

Post Trade Settlement Committee Task Force on Settlement Internaliser (with links to Account Structure)

Settlement Internaliser considerations: issues and proposals 8th April 2013

Background

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. The AFME Post Trade Division is AFME's European post trading centre of competence. Its members are the major users of international securities markets. The Post Trade Division acts as an agent for change, providing and supporting solutions in securities clearing, settlement and custody, to reduce risks and increase efficiency for market participants, representing its members' views towards market infrastructure organisations and public authorities.

Of the broader AFME membership (see www.afme.eu) the following members – investment banks, regional and global custodians and wealth management / private banking – actively participate in the Post Trade Division: Banco Santander; Bank of America Merrill Lynch; Barclays; BNP Paribas; Bank of New York Mellon; Citi; Credit Suisse Securities Europe; Deutsche Bank; Goldman Sachs; HSBC; J.P.Morgan Chase Bank; KAS Bank; Morgan Stanley; Nomura International; Nordea Bank; Royal Bank of Scotland; Société Générale; UBS Investment Bank; UniCredit Group.

This paper was prepared by a Task Force of the AFME Post Trade Settlement Committee.

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1. Purpose, Scope, Definitions and Methodology

Purpose

The purpose of this paper is to contribute to the debate on the practices relating to settlement internalisation, explaining the benefits and downsides, as well as build upon the previous AFME paper on Central Securities Depository (CSD) account structures, and taking the new legislative discussion into account, set out the operational challenges and potential asset protection levels afforded by omnibus vs. segregated account structures. This paper seeks to clarify the following:

- The definition of Settlement Internalisation
- The purpose of Settlement Internalisation, and the participants
- Why the concern on Settlement Internalisation?
- The consequences of CSDR in relation to Settlement Internalisation
- The consequences of a ban on settlement internalisation with enforced settlement at CSD level
- AFME recommendations on Settlement Internalisation

Scope & methodology

The core scope of this paper relates to securities settlement (Equity & Fixed income products) across Europe (although application could be applied on a global basis). The paper focuses on internalisation at intermediary (including investor CSD) levels in the post trade chain and focuses on the operational impacts associated with this practice rather than the legal aspects.

Settlement internalisation should not be confused with the term *systematic internaliser* which is a practice at trading level and which is dealt with by MIFID.

The practice of netting positions at a Central Counter Party (CCP) should also be considered out of scope as this netting is done prior to settlement instructions being sent to a CSD or intermediary. However, if the buyer and the seller in an electronic trading area are the same entity, there is a market practice of "clearing prevention" which means that no netting will take place over the CCP but there is a settlement internalisation that follows outside the CCP.

It is the case that all business activity, and all questions of CSD account structure, are dependent on the applicable legal environment, and that frequently it is national law that determines account structures at a national CSD.

This paper takes a set of principles and an operational and functional analysis of business activity, in order to derive a set of requirements and considerations that it believes should apply to the outside environment, including the legal environment.

Definitions

The latest draft of CSDR defined the settlement internaliser as follows:

(3a) 'settlement internaliser' means a credit institution or investment firm or third-party firm authorised in accordance with Directive 2006/48/EC or with Directive.../.../EU [new MiFID] which executes transfer orders on behalf of clients or on its own account other than through a securities settlement system;¹

At AFME, we do not believe that this definition describes the process of settlement internalisation and instead is more akin to “systemic internaliser” as defined in MiFID, because this definition refers to execution rather than settlement.

Settlement Internalisation could be defined as:

(3a) 'settlement internaliser' means a credit institution or investment firm or third-party firm authorised in accordance with Directive 2006/48/EC or with Directive.../.../EU [new MiFID] which executes settlement instructions on behalf of clients or on its own account other than through a securities settlement system;

This is the practice whereby;

- An intermediary holds more than one client's securities in an omnibus account (in a country where the intermediary or nominee concept is legally accepted) at a CSD (Issuer or investor) or local agent; and
- One client of the intermediary wishes to sell (deliver) the same securities as another client of said intermediary wishes to buy (receive); and
- The delivery and receipt of those securities will be fully or partially settled between the 2 clients, with movement entries being recorded on the books of the intermediary; and
- No instruction for delivery or receipt of securities will be passed to the underlying CSD or intermediary where the omnibus account is held.

Please refer to annexe 1 which provides definitions of the terms that are referred to in this overall definition.

Settlement Internalisation is possible on different layers where the counterparties of the settlement are with the same intermediary; international level (Global Custodians,) and national level (local agents).

AFME believes that investor and International CSDs also practice “settlement internalisation” but they are not covered by the above definition because they operate a Securities Settlement System. It is paramount that any legislation (requiring reporting or otherwise) be applied to these activities as well in order to ensure a level playing field.

¹ Report (A7-0039/2013) on the proposal for a regulation of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDs) and amending Directive 98/26/EC (COM(2012)0073 – C7-0071/2012 – 2012/0029(COD)) Committee on Economic and Monetary Affairs; Rapporteur: Kay Swinburne; ARTICLE 2 (Definitions) Paragraph 3(a) as proposed by Kay Swinburne and Sharon Bowles in their amendment 213 of the text)

2. Settlement Internalisation Rationale

As a result of the omnibus account with nominee concept, intermediaries & their underlying customers can benefit from settlement internalisation in several ways:

- The costs of an internal settlement will be considerably less than the costs of a settlement that is carried through to the CSD level. This cost differential is based on the fact that there is at least one less set of settlement instructions required. No settlement instructions will need to be sent to the issuer CSD level and/or the next intermediary level;
- Efficiency: There will be fewer real world settlements that need to be effected in a given market, as these can be done on the books of a single intermediary rather than both on the books of an intermediary and again at the issuer CSD level. This means that timescales for settlement can be set by the intermediary rather than having to meet CSD deadlines;
- The earlier in the intermediary chain the settlement will take place, the quicker and more efficiently final settlement will be achieved;
- There will be at least one fewer set of reconciliations as there will be no need to reconcile the settlement movement at an issuer CSD or next intermediary level. This increases efficiency, reduces risks (one less reconciliation to get wrong) and reduces sets of operational costs at intermediary and CSD levels;
- Static data maintenance is done at the client holding intermediary level, with no need for it to be duplicated at the CSD: The intermediary will hold the details of the underlying beneficiary on its books, ensuring that the assets held in their client omnibus account at issuer CSD level match those assets that they maintain for customers on their records. Duplicating at the CSD adds further cost and potential for risk of data to be maintained incorrectly with the risk of reconciliation breaks and potential fails. A further concern would be that any data errors arising could create greater problems in proving asset ownership which is the contrary of what is intended;
- The reality is also that even if instructions were sent to the CSD, no real world movement would occur at the CSD, as all customer assets would be held in a single omnibus account and the deliverer and receiver accounts (cash and securities) are the same accounts of the intermediary. Therefore, there is no gain from effecting a settlement at this level (unless accounts were segregated). This would require two instructions to be sent to the CSD (one debit instruction and one credit instruction on the same accounts). We believe the CSD would charge the intermediary for each of these instructions which inevitably leads to these costs being passed back to the end investor;
- T2S landscape: In the envisaged T2S landscape, investor CSDs will look to open omnibus accounts with their issuer CSD counterparts. This will then allow them to settle transactions across their omnibus accounts throughout the settlement periods and ensure that the reconciliation burden falls on them to their customers, rather than

having to maintain multiples of segregated accounts at each issuer CSD, and then both investor and issuer CSD having to manage multiple reconciliations, static and settlement costs. Please see TFAX recommendations paper which can provide more detail on this, demonstrating how CSDs & intermediaries are looking for omnibus account structures and their ability to “settlement internalise” to ensure that T2S can function in an efficient, low cost manner.

3. Regulatory Context

There are several legislative proposals within Europe that are focussing on the key question of “who owns what”, and proposing how to solve this question. The reason for the importance of this question is that the European Commission has set out two key objectives for the financial market since the Financial Crisis;

- 1) Protect the assets of the investor at all costs
- 2) Ensure the integrity of the Post Trade system

A key part of these objectives will be addressing the need for clients being able to at all time identify its assets and have immediate unrestricted access to them. Key elements to answering the “Who Owns What” question in the settlement space are as follows:

- The finality or reversibility of settlement (when does final settlement actually occur & could a settlement that a client believes has settled be reversed or be determined not to have settled²)
- Delivery vs. payment: is this actual irreversible DVP or does the involvement of intermediaries’ impact this?
- Can one client’s assets be used to settle another client’s obligations?
- What happens in various insolvency scenarios of counterparties or intermediaries in the chain and will this impact an underlying customer and its holdings of assets?

Taking these themes, there has been widespread debate on the practice of “Settlement Internalisation” since 2009 , suggesting that it might hinder the ability to answer the “Who Owns What” question (as there is a question as to finality of settlement, when is a transaction irreversible, & what happens in a default scenario³), when the CEBS (Committee of European Banking Supervisors) issued a paper which suggested that further analysis was required in the area of settlement internalisation (even if legislation was not required at this point in time). This call for further analysis has been built upon in the CSDR draft proposals, which include a section on settlement internalisation. Debate on this section in European Parliament has covered both the needs for settlement internalisation reporting (quarterly or annual), and the possibility of banning the practice altogether and enforcing settlement at issuer CSD level. It is yet to be determined what the final outcome of these discussions will be.

There are further wider discussions/draft proposals covering segregation & omnibus account structures both in CSDR and beyond, which need to be considered (if settlement internalisation was to be prohibited).

² This is an issue that the Settlement Finality Taskforce under the T2S programme is investigating, & is also being covered by the Securities Law Legislation.

³ This is equally a practical question for investor CSDs or International CSDs settling in Commercial Bank money.

- CSDR drafts: provision for the allowance of both omnibus and segregated account structures;
- Securities Law Legislation discussion paper (November 12) (in response to which AFME has written a paper on matters such as omnibus and segregated accounts);
- T2S (TFAX) discussions: Investor CSDs will set up accounts with Issuer CSDs in order to be able to offer pan European settlement from one CSD (as Global Custodians are actually doing nowadays). Account structures have therefore been covered as part of the TFAX group to investigate the ideal set up of customer accounts (with the conclusion that omnibus account structures are critical for the efficient functioning of the Euro system).

Considering that settlement internalisation occurs by definition outside of Securities Settlement Systems (SSSs), it will be important to align and reconcile the legal and practical implications deriving from the above legislative proposals for SSSs and for their participants with the activities of entities who are deemed to be carrying out internalisation. In the case of internalised settlements, the same level of investor protection given by SSSs is achieved through the operational and accounting procedures of the bank or custodian, for example through reference to the settlement confirmation (MT548) or the payment confirmation (MT900-910) or the production of an end-of-day statement of transactions, all of which are already common practice and fully regulated under banking laws.

4. Consequences of CSDR proposals on Settlement Internalisation

If the current proposals in CSDR were to be imposed then the impacts are likely to be limited. The main focus today is on reporting related to the practice and AFME members believe that providing data would be feasible (depending on the regularity and the detail required). The key for members is that:

- 1) The regulation clearly defines what Settlement Internalisation is & it identifies all players who carry it out (i.e. would investor CSDs be in scope?);
- 2) The European Commission/ESMA then clarifies exactly what the concern related to the practice is; Investor asset protection? Systemic risk potential? Both? By clarifying this, the industry can then help to ensure that any reporting captures the relevant data to highlight areas of concern;
- 3) Parameters: Who should report (what are the thresholds of volumes/values? Will certain players be exempted? If so, for what reason?) For which products (will all products be included? Should some be exempted? On what basis?) How will new entrants be captured or know that they need to report? All key questions that need to be determined;
- 4) Timeframes for compliance: There will need to be a lead time to ensure compliance as depending on the answers to whom, what and how often, players will need to configure systems to meet the new reporting demands;
- 5) What will the data be used for? There is concern on how any data provided will be utilised and by whom. Again, this needs to be clarified, as action taken could have unforeseen consequences in a complex interconnected market. It is vital therefore those scenarios are tested to determine possible consequences during times of market stress.

Notwithstanding the above areas that need further clarification, AFME members can could agree with such proposals.

However, members would have greater concerns if a decision were to be taken to ban the practice altogether and force settlement at issuer CSD level.

5. The Consequences of a prohibition of Settlement Internalisation and a ban on Omnibus Account Structures

AFME members have a number of questions as to what benefits a ban on settlement internalisation would actually achieve by itself. This is because:

- 1) The practice of settlement internalisation is not as widespread as perhaps thought. The majority of settlement still takes place at CSD level, as settlement between customers tends to be across institution (i.e. one intermediary's customer will trade with a different intermediary's customer meaning that assets will need to be settled from one account to another). The CEBS report from 2009 determined that the majority of intermediaries did not settlement internalise, and for those that did, the figures tended to be small (1-3%), with only a few cases of large Global Custodians, where it was as high as 30%;
- 2) CSD level settlement for genuinely internalised trades will increase costs and certain risks (additional reconciliations, static maintenance) for no real movement of assets in a single account. The way to settlement finality takes longer as additional layers are involved.
- 3) Asset protection: All the customer assets will be protected in the event of the intermediary going into default as they are within a client omnibus account. The Securities Law Legislation (SLL) should provide EU confirmation on this issue. Today local legislation is applicable/valid.
- 4) If however, a ban was coupled with a mandatory requirement for segregated accounts at the investor level, concerns would be far greater, as has been highlighted at length in the AFME paper on Account Structures (published March 2012). General conclusions based on the analysis in this AFME paper on "CSD Account Structure", were as follows:
 - No requirement of mandatory account segregation should be in place;
 - CSDs should offer the participants the possibility to operate multiple securities accounts (e.g. also omnibus accounts);
 - Omnibus accounts reduce costs to end investors and complexity in the holding chain, which in turn will reduce operational errors and possible mismatches.
 - Segregated accounts can provide perceived great levels of asset protection and transparency;
 - Request of a sound legal environment to be developed in the upcoming legislative initiatives that optimises asset protection for end investors for assets held both in segregated and in omnibus accounts.

More specifically, there are many benefits that omnibus account structures bring to the market:

- Data uniqueness: Omnibus account structures reduce the numbers of locations where the same data needs to be stored and maintained. This means that when the data changes, fewer updates to data are required, reducing risk of errors from incorrect

static data; Simplicity, not complexity: The operation of a single omnibus account involves the maintenance of one account, with one account name, one set of static data, one set of securities balances and one set of securities movements. This is both less risky and less costly;

- T2S: The TFAX report highlighted that CSDs and intermediaries alike see the need for omnibus account structures in a T2S environment including the ability for investor CSDs to internalise settlement where an investor CSD will operate accounts in another CSD;
- Asset Protection: Omnibus account structures could even enhance asset protection for customers as there is a specific scenario where if accounts were required to be segregated to CSD level, and the beneficiary details were incorrect at the CSD, their assets would potentially be at risk. The omnibus account structure would eliminate this risk.

The AFME paper on Account Structures also touched on the case for segregated accounts and the legal uncertainty in this context. It emphasised that there is a need for legal equalisation of both account structures (omnibus and segregated accounts). AFME sees a segregation for specific transparency needs (ensuring regulatory authorities, tax authorities, issuers and any other entity with the legal right to gather information about securities holdings) and in cases where separate rights and obligations are linked to securities holdings in relation with certain hedge funds.

6. Conclusions and Recommendations

Based on the preceding analysis, the Task Force reached the following conclusions:

1. Any legislative action ESMA might propose (in connection with the current EP compromise) could be developed more efficiently in close cooperation with the intermediary community to determine the detailed requirements for reporting;
2. AFME would recommend that ESMA monitor the reporting for a period of time (minimum a year) & consider the future settlement environment (i.e. T2S) before determining any legislative action;
3. AFME believes that there is a need for a harmonised and clear definition of change of ownership in upcoming legislation initiatives (in particular in SLL), referencing both omnibus or segregated accounts.

To conclude, settlement internalisation has and will continue to play a role in the post trade space, and adds to the efficiency of the current Europe post trade landscape. Additional reporting is welcomed, and if determined required, new controls. However, an outright ban on the practice would have adverse consequences bringing about a new set of issues as outlined in the preceding analysis in this paper.

ANNEX 1

Definitions

For consistency and ease of cross reference, we have in several cases used terms in the sense as defined in the European Central Bank “Glossary of terms related to payment, clearing and settlement systems” and in the Corporate Actions Joint Working Group (CAJWG) and Joint Working Group on General Meetings (JWGGM) documents: *Market Standards for Corporate Actions Processing*, and *Market Standards for General Meetings*.

- Omnibus (or multiple beneficiary) account: a securities account on which are held securities that belong to multiple end investors.
- Single beneficiary account: a securities account on which are held securities that belong to one single end investor.
- Direct holding system: an arrangement for recording ownership of securities (or similar interests) whereby each and every end investor in the security is registered with a single entity (e.g. the issuer itself, a CSD or a registry); in some countries, the use of direct holding systems is required by law either for all types of investor, or for some types of investor; in a direct holding system, there is typically an obligation only to use single beneficiary accounts at the CSD (for those categories of investor to which the obligation applies), and thus a prohibition on the use of omnibus securities accounts.
- End investor (or final investor): physical or legal person who holds the security for its own account, not including the holder of a unit of a UCITS (undertaking for collective investments in transferable securities).
- Intermediaries: financial institutions that provide and maintain securities accounts for clients. This would include investor CSDs holding accounts at Issuer CSDs.
- Last intermediary in the chain: the intermediary with which the end investor holds its securities account.
- Nominee: a person or entity named by another to act on its behalf. Under some circumstances, a legal system may view an intermediary (i.e. a nominee), and not the end investor, as being the legal owner of a securities position.
- Nominee concept (recognition of the): Recognition by a legal system, or by other entities (such as issuers and tax authorities), that the entity viewed as the legal owner of a securities position may be an intermediary acting on behalf of clients, who in turn may be intermediaries or end investors.
- Segregated securities account: term used to distinguish a securities account from an omnibus securities account; in some cases, a segregated securities account may be a single beneficiary securities account; in other cases, a segregated securities account may hold securities on behalf of a specific category or sub-category of intermediaries or end investors.
- Segregation: the act of separation or setting apart; a segregated account is an account that is opened so that it can be used to separate a particular activity, or the assets of a particular client or category of clients, from other activity, or from other assets held by an intermediary.

- Sub-account: an account within an account i.e. the ability within a single securities account to distinguish between different securities movements and positions so as to maintain separate sub-balances within the overall balances of the securities account; from a functional perspective, separate sub-accounts function as if they were separate accounts.

Definitions:

Settlement Internaliser as per the proposal in CSDR:

Article 3a

'Settlement internaliser' means a credit institution or investment firm or third-party firm authorised in accordance with Directive 2006/48/EC or with Directive.../.../EU [new MiFID] which executes transfer orders on behalf of clients or on its own account other than through a securities settlement system; (Swinburne 28, Bowles 213)

Systemic Internaliser as per MiFID:

Article 4. 7

'Systematic internaliser' means an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF;