



Dominic Hobson

talks to

Mark Gem



The future of the omnibus account

KYC, AML and sanctions screening are symptoms of rising regulatory pressure for greater transparency into who lies behind cash payments, securities transactions and assets in custody. For custodian banks, this has implications for the future of the omnibus account, which is a primary source of operational efficiency. Dominic Hobson asked Mark Gem, head of compliance at Clearstream, why he sees these developments as an opportunity rather than a problem.

In January this year, Clearstream agreed to pay \$151.902 million to settle with the Office of Foreign Asset Control (OFAC), a department of the United States Treasury, in relation to serving back in 2007-08 as the route by which a country subject to American and United Nations sanctions held securities in the United States. The general learning point that the industry drew from OFAC was a clear alert to firms

operating in the securities industry that omnibus and custody accounts require scrutiny. The principal issue cited by OFAC was that the securities were held in an account structure where Clearstream did not know who the beneficial owner was.

That account structure was an omnibus account, in which fungible interests in the same securities are commingled, and held in the name of the custodian bank. It is such a standard feature of the securities services industry today that global custodians are reluctant to enter markets that do not permit omnibus accounts, and expect their sub-custodians to plead with local regulators for them to be allowed. Both at the time of the Clearstream settlement and in subsequent guidance to the industry as a whole, OFAC has made clear that it expects custodian banks to undertake closer scrutiny of omnibus accounts to identify the ultimate beneficiaries.

The attraction of the omnibus account to custodians is its operational efficiency. 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. However, this creates 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. “Omnibus accounts also reduce transparency, by substituting a record of the identity of the custodian for the identity of the beneficial owner,” explains Mark Gem, head of compliance at Clearstream in Luxembourg.

As he points out, official thinking on transparency into customer accounts has changed. In its 2004 paper on the issue of client identification, the International Organisation of Securities Commissions (IOSCO) did not require custodians to look at owners behind omnibus accounts. Until 2009, the official guidance from another department of the United States Treasury, the Financial Crimes Enforcement Network (FinCEN), was that financial intermediaries were not required to look beyond their immediate counterparties either.

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In fact, in 2003 FinCEN and the Securities and Exchange Commission (SEC) had issued a rule under the PATRIOT Act of 2001 specifically exempting brokers from looking through omnibus accounts. SEC and Commodity Futures Trading Commission (CFTC) guidance issued in 2003 and 2006 had advised brokers to treat the holder of an omnibus account as the only customer whose identity they needed to know.

“Until recently, regulators themselves thought reliance on the first gatekeeper in the chain was sufficient, provided it was a regulated entity,” says Gem. “Because it was a regulated entity, every entity behind it was deemed to be okay too.” These expectations are now changing, initially in the payments industry. In February 2013, the Financial Action Task Force (FATF) obliged banks to conduct full due diligence on their correspondent banks, including an assessment of their anti-money laundering controls, seeking senior management approval of the relationship, and ensuring the correspondent conducted thorough customer due diligence of their own. Importantly, the FATF warned at the time that applying similar obligations to the securities industry was “under consideration”.

In Europe, the Market Abuse Directive (MAD), adopted by the European Parliament in January 2014 and scheduled for implementation in all member-states of the European Union (EU) in 2016, makes the “aiding and abetting” of market abuse a criminal offence. According to Mark Gem, this may argue for more thorough investigation of beneficial ownership. “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,” he says.

Gem warns that assuming MAD applies mainly to the front office rather than the back is a mistake. “The regulators will go for the tallest guy in the room and will not distinguish between front and back office,” warns Gem. “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.”

At Clearstream, unsurprisingly in the aftermath of recent events, the hard thinking about

what to do is already well under way. “It got me thinking about combining two things,” says Gem. “What can we do to preserve the benefits of the omnibus account model while better regulating the potential for abuse?” The obvious solution is for the securities industry to abandon omnibus accounts and switch to beneficial owner accounts everywhere. Gem thinks this would be inadequate, since it would still not identify any beneficiaries beyond the immediate principals to a trade. It would also be inefficient for the industry.

“It would not be good for the industry we work in,” says Gem. “Omnibus accounts create tremendous economies of scale, with consequent reductions in processing costs, which makes markets more open to a wider range of investors. It is difficult, on a named account basis, to see how capital markets could operate in the way that they do today.” As he points out, this is precisely why TARGET2-Securities (T2S) endorses omnibus accounts. Gem accepts regulations (such as the Alternative Investment Fund Managers Directive, AIFMD, which insists on segregation of customer assets) and investors (who think it provides additional protection in case of bank failure) are driving the industry towards segregated accounts. But he still argues it is better to regulate the flaws in omnibus accounts than to get rid of them altogether.

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One way to do this is to copy what the payments industry has done. The SWIFT MT 202/5 message series has since 2009 ensured that correspondent banks always know the iden-

tity of both the payor and the payee of any payment. It is a measure of the rising regulatory focus on this issue that the Basel Committee on Banking Supervision nevertheless argued the same year that existing payments message standards did not go far enough in delivering full transparency, because they do not carry information about originators and end-beneficiaries.

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Gem thinks the securities industry needs to develop messages which include at least the same level of information as the MT 202/5 messages. A SWIFT securities settlement instruction currently allows the instructing party to mention all the receiving and delivering parties to the transaction, the cash settlement parties, and a number of other parties that are sometimes required in specific markets for regulatory or tax purposes. In other words, securities settlement instructions already cover a wide range of parties that could easily meet any regulatory requirements enforced in the future, but existing standards require only two parties in the settlement chain to be disclosed.

This is actually one fewer than the SWIFT Securities Market Practice Group recommends. “In terms of transparency, a gap has opened between payment standards and securities standards,” says Mark Gem. “If you look at the structure of the typical payments message and compare it with the typical securities settlement instruction, you can see that screening for PEPs, money launderers and sanctioned countries is quite an industry in payments,

but that there is nothing similar in securities. Transparency in the securities industry and in the payments industry is not equivalent.”

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In fact, since 2007, eleven payments banks have operated to the so-called Wolfsberg Correspondent Banking Standards, which introduced with the co-operation of SWIFT an enhanced message format designed to include more information about the principals to a payment. The Wolfsberg principles explicitly jettison reliance on regulatory equivalence, and advise correspondent banks to assess every counterparty thoroughly, including their clients.

While the adoption of a set of global standards appeals to a securities industry that has a strong interest in the adoption of a consistent approach by regulators everywhere, Gem worries that they will not go far enough for regulators. In the United States, SEC Rule 613 now requires firms to establish a “consolidated audit trail” in which brokers are expected to know the customer of their customer in each transaction. Theoretically, this “handshake” methodology enables regulators to move steadily back up the chain to find the beneficial owner. But it will not work across borders, unless regulators everywhere adopt the same approach.

In this lack of global reach, Mark Gem senses an opportunity for the securities industry to avert an unhelpful regulatory imposition by adopting a variant of the “handshake” methodology. He calls it “mandatory second level matching.” In this model, the custodians on either side of a securities transaction would

match the trade details of the customer of their customer and not just the trade details of their own customer. In other words, the details of the second-level beneficiary of a transaction would be included in settlement instructions along with the details of the originator of the message.

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It has the advantage of being a familiar practice already. “In a number of domestic markets we already have to provide second level matching, because that is the local regulatory standard.” says Gem. “It is one of the tools we have available already.” He adds that information about the clients’ underlying tax reclaims could also prove useful, because in many jurisdictions only pre-qualified investors can make tax reclaims. For an industry swamped by regulatory demands, the adaptation of existing data sets and markets practices to an additional purpose can help to contain the cost of compliance with rising regulatory demands for greater transparency.

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