ensure that they can work with the industry in a cooperative fashion to prevent the use of securities settlement and custody chains from being used to facilitate money laundering, financing of terrorist activities or illegal access to capital markets by those who subject to sanctioned parties or are PEPs.

The industry must play a role in educating the regulators as to the differences, advantages and disadvantages of the various types of accounts and why some are favoured in certain jurisdictions over others.

No one doubts that achieving transparency in securities transactions and custody chains is a good goal for both regulators and the global securities industry to work to in order that civil society has confidence that its capital markets are not used for nefarious purposes.

However, this discussion needs to be informed by a realistic sense for what can be done and the externalities that will be incurred for an industry that is already subject to significant cost as well as competitive and regulatory pressures at this time.

APPENDIX A

TRANSPARENCY IN SECURITIES TRANSACTIONS AND CUSTODY CHAINS
Study on the Benefits and Costs of Securities Accounting Systems

Analysis of Questionnaire Responses

In line with the Coventry University academic research study on the benefits and costs of securities accounting systems, members of ISSA were surveyed to integrate their views as stakeholders in this process. This analysis is based on a consolidated evaluation of the responses received.

It must be noted that the views solicited were short, factual responses from experienced professionals who are stakeholders in the securities landscape and not meant to be a formal, definitive or authoritative legal analysis of the questions asked.

100 questionnaires were sent out and 32 responses were received representing a response rate of 32%.

Out of this figure, 12 came from market infrastructures segment and 20 from custodians/buy side of the market.

Responses by global region and industry segment show sufficient interest in the issue of transparency in securities transaction and custody chains.

No viewpoint is expressed as to whether such a response rate is adequate. Baruch and Holtom (2008)[97] examined the response rates for surveys used in organisational research analysing 1607 studies published in the years 2000 and 2005 in 17 refereed academic journals identifying 490 different studies that utilized surveys.

Examining the response rates in these studies, which covered more than 100,000 organizations and 400,000 individual respondents, the average response rate for studies that utilized data collected from organizations was 35.7 percent with a standard deviation of 18.8.

[97] Yehuda Baruch and Brooks C. Holton, "Survey response rate levels and trends in organizational research", doi: 10.1177/0018726708094863 *Human Relations August 2008 vol. 61 no. 8 1139-1160*, available at: http://www18.georgetown.edu/data/people/bch6/publication-39527.pdf (accessed 20 August 2015).

Key findings to note:

- Of those who responded, the use of an omnibus account structure or some variant thereof was prevalent in their jurisdiction (77%).
- Respondents to the survey by and large believe that the omnibus account structure offers more advantages and is more beneficial to market participants and stakeholders than other account structures although this outcome may be shaded by the make-up of respondents and their own experience.
- Nonetheless, these same respondents indicate that they would not hesitate to adapt account structures other than the omnibus account structure if such account structures could sustain the identified advantages of the omnibus account.
- 78% of respondents think that segregated account structures provide sufficient information to understand the parties behind those accounts and would assist them in undertaking KYC.
- 59% of those who responded believe that knowing the names of beneficial owners by custodians would not necessarily promote the transparency needed to expose illicit activities such as money laundering and funding of terrorism.
- 72% of respondents believe that the perception that the omnibus account structure is prone to being used for money laundering and terrorism is largely exaggerated.
- 98% of those who responded have systems in place to protect themselves from providing services to customers who might be subject to sanctions.
- 43% of the respondents think that the use of on-demand disclosure frameworks by the securities industry would be more effective to identify beneficial owners of assets than any other account structure or tool. 35% give preference to the final beneficial owner model.
- A majority of respondents believe that account structure and naming convention are critical to ensure that money is not lost to the investment community under a Lehman Bros, MF Global or Madoff-like scenario.
- 72% of respondents – when asked whether the model that relies on the first regulated entity in the custody chain as a way of undertaking KYC checks – report that this model is still "fit for purpose".
- Respondents do not have sufficient information to offer a view as to whether the payment industry's experience in respect of AML and KYC might be a suitable approach for the securities services industry.
- Additional thoughts from respondents indicate that the scale of the problem involved in terms of achieving optimal transparency is significant and that regulatory inconsistency, e.g. data protection, bank secrecy, etc. and the drive for market efficiency, e.g. T2S, mitigates against its achievement.
- A call for a global standard for transparency in the securities industry, e.g. industry developed and managed, is seen as a more desirable solution than additional regulation.

Figure 1: Respondents by Industry Segment

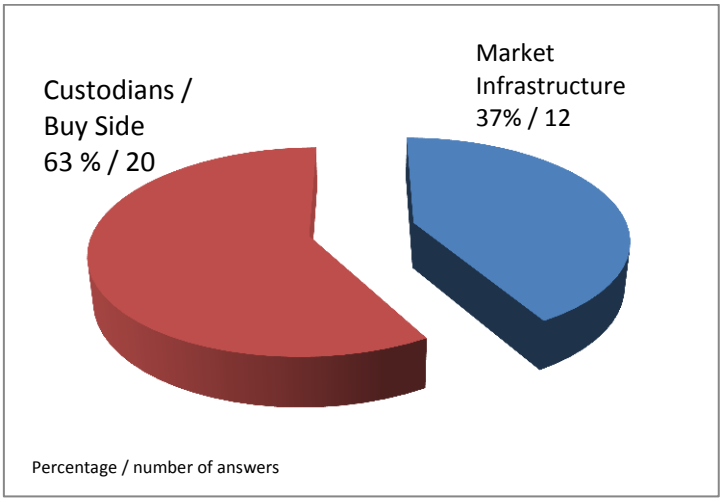


Figure 1 illustrates that of the 32 survey responses received 12 respondents identified themselves as market infrastructure focused while 20 categorised themselves as being custodians or on the buy side.

Figure 2: Respondents by World Region

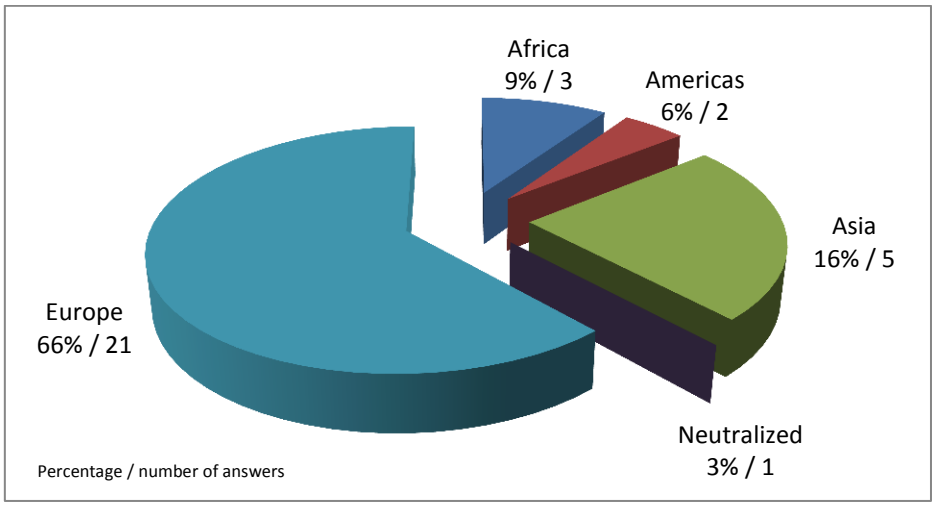
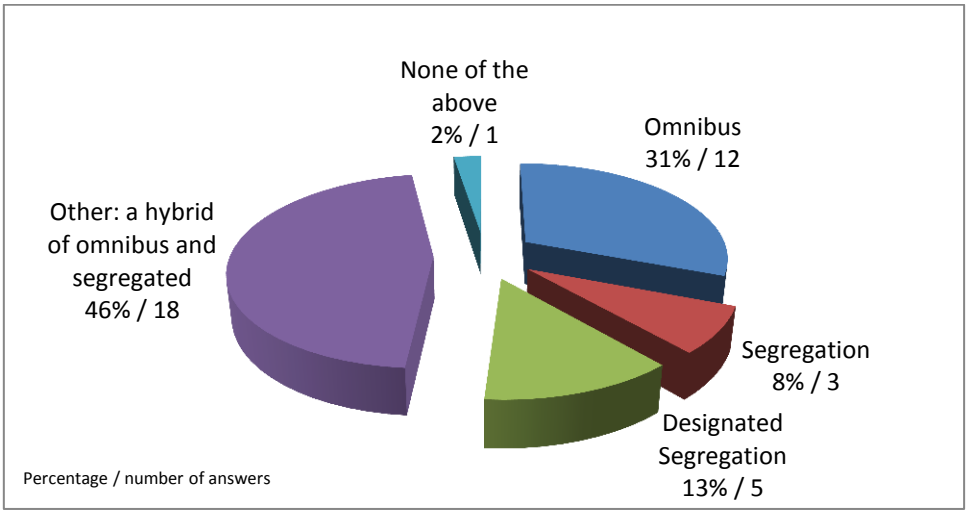


Figure 2 illustrates the spread of responses: 21 out of 32 from Europe; 5 from Asia; 2 from the Americas and 3 from Africa. One party has requested neutralized treatment. A further country by country breakdown is not possible in order to preserve confidentiality of members.

Figure 3: Account Holding Structure



Respondents who identified their organisation as having a country specific focus were asked to identify the appropriate account holding structure permissible in their country.

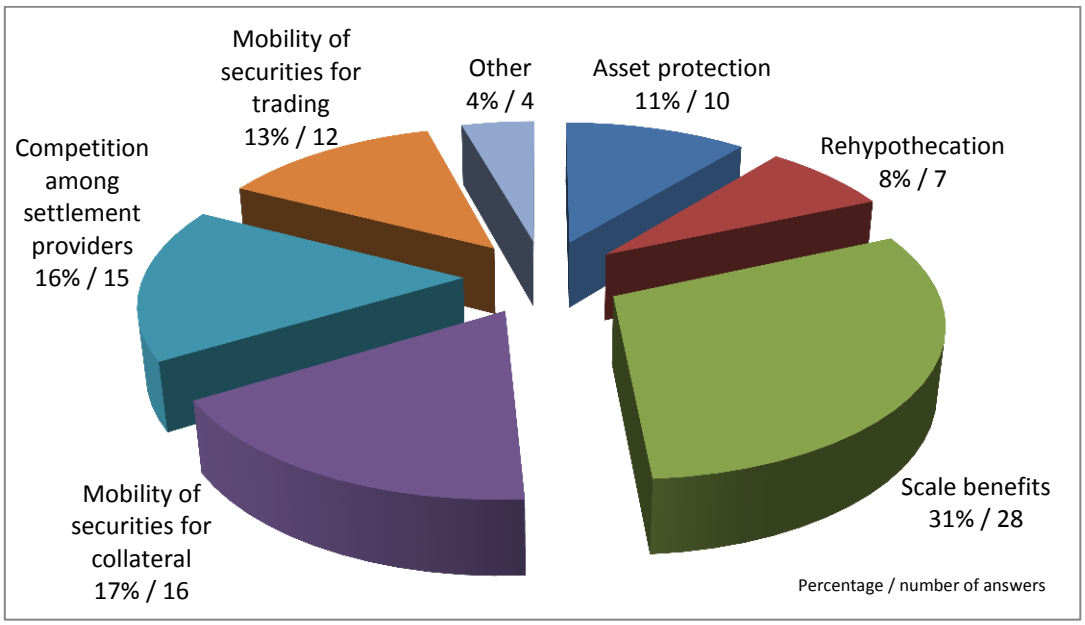
It must be noted that some respondents indicated more than one type of permissible account holding structure for their country.

Additionally some respondents identified more than one type of permissible account holding structure if they operated across several jurisdictions. For instance, one respondent indicated 4 categories because they operate in several jurisdictions.

Finally, in one case where multiple responses were received from the same jurisdiction, the responses indicated different permissible account holding structures for the same country, e.g. omnibus and other.

Of those who responded, the use of an omnibus account structure or some variant thereof was prevalent in their jurisdiction (77%). This is not surprising given the large pool of respondents from European jurisdictions where this structure dominates.

Figure 4: Areas of Benefit of the Omnibus Account Structure



Respondents were asked to identify areas of benefits of the omnibus account structure. Here they were given several suggested answers and were encouraged to provide additional thoughts on the 'other'.

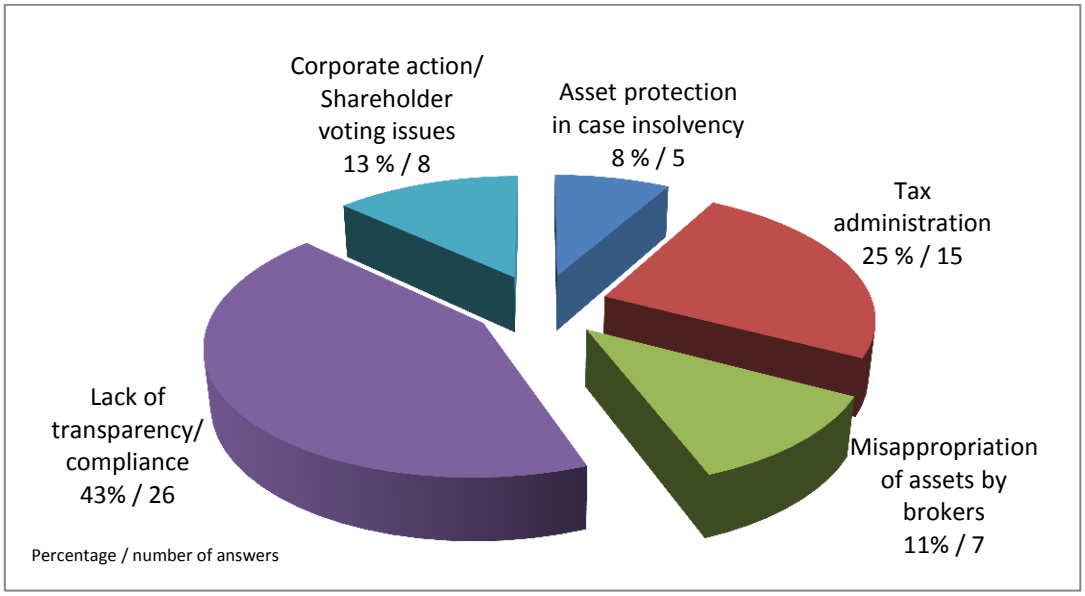
In terms of 'other' responses, the ease with which the omnibus account structure facilitates entry into new markets was cited. The 'other' responses emphasised efficiency and ease of administration.

More than one response was requested, hence the number of responses (92) exceeds the number of respondents (32).

Respondents to the survey by and large believe that the omnibus account structure offers more advantages and is more beneficial to market participants and stakeholders than other account structures.

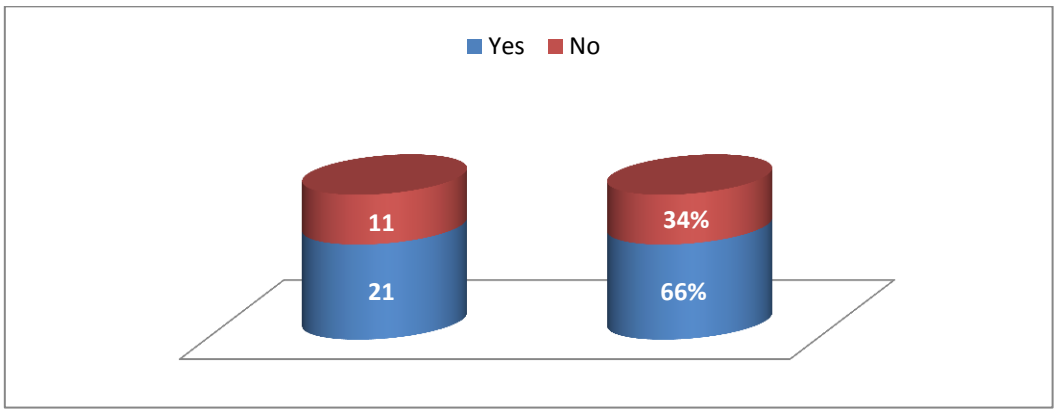
This may be due to the make-up of survey respondents and their own experience as those respondents with experience of segregation and other hybrid structures were equally passionate in support of the latter account structures (although they were clearly smaller in number).

Figure 5: Detriments of the Omnibus Account Structure



Respondents were asked to identify the detriments of the omnibus account structure and provide their rationale for such identified detriments. Lack of transparency and an ability to monitor individual activity was cited most frequently (43%). The difficulty presented by the omnibus account structure in respect of facilitating individual account tax administration and processing also was seen as a disadvantage (25%). Facilitating corporate actions and shareholder voting, preventing misappropriation of assets by unethical brokers and asset protection issues in the case of insolvency, e.g., Lehman Brothers and Madoff, were cited as well in line with the literature discussed in the study.

Figure 6: Adoption of the Account Structures

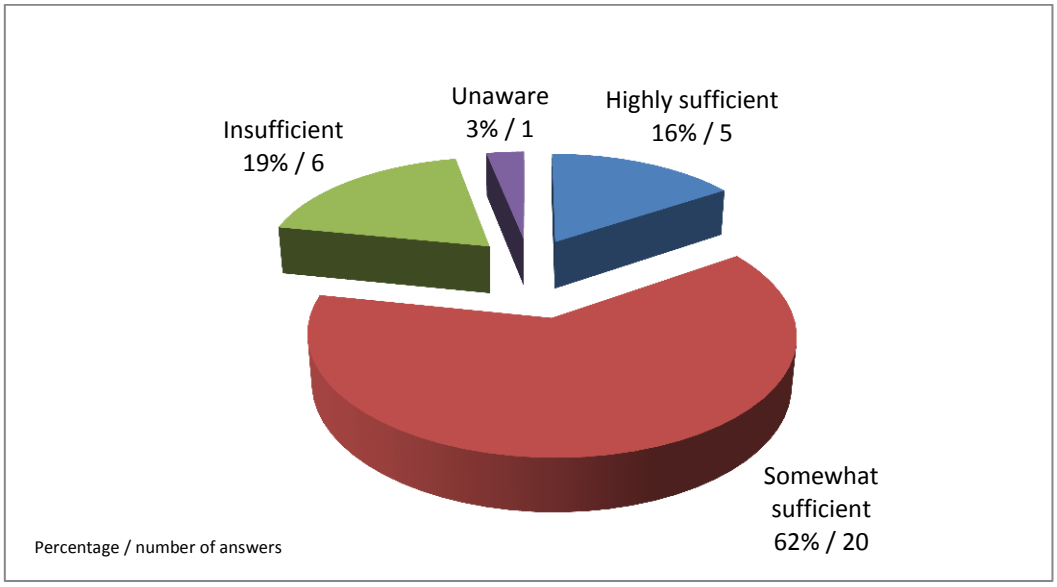


Respondents were asked if they would consider using another account structure in view of the disadvantages of omnibus account structure and 66% answered in the affirmative while 34% said no.

This suggests that although most respondents affirmed the overriding benefits of the omnibus account structure, they will not mind variants of omnibus accounts that can sustain its identified advantages.

This suggests that respondents are unwilling to waive identified benefits of the omnibus account structure.

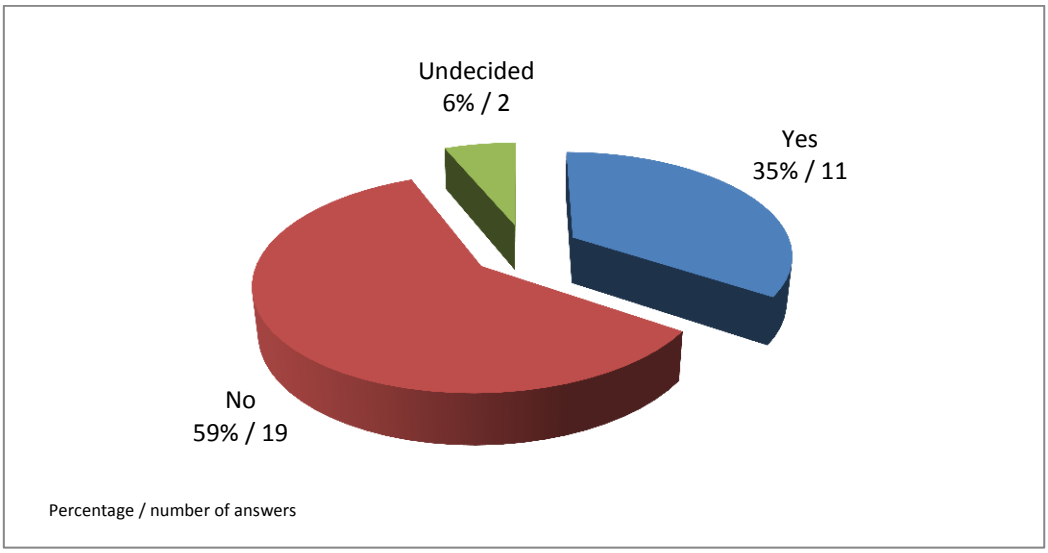
Figure 7: Do Segregated Account Structures provide sufficient Information of Account Owners?



78% of respondents thought that segregated account structures provide sufficient information to understand the parties behind those accounts (e.g. ultimate beneficial owner [not legal owner] or controlling parties).

In the space for additional comments provided, the most frequent added response was that the use of segregated accounts would assist in undertaking KYC tasks.

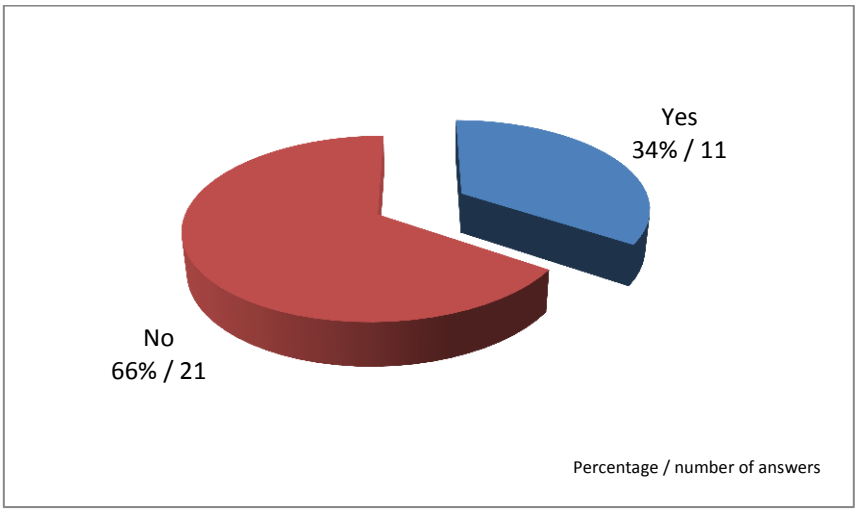
Figure 8: Do you think the fact that Custodians do not know the Beneficial Owners of Assets in Omnibus Accounts impedes the Transparency needed to expose illicit Activities such as ML, TF and Drug Trade?



The present practice along the securities services value chain is that custodians need not know the beneficial owners of assets in omnibus accounts.

By an almost two to one majority, most respondents do not believe that the fact that custodians do not know the beneficial owners of assets in omnibus accounts impedes the transparency needed to expose illicit activities such as money laundering, terrorist financing and drug trade.

Figure 9: Is the Suggestion by Regulators that CSDs should maintain a List of the Names of the Beneficial Owner on each Account at the CSD for AML, PEP and CTF Reasons a reasonable Requirement or Approach?

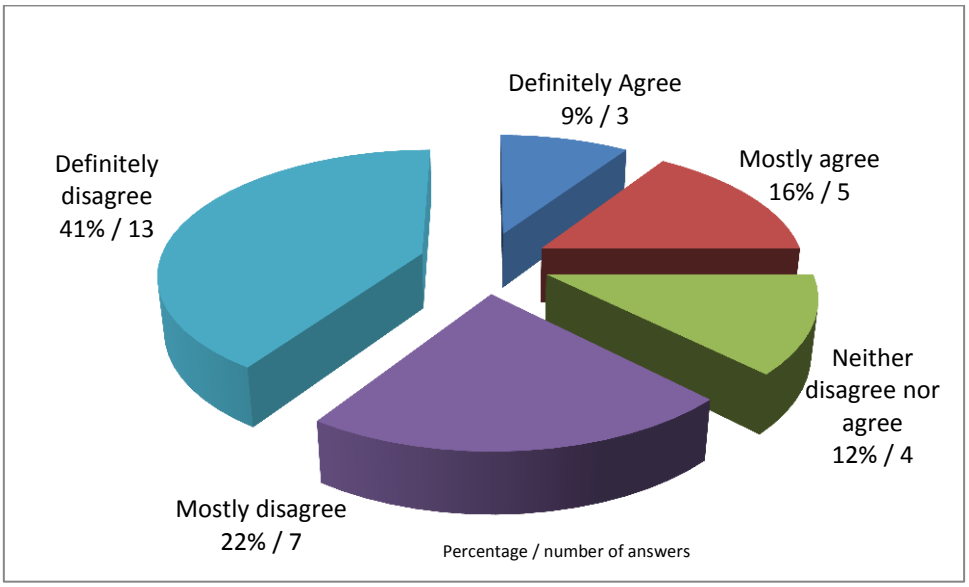


Survey respondents see limited value in CSDs maintaining lists of the names of beneficial owners on each account for anti-money laundering, politically exposed persons screening and counter-terrorism financing purposes.

This suggests that mere knowledge of the names of beneficial owners does not equate to identification of those who might be involved in illicit activity.

Respondents hold the view overwhelmingly that the recordkeeping burden required to maintain individual accounts along the chain would be substantially higher than the benefit.

Figure 10: Is Prohibiting Omnibus Accounts justified in order to prevent Market Manipulation and Destabilisation?

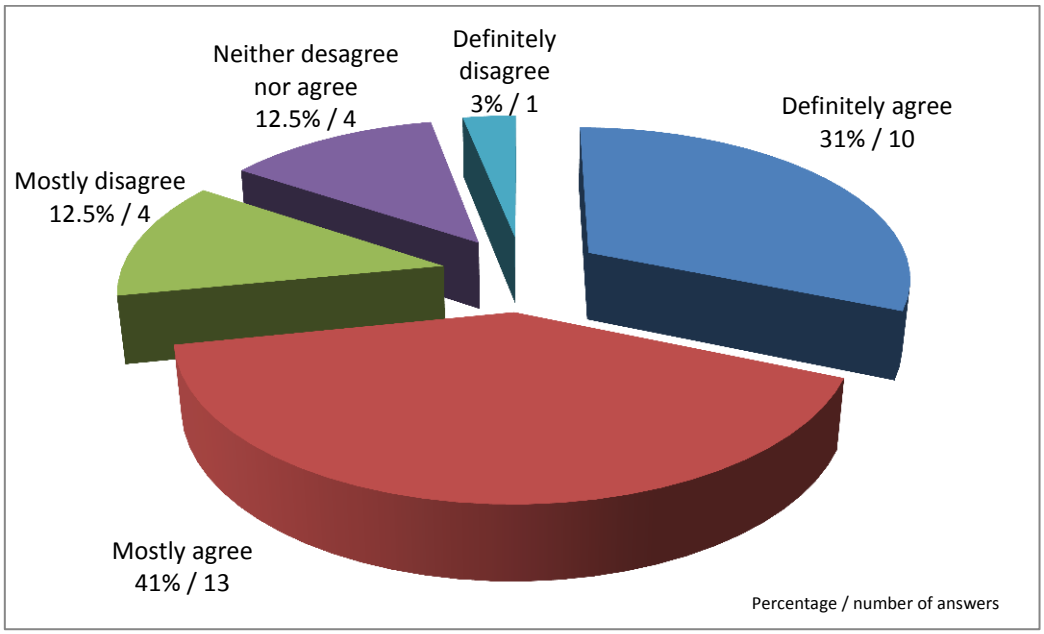


Respondents were asked whether prohibiting omnibus accounts is justified in order to prevent market manipulation and destabilisation.

One quarter of respondents (roughly equivalent to the number whose jurisdictional experience is with segregated or designated segregated accounts) believe that it is justified, while 63% do not believe so.

12% express no view on this subject.

Figure 11: Is the Perception that the Omnibus Account Structure is prone to being used for ML and Terrorism Activity largely exaggerated?



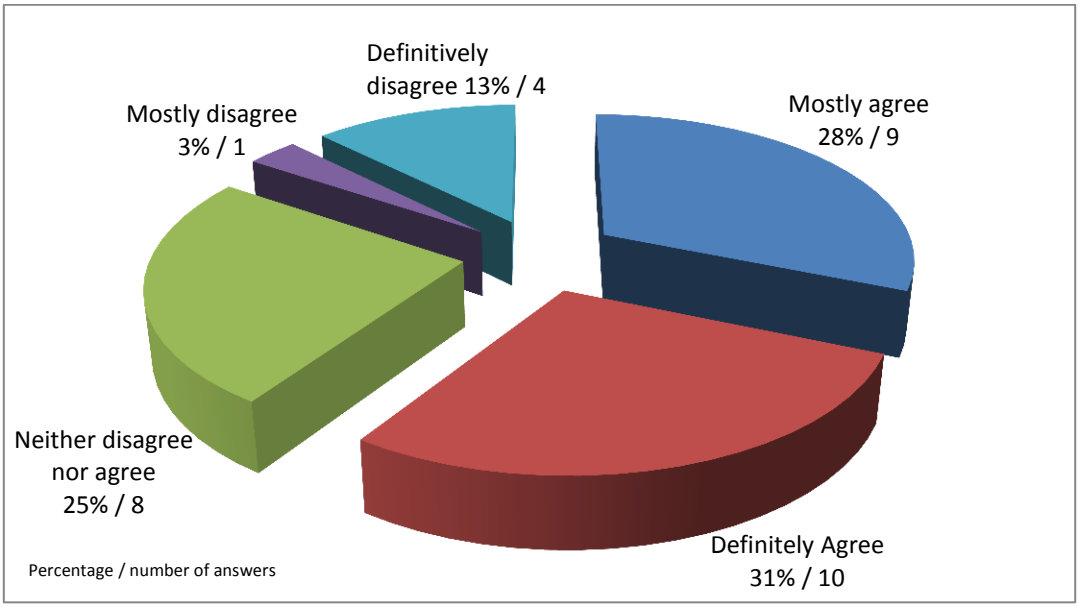
Respondents were asked whether the perception of omnibus accounts being used for money laundering and terrorism financing is largely exaggerated.

This was asked in the context of the view that the omnibus account structure does not impede accurate recording of tax information for all parties involved in securities transactions and for netting purposes.

72% of the respondents agree that the perception is largely exaggerated while 15.5% believe that the perception is right.

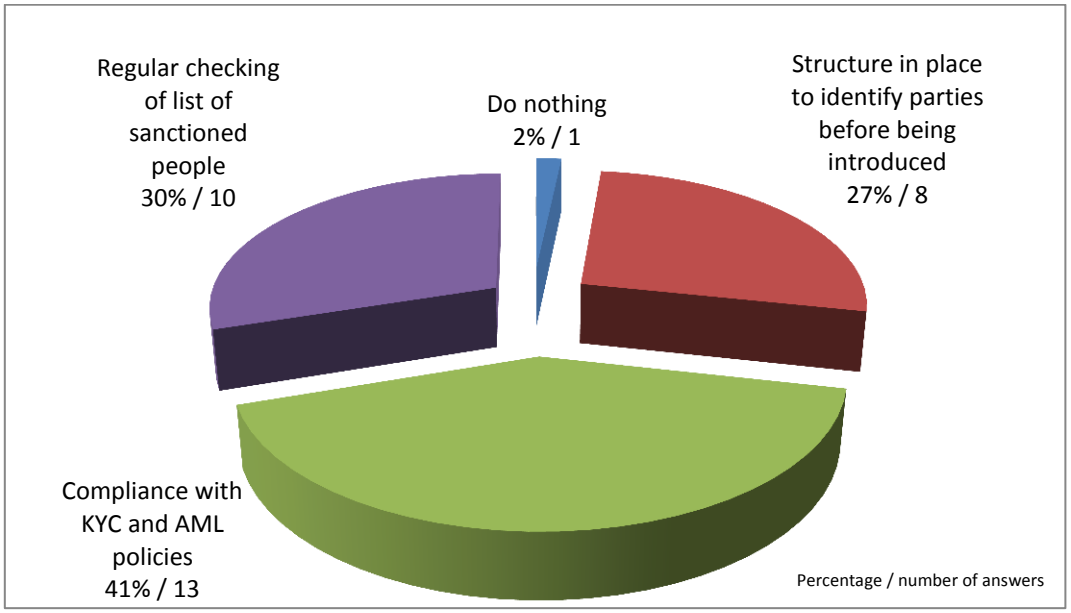
This suggests that most respondents believe the structure still provides for adequate tax calculation and recording and therefore does not aid money laundering and terrorism activities.

Figure 12: If the Name of Beneficial Owners has been identified, is the Identification of their Location also important?



Respondents were asked whether the location of beneficial owners of securities is important since they have been identified by name. 59% of respondents report that their location is important while 41% report that the location is not. This suggests that most respondents believe that the location is important for OFAC to identify individuals from countries that are subject to sanction.

Figure 13: What does your Firm do to protect itself from providing Services to Customers that are Subject to Sanctions?



Respondents were asked to indicate what their firms do to protect themselves from the risk of directly or indirectly providing services to or dealing in securities in which there is an ownership or other interest of parties subject to sanctions.

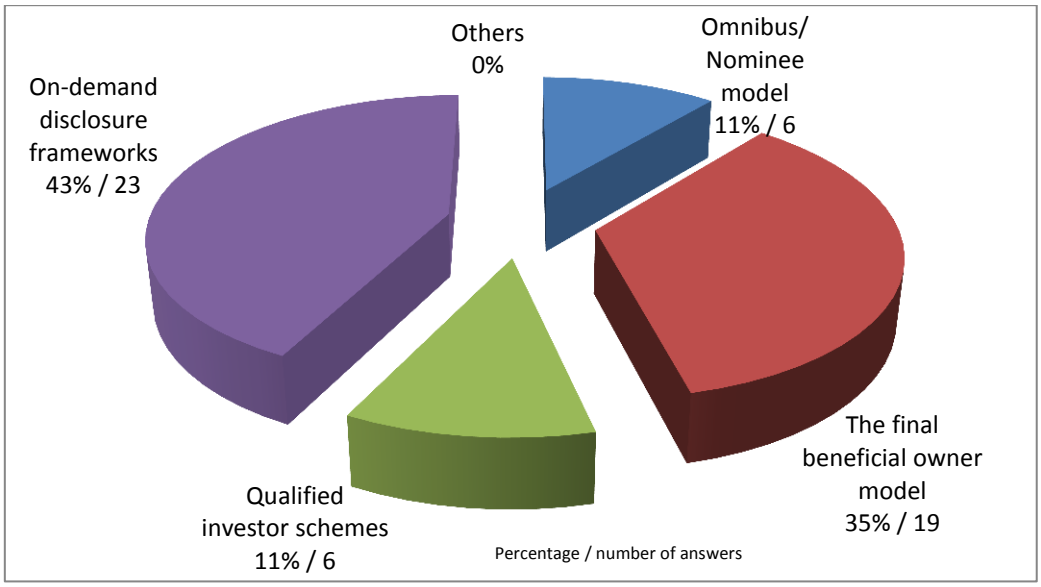
98% of respondents indicate that they are pro-active on sanctions screening.

27% have relevant structures in place; 41% comply with KYC and AML policies; and 30% regularly check the list of sanctioned people.

This suggests that members are careful to ensure that they do not shield criminals through the provision of securities services provided for their customers.

The organisation that indicated "do nothing" operates only domestically in a segregated market.

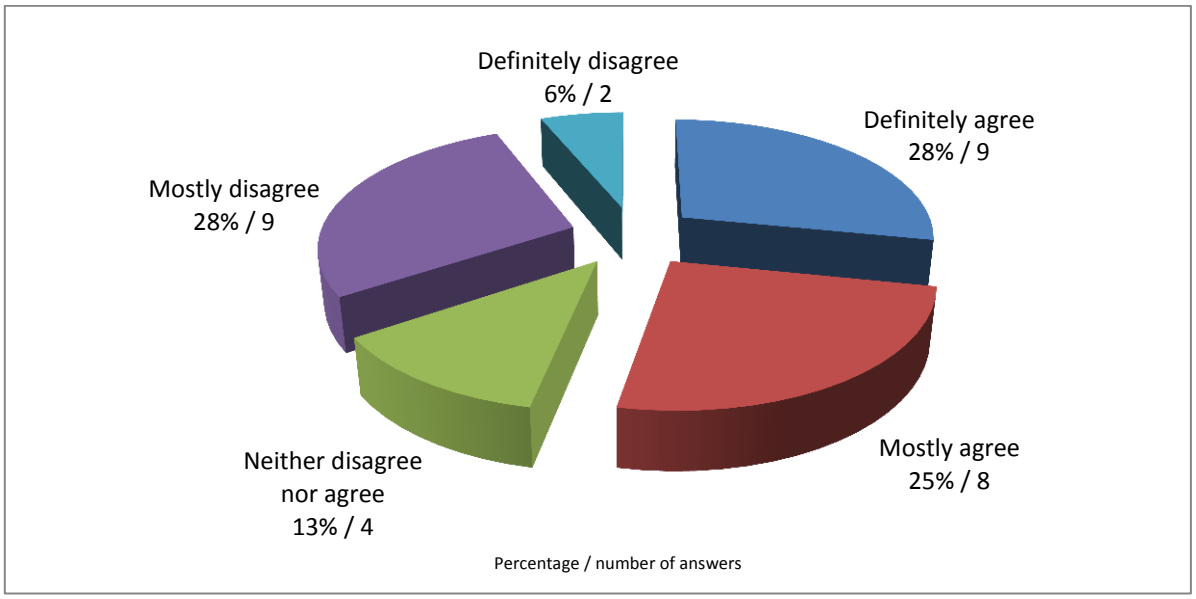
Figure 14: Which Securities Account Structure will aid the Achievement of Identifying Beneficial Owner of Assets within an Account or Transaction?



Firms operating in the securities industry as custodians and intermediaries often face the question of how to accurately identify the beneficial owner of assets within an account or transaction.

43% of the respondents think that the use of on-demand disclosure frameworks by the securities industry would be more effective to identify beneficial owners of assets than any other account structure or tool. 35% give preference to the final beneficial owner model.

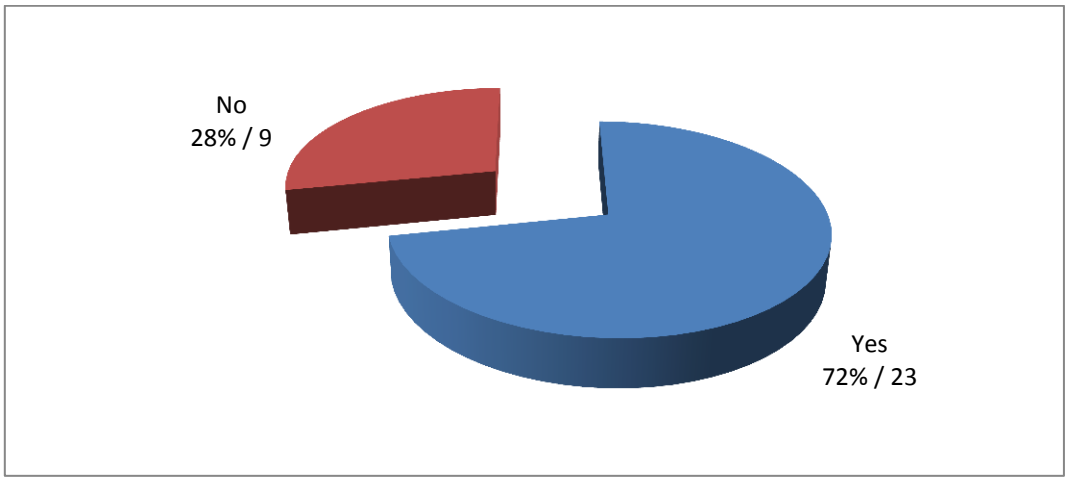
Figure 15: The Account Structure and naming Convention are of paramount Importance to safeguard against the possible Loss of Money to the Investment Community through default of an Intermediary or Fraud.



Protecting against the difficulties of retrieving or porting assets in the event of a default of an intermediary (e.g. Lehman Bros and MF Global) or fraud in financial services (e.g. Madoff) suggests that the account structure and naming convention are of paramount importance to safeguard against the possible loss of money to the investment community.

53% of respondents agree and 34% disagree, meaning that the majority hold the view that account structure and naming convention are critical to ensure that money is not lost to the investment community under a Lehman Bros, MF Global or Madoff-like scenario.

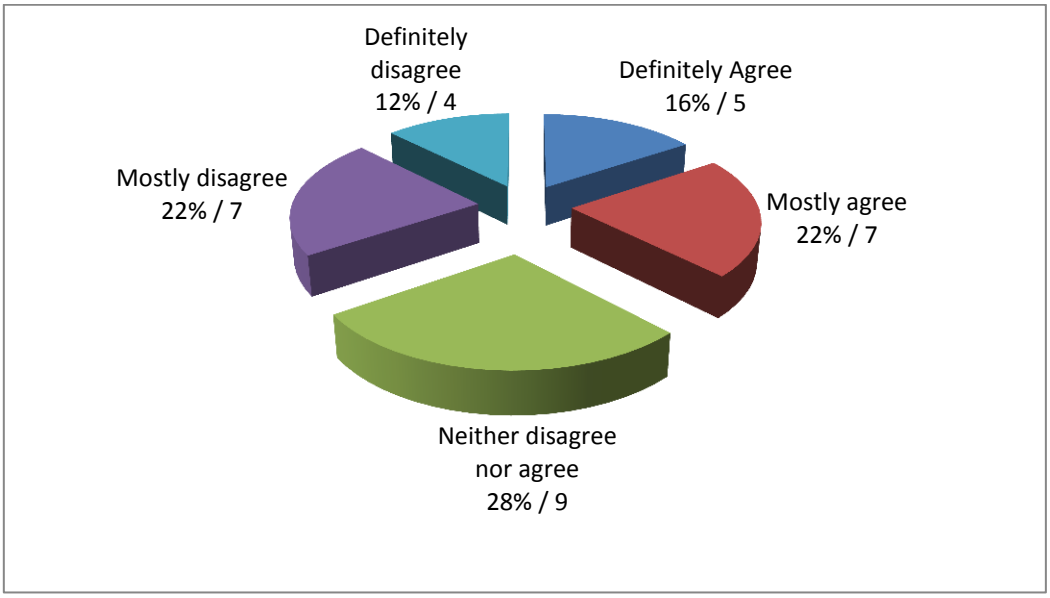
Figure 16: Is the Model of relying upon the first regulated Entity Model in the Custody Chain to undertake KYC Checks on Beneficial Owners still "fit for purpose"?



Respondents were asked whether the model that relies on the first regulated entity in the custody chain as a way of undertaking KYC checks is still "fit for purpose".

72% of the respondents report that the model is still useful as it enables the identification of customers along the securities custody chain.

Figure 17 The Experience of the Payments Industry and its Success at compiling detailed Information in respect of each individual Payment Transaction and who is undertaking them for AML and KYC Purposes would not be a suitable Approach for the Securities Services Industry



The feedback suggests that members do not have sufficient information to offer a view as to whether the payment industry's experience in respect of AML and KYC might be a suitable approach for the securities services industry.

Additional Thoughts from Respondents on the Subject of Transparency in Securities Transactions and Custody Chains

"To have transparent systems, it is necessary to know exactly who the original owner was in a specific chain of transactions, identifying the beneficial owner. The question is at what level this control should be executed; at the CSD or at broker-dealer/custodian level. The regulator of each country should define this level, considering the indirect effects that measures like these could provoke in the execution/settlement of transactions."

"Emphasis should be put on how the various processes/procedures in KYC, AML, FiSa, FATCA, CRS, MIFID, etc. interlink especially between cash management /payments and securities services. Portraying one comprehensive picture would help clients, regulators and media understand better and would result in less micro-regulations."

"Worldwide approval to force financial institutions to identify beneficial owners and to force them to transmit the information up or down the custodian chain is in clear disagreement with data protection issues, banking rules and national law legislation – this is the big issue – not account structure."

"We would support an international solution of standards where the data identifying a beneficial owner might be used across the board, e.g., for tax, for FBA, for client asset protection, for AML. However, we believe the industry needs to preserve the omnibus model to ensure efficiency and scale benefits."

"For more than 40 countries the AEOI is coming soon which will increase transparency. We also see more initiatives with regards to trade repositories, e.g., EMIR-LEI. However, this cuts against efficiency initiatives such as T2S."

"A global standard as well as common understanding and handling in the international securities industry is needed to achieve transparency."

"In order to operate efficiently, particularly as settlement cycles shorten, it is essential to operate pooled nominees. The downsides can be effectively mitigated by a well-controlled custodian."

"Block trading and subsequent allocation as well as CP netting drastically complicate the ability to link ultimate seller and buyer of a security much more so than the ability to link an originator of a payment with the ultimate beneficiary."

APPENDIX B

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