CDD -The Compliance View

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Initial Situation

- There are **notable parallels** between the situation of a correspondent bank offering services to foreign financial institutions and the situation of a securities intermediary offering omnibus account. An equal amount of value is transferred cross-border by securities intermediaries in the form of settlement messages than by the cross-border payments industry.
- In that sense, it is meaningful to test the securities processing industry against the standards set by the **Basle Committee on Banking Supervision** when setting out its case for the development of standards governing cover payments involving intermediate financial institutions.

Initial Situation

*"Existing messaging practices do **not ensure full transparency** for the cover intermediary banks on the transfers they facilitate… Lack of originator and beneficiary information for funds transfers **can hinder or limit** a cover intermediary bank's ability to accurately assess risks associated with correspondent and clearing operations. The cover intermediary bank would also be unable to screen transactor information against locally applicable lists of individuals or entities whose assets, under local law, must be blocked, rejected or frozen. This could be particularly problematic where the list of the intermediary bank's country is more comprehensive than the list of the originator's (or beneficiary's) country… To comply with locally applicable requirements, such as the blocking, rejecting or freezing of assets of designated individuals or entities, cover intermediary banks thus might need to receive originator and beneficiary information."*

Basel Committee on Banking Supervision; *Due diligence and transparency regarding cover payment messages related to cross-border wire transfers*, May 2009.

What should capture our attention here is that the situation of a financial institution settling a securities trade is **similar** to that of an intermediate financial institution; assets can be transferred between parties whose **identities are not known** to the institution.

Initial Situation

The **FATF** Glossary defines a "**financial institution**" as including a person or entity that, among other things, conducts as a business the following activities:

- The transfer of value or money;
- **Trading** in :
  - (a) money market instruments such as cheques, bills, certificates of deposits (CDs), **derivatives**, etc.;
  - (b) foreign exchange;
  - (c) exchange, interest rate and index instruments;
  - (d) **transferable securities**;
- **Participation in securities issues** and the provision of financial services related to such issues;
- Individual and collective portfolio management;
- The **safekeeping** and administration of cash or **liquid securities** on behalf of other persons;
- Otherwise investing, administering or managing funds or money on behalf of other persons; and
- Underwriting and placement of life insurance or other investment related insurance.

Initial Situation

*While the activities of **securities industry** participants do not constitute a distinct activity category under the 40+9 Recommendations, the activities described in the questionnaire responses **fall squarely within the FATF's definition of a financial institution**. However, and perhaps not surprisingly, the full scope of securities industry activity is broader still. As such, a **more detailed overview of the industry is needed in order to fully appreciate its ML/TF vulnerabilities**. As the complexity of products and the diversity of the actors in the securities industry continue to expand, it is suggested that the FATF keep under consideration the extent to which the definition of "financial institution" still covers Persons engaged in activities associated with the securities industry.*

2009 FATF Report: **Money Laundering and Terrorist Financing in the Securities Sector**

A Best Practice approach

- The standard must ultimately be that the intermediaries served by a custodian, depository or settlement agents must put their provider in a position to **comply at all times with its own standards, applicable laws and regulations**.
- A question which must be answered is whether the standard can be achieved by defining better what is meant by "**equivalent regulation**", what standards that implies and what representations should be sought from market participants.
- The payments industry did take steps to better due diligence approaches notably through the **Wolfsberg Principles**. But the payments industry was also confronted with regulators requiring the development of messaging standards.
- Securities Industry has **not yet crossed that frontier** and have the opportunity to ask whether the development of due diligence standards might not be an adequate response to the challenges of transparency.

A Best Practice approach

Account Structure

A potential accompaniment to the definition of best practice principles would be to regulate better the use of the **omnibus account**. The extreme version of this solution would be to move away from the nominee / omnibus model completely.

Leaving aside the question of the benefits of the omnibus model, one difficulty with this approach is that it would only identify the principals behind securities transactions rather than the successive layer of the intermediation chain if the industry put in place additional features.

A Best Practice approach

A better approach might be to regulate the conditions under which securities intermediaries offer omnibus accounts. At present, omnibus accounts are generally offered only to regulated financial institutions.

The questions that might be considered here are;

- Should the omnibus account be restricted only to those financial institutions whose control frameworks are adapted to securities intermediation?
- What would be the salient characteristics of those frameworks?
- Should the omnibus account be restricted to financial institutions subject to “internationally recognised” regulations? What are these?
- Should the omnibus account be restricted to those financial institutions who have “signed up” to commonly-recognised best practice principles such as ISSA might develop?

Potential technical approaches

The securities equivalent of the MT202 COV

An equivalent of the MT202 / 205 COV could be introduced for MT5XX messages

Advantages

- Would not disturb existing account structures
- Would enable meaningful screening of transactions by providers with a limited investment in standards
- There are **“off-the-shelve” Solutions** available that would require minimal adjustments
- Most banks already use one or the other automated screening solution
- Participants are authenticated
- Full **audit trail**
- Proven and tested for cross border transactions
- **Quick** access to information

Potential technical approaches

A handshake model?

Each regulated intermediary would communicate details of its own, immediate principals to its upstream agents and depositories akin to the SEC Rule 613 system providing full transparency across the system as a whole.

Advantages

- Participants **do not need to acquire all of the counterparty information themselves** replicating it redundantly along the transaction chain
- Would re-use the technical standards of second-level matching, minimising investment
- For non banks or banks without large transaction banking business it requires **less investment in infrastructure**
- From a data protection point of view , no aggregation of data

Disadvantages?

MT5xx COV

- The operating costs of screening third party data would be very significant for institutions that do not already use a screening solution e.g. Institutions without Transaction Banking, little international presence
- The risk exposures arising from that data might pose challenges – what about the things we could have found but did not?
- functional only with respondents that got properly assessed

Handshake model

- The regulators might ultimately require a different standard – handshake model is work intensive at the regulator's end.
- on a cross-border level there is no one regulatory agency with the authority to acquire the information from each intermediary to obtain a consolidated view of the principals and the actors involved in a given transaction
  - would require international cooperation of regulators/law enforcement.
  - Fully functional only within same or equivalent regulation
- Relatively slow access to full data trail

What Do I need to know?

MT5xx COV

- Who are our immediate principals?
  - Name
  - Address (incl. Country of incorporation)
  - Management structure (branches, subs, affiliates, headoffice)
  - Beneficial owner(s)/Ownership structure
  - Products and Service offered
  - Adverse Media (?) e.g. Recent enforcement?
  - CDD standards
  - Name of AML Officer
- Intermediaries?
- Underlying Originator/Beneficiary
  - Name
  - Address
  - Unique identifier
- Securities transferred
- Amount transferred

Handshake model

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  - CDD standards
  - Name of AML Officer
- Who are my upstream Agents?
- Securities transferred
- Amount transferred

Similarities

- MT5xxCOV vs. Handshake model – can one or the other exit on an isolated basis?
- Both not possible without **common** international **standards on CDD/KYC** adhered to by all participants in the chain.
  - An institution can only rely on correspondents if it has assessed or knows the correspondent's KYC/CDD approach
  - An internationally agreed approach creates a level playing field for all participants in the market
  - Potential for centralized solutions internally and externally e.g. central/joint CDD/KYC repositories offered by third parties

Similarities

One of the main components of all mentioned approaches is Know Your customer:

- CDD
- Experience during client relationship
- Know if one can trust or needs to mistrust its business partner
- Feel at home in a common/equivalent regulation

CDD is not new and was never limited to banking industry only!

- KYC / CDD is not only about AML, Sanctions and Terrorism Financing!
- Who would lend money to an unknown?
- How do we manage credit risk without knowing your client?
- How do we manage your reputational risk without knowing your client?
- Already the Italian Merchants or Vikings of the medieval times did only trade with whom they knew
- How do we investigate in case of a dispute?
- How do we debit/credit tax? (FATCA!)
- We are not restricted on dealing in the same or an equivalent regulation

Conclusion

- The industry could and perhaps **should do more** to establish the principles to which securities intermediaries would be expected to adhere and the representations to complement them. If properly implemented, **such a standard could forestall and pre-empt calls for further transparency** and the costs and risks that such a direction would bring.
  - 2004 IOSCO
  - 2008 MONEYVAL criticized the vulnerability of the securities sector
  - 2009 FATF issued a report on “Terrorist Financing in the Securities Sector”
  - 2014 Enforcement on Clearstream
  - 2014 OFAC FAQ on Clearstream Sanctions Case

- In conclusion, because of recent market evolutions **there may be a case for developing best practices or standards** to provide greater levels of transparency in order to protect the industry and satisfy the expectations of the authorities. Any evaluation of this should include not only the cost of implementing such new standards but also an assessment of any additional liability that may result.

Conclusion

- In the event that it would not, the options available involve investment and complexity. Nonetheless, it is also clear that no actor can implement tighter standards alone.
- The case for protecting the model of intermediated securities holdings should arguably be developed and communicated alongside measures to reinforce it and address the challenges of transparency.
- In the event that it would not, the options available involve investment and complexity. Nonetheless, it is also clear that **no actor can implement tighter standards alone**.
- The system of intermediation enables over USD 120 Trillion of securities in issuance to be concentrated into (I)CSD accounts by a relatively small number of financial institutions intermediating the interests of the global economy as a whole. The case for protecting that model should arguably be developed and communicated alongside measures to reinforce it and address the challenges of transparency.
- To rely on a counterparty an institute needs to be satisfied that the counterparty **acts to the institutions standards r**ather than to the counterparties'
- Best practice for CDD/KYC as **a first step** on a long way
- Better we do it **before** the regulators impose it - change is the only constant

Questions to consider

1. **Account opening/maintenance and transaction monitoring**
   - What compliance standards does your primary regulator require for account opening/maintenance, asset safekeeping and transaction monitoring, where you operate an account where the beneficial owner is not designated or disclosed?
   - What is covered (e.g. money laundering, terrorist financing, tax evasion, OFAC)?
   - Does your monitoring extend to such things as trading abuses e.g. penny stock “pump and dump” abuses?
   - Does your monitoring focus mainly on trading and transaction activity (including Securities Lending / Repo) or also extend to asset safekeeping and collateral management activities.
   - How are these standards influenced by foreign regulators and what complexities does operating a global business put on the table in terms of regulatory mis-alignment?
   - What regulations are impacting your clients (e.g. AIFMD) and how are these impacting approaches from your clients for greater account designation, segregation and activity monitoring?
2. **How do your rules/contracts enforce compliance standards**
   - What compliance standards do your rules/contracts impose on participants/clients and how do you monitor?
3. **Recent changes to compliance standards**
   - Have these standards changed in last 5 years and, if so, how and what drove these changes?
4. **Future changes to compliance standards**
   - What changes do you anticipate in the next five years and what is driving them?
5. **Obligation to inquire?**
   - Do you operate under a standard that requires you to scrutinize all data sent to you but not to make any further inquiries beyond that unless suspicious activity is suspected?

Questions to consider

6. **What if your regulator required compliance at the beneficial owner level?**
   - Do they require that standard today?
   - If not and the regulator required tracking of transactions/ custody at the beneficial owner level, would you advocate:
     - Full segregation at beneficial owner level (no omnibus accounts)
     - Consolidated audit trail tracking
     - Securities equivalent of MT 202 cover message (payer and end beneficiary)
     - Other
   - Who would be responsible for each of these alternatives –you or your participant/client?
   - What costs/implementation challenges would you anticipate under each of the alternatives suggested in 6b above?
   - Do you see more transparent beneficial owner tracking as a beneficial development in terms of regulatory compliance and investor protection, or do the existing practices of leveraging omnibus accounts constitute a best target practice model in your eyes?
7. **Compliance risks of beneficial owner level tracking**
   - Review the risk to you of each alternative under question #5 (6)
   - Do you have concerns that by increasing tracking of beneficial owner data by your firm that this may materially increase your business compliance risks?

Contact

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