
ISSA Symposium Transparency in Securities Transaction and Custody Chains

May 2014

Confidential

Transparency in securities processing

Background

Compliance has become a major focus for financial services, but the securities industry has been relatively lightly affected.

There are three trends that might cause us to question the compliance framework in which the industry works:

1. Increasing regulatory attention and focus on sanctions enforcement and counter-terrorism measures has led to new standards and processes in correspondent banking. Some of those standards might be relevant for us too
2. Concerns that the lack of transparency in securities trading have led the SEC to adopt new standards that depart from traditional guidance
3. The settlement between Clearstream and US Treasury highlighted differing expectations between the industry and enforcement authorities.

The working group paper aims to provoke and industry wide discussion into the transparency in securities transactions and custody chain at the ISSA Symposium which is taking place from 20 to 23 May.

What is the issue?

Transparency in intermediated custody chains

- The global system under which securities are safe kept and settled is based on a clear distinction between **beneficial and legal ownership**.
- The practice of **co-mingling fungible interests** brings benefits to the market and to end investors because it creates large economies of scale, low transactional costs and promotes a degree of liquidity and mobility of securities and collateral that has become a cornerstone of market stability.
- To achieve that, the global system intermediates many players into securities custody **transforming the legal ownership of securities interests multiple times**.
- But the omnibus model also reduces transparency by **substituting a record of the end investor's identity** for a record of the custodian's or the broker's identity.

The management of the compliance risks is made the more challenging by the lack of transparency

Bad guys and omnibus accounts



The Beneficial Owner ...

... is a client of an institution
somewhere ...

...which is a client of a bank ...

... who deposits the assets
somewhere...

Is the existing standard clear?

- Custodians, depositories and clearing agents must perform **customer due diligence** for all accounts and extended due diligence on those customers deemed to be higher risk.
 - The lack of visibility of custodians and securities settlement agents over the principals of the securities whose transactions they process has been mitigated by the principle of “**equivalent regulation**”.
 - Where a securities intermediary is a regulated financial institution (and so is “equivalently regulated”), it does not generally disclose to its custodians, settlement agents and depositories for whom it is acting **on the basis that it itself has performed due diligence and KYC on its own clients**
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In comparison to other areas of financial services, there has been little discussion at policy-making level about how compliance risks should best be managed in the context of the nominee account.

Principles on Client Identification and Beneficial Ownership for the Securities Industry – IOSCO 2004

- The **objective** of the paper was to ensure that securities service providers identify their clients and beneficial owners in order to prevent fraud and market abuse whilst acknowledging that policy goals relating to money laundering and terrorist financing would also be served.
 - The paper argues that securities services providers should be compelled by regulation to identify clients and beneficial owners but also to put in place “**specific Client Due Diligence policies for omnibus accounts**”.
 - **IOSCO stopped short of recommending that securities service providers look behind their regulated omnibus account holders**
- IOSCO recommended that when dealing with foreign holders of omnibus accounts, providers should be required to;
- *Understand the business and professional reputation of the omnibus account holder;*
 - *Assess to adequacy of the omnibus account holder’s Client Due Diligence process*
 - *Assess the regulatory and oversight regime of the country of the omnibus account holder in order to establish that it is subject to equivalent client due diligence standards*
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The approach of IOSCO was explicitly embraced by other regulators

- **FinCEN** and the **SEC** jointly issued a rule under the PATRIOT Act in May 2003 specifying that “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.”
- In guidance issued in October 2003, the **US Treasury** and the **SEC** made clear that even when broker-dealers have information regarding a financial intermediary’s underlying customers, they should treat the holder of the omnibus account – as the sole “customer” for purposes of the customer identification program rule.
- **FinCEN** and the **CFTC** issued almost identical guidance in February 2006.

Is it sufficient for us to rely on the first regulated intermediary in the chain to identify the beneficial ownership?

- The regulatory guidance, though explicit on exempting securities intermediaries from any requirement to look through their regulated customers, has been silent on the consequences of a violation caused by the unidentified client of regulated account holder.
- There are signs that regulators are increasingly likely to challenge the principle of “equivalent regulation” in the area of beneficial ownership identification.



“a vulnerability to money laundering exists because a securities intermediary may not know the beneficial owner of an investment if held in an omnibus account maintained for a (foreign) financial institution”.

Moneyval / FATF, 2009

“Clearstream provided the Government of Iran with substantial and unauthorized access to the U.S. financial system. Today’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.”

OFAC Director, Adam Szubin

23 January 2014

OFAC also issued general guidance to the securities industry in January 2014

What can (custodians and securities intermediaries) do to protect themselves from the risk of directly or indirectly providing services to—or dealing in property in which there is an ownership or other interest of—parties subject to sanctions? Best practices include:

- Making customers aware of the firm’s U.S. sanctions compliance obligations and having customers agree in writing not to use their account(s) with the firm in a manner that could cause a violation of OFAC sanctions.
- Conducting due diligence to identify customers who do business in or with countries or persons subject to U.S. sanctions. Such customers may warrant enhanced due diligence.
- Imposing restrictions and heightened due diligence requirements on the use of certain products or services by customers who are judged to present a high risk from an OFAC sanctions perspective. **Restrictions might include limitations on the use of omnibus accounts, where a lack of transparency can be exploited in order to circumvent OFAC regulations.**
- **Making efforts to understand the nature and purpose of non-proprietary accounts**, including requiring information regarding third parties whose assets may be held in the accounts.
- Monitoring accounts to detect unusual or suspicious activity – for example, unexplained significant changes in the value, volume, and types of assets within an account. These types of changes may indicate that a customer is facilitating new business for third parties that has not been vetted for possible sanctions implications.

Market abuse measures are also driving increased transparency

- In the **EU**, the Market Abuse Directive which was adopted by parliament in January 2014 and which is scheduled for transposition in 2016 seeks to extend market abuse protections more explicitly to the OTC markets. Amongst other things, the directive will criminalise the “aiding and abetting” of abuse.
- In the **United States**, with its Rule 613, the SEC has issued requirements for securities broker-dealers to establish a “consolidated audit trail” of securities transactions forcing the communication of the identities of the buyer and the seller to each intermediary involved in the execution of a trade. The requirement does not, however, extend to the settlements of the trades.

The payments industry

Is this where we're headed?

Transparency

- The introduction of the **MT202/5 cover** message in 2009 harmonised the transmission of payer and final beneficiary details cover payments
- An MT202/5 COV is designed for use when two financial institutions effect a payment through correspondents
- Final payor and beneficiary details are therefore also known to the **underlying correspondents**
- The standard has driven an **exponential increase in the operating costs and risks** of correspondent banking

The Wolfsberg Correspondent Banking Standards

- Financial institutions should not rely solely on the fact that a foreign correspondent is subject to an internationally-recognised regulatory environment
- The financial institution should assess the foreign correspondent's geographic risk, its branches, subsidiaries and affiliates, its ownership and management structures, its underlying business, its customer base, the products and services offered, its regulatory history and the effectiveness of its anti-money laundering controls.
- The downstream relationships of the correspondents should be understood

Due diligence and transparency regarding cover payment messages: Basle Committee on Banking Supervision, 2009

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.

... 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.

But we're different, right?

- SWIFT FIN messages are evenly split between securities and payments volume
- High value payment systems and security settlement systems have similar cross-border turnover by value

How are we similar?

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.

How are we different?

Payments are made for almost any purpose and in almost any context. Securities trades and transfers are made in a much more homogenous environment and often but not always on regulated trading forums.

A Hint from the Authorities?

The correspondent banking industry was required to transmit principal data down the payment execution chain

Its situation is analogous to that of securities intermediaries in certain respects

Have the authorities ever taken a position on this point?

INTERPRETIVE NOTE TO RECOMMENDATION 13 (CORRESPONDENT BANKING)

The similar relationships to which financial institutions should apply criteria (a) to (e) include, for example those established for securities transactions or funds transfers, whether for the cross-border financial institution as principal or for its customers.

Possible approaches; Can we remain what we are?

- Defining best practice standards
 - Regulating more strictly than today the use of the omnibus account
 - Developing tools and technologies:
 - ❖ Incorporation of originator and beneficiary details in third party settlement messages
 - ❖ Handshake methodologies
 - ❖ Others?
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Defining potential solutions and approaches; a possible principle

Intermediaries served by a custodian, depository or settlement agent must put their provider in a position to comply at all times with the provider's own standards, applicable laws and regulations.