

Post Trade Settlement Committee Task Force on CSD Account Structure

CSD Account Structure: Issues and Proposals

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Background

AFME is a trade association whose members conduct domestic and cross-border securities operations in the EU/EEA area in their capacity as financial institutions, in a wide range of banking activities for their customers and for their own account. AFME's members are securities account providers in the context of European and national regulated activities. The AFME Post Trade Division is the European post trading centre of competence of the Association for Financial Markets in Europe (AFME). 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: Bank of America Merrill Lynch; Barclays; BNP Paribas; BNY Mellon; Citi; Credit Suisse; Deutsche Bank; Goldman Sachs; HSBC J.P.Morgan; Morgan Stanley; Nordea; RBS; UniCredit; UBS.

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

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1. Executive Summary

- Across different European countries there are currently many different sets of legal, regulatory and operational requirements and needs that determine how CSD

participants can hold securities at a CSD (i.e. that determine the securities accounts structure used by CSD participants).

- These different sets of requirements have different impacts on asset protection, asset servicing and operational cost and facility for end investors and for intermediaries.
- This paper analyses the rationale for CSD account structures that use omnibus securities accounts (i.e. securities accounts on which securities belonging to multiple end investors are held), and the rationale for more segregated CSD account structures (including CSD accounts structures where at the level of CSD securities accounts there is segregation by end investor).
- This paper sets out a specific set of recommendations with respect both to CSD account structure, and to the legal environment in which CSDs and their participants operate, that will allow increased market access for end investors, while maintaining optimal levels of asset protection and asset servicing for end investors.
- This paper specifically concludes that there should be no mandatory obligation to segregate by end investor at the level of a CSD, as any such obligation places a heavy operational burden on all intermediaries in the custody chain, and will have the effect of limiting access for some categories of end investor to that CSD.
- Any mandatory obligation to segregate by category of end investor, by category of activity, or by client of a CSD participant should be limited to the greatest possible extent, as this would impose a similar burden, and would have similar, if reduced, effects.
- The paper recommends that there be appropriate legal change so as to ensure that under all relevant circumstances, including when omnibus accounts are used at the CSD, end investors benefit from an optimal level of legal protection and an effective ability to benefit from rights associated with securities positions.
- AFME members believe that this analysis and the associated set of recommendations have a broader applicability, and are relevant through the entire custody chain. Mandatory obligations to segregate by end investor should apply at the level of the last intermediary in the custody chain: any obligations to segregate higher up the chain are both unnecessary, as an optimal level of asset protection and asset servicing should in any event be achieved, and counterproductive, as they involve higher costs and limitations on market access for end investors.

2. Purpose, Scope, Definitions and Methodology

Purpose

The purpose of this paper is to contribute to the current debate in Europe on how securities accounts should be structured both at Central Securities Depositories (CSDs) and at intermediaries. This is a complex debate that touches on a wide range of issues that extend from detailed technical considerations to fundamental legal questions. Some participants in the debate have expressed the strong view that intermediaries need the ability to use omnibus accounts to hold client assets; other participants argue that there are significant public policy reasons why the use of segregated accounts, including segregation by end investor, should be mandated both at the level of the CSD and at the level of each intermediary in the custody chain.

This paper will set out rationales for both viewpoints, and will set out some conclusions and some practical and constructive recommendations for a possible way forward.

Discussion of these issues is timely, as they are relevant for the current legislative programme of the European Commission in the post-trade area, and in particular the Regulation on Central Securities Depositories and the Securities Law Directive; they are also specifically relevant for the Eurosystem's TARGET2-Securities (T2S) initiative.

It is particularly important to AFME members that a harmonised approach be adopted across Europe, including the European Union, but also more broadly the European Economic Area and Switzerland. The ideas in this paper are intended to apply to all such jurisdictions.

Scope

The core scope of this paper is securities accounts at CSDs and, more specifically, securities accounts at a CSD on which a CSD participant holds securities on behalf of its clients.

From a conceptual perspective, a CSD participant could hold all the securities that it holds on behalf of all its clients in a single (“omnibus”) securities account at that CSD; however, other (more “segregated”) securities account structures would also be possible. An example of such a structure would be one in which a CSD participant operates a separate securities account for each of its clients, who may be end investors or may themselves be intermediaries; another alternative would be a structure whereby a CSD participant operates a separate securities account for each individual end investor.

This paper looks at the different constraints and drivers that determine different securities account structures at CSDs for the purpose of holding securities on behalf of clients of CSD participants.

This paper does not cover obligations that fall on CSD participants, and on other custodial intermediaries, to segregate their proprietary assets from the assets of their clients. Nor does this paper cover obligations that fall on CSDs to segregate their proprietary assets from the assets of their clients. These obligations are clear to all participants, are unchallenged, and are fully supported by AFME and its members. These obligations also reflect existing legal requirements that are harmonised at the level of the European Union through the Markets in Financial Instruments Directive (MiFID).

The account structure with which a CSD participant holds client securities at a CSD may have significant legal and operational implications, and these implications may have an impact all the way down the custody chain to the end investor. Accordingly, this paper will also touch on issues related to how securities are held through the custody chain, and how – in a custody chain – an end investor can ensure that it benefits from asset protection and from a full entitlement to rights derived from securities positions.

Although the paper has been inspired by a current European debate, and focuses in particular on account holding structures at European CSDs, the analysis and conclusions are not limited to Europe, but have a more general applicability. European securities markets function within a global marketplace, and non-European investors are major participants in European markets. Market infrastructure and public policy considerations need to take this broader context into account.

This paper looks only at the investor-side of a CSD’s activity; it does not cover the issuer-side, i.e. the relationship between a CSD and issuers and/or issuer agents.

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.
- 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.

Methodology

This paper takes an operational rather than a legal approach.

It is necessarily 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.

This paper takes a generic approach to the issues discussed. It does not focus on individual countries, nor on individual technical solutions. It does not distinguish between sub-accounts and separate securities accounts on the grounds that they are functional equivalents.

3. Principles

We believe that any solutions must comply with the following principles:

- i. Safety and soundness
End-investor asset protection, legal certainty and minimisation of risk.
- ii. Access to markets for end investors and intermediaries
Open access to domestic and non-domestic markets within the European Union for all citizens and investors.
- iii. Absence of discrimination
Both domestic and cross-border market participants should benefit from a level playing field and equal conditions of access.
- iv. Transparency
Transparency, with clear and open criteria in support of market integrity.
- v. Flexibility and freedom of choice for investors and intermediaries.
- vi. Efficiency
The most effective, low-cost and usable process possible.

4. Current Situation; Problem Description

There is a widespread awareness that investors and intermediaries that hold securities with European CSDs can be faced with significant issues.

These issues do not in general affect end investors that invest in securities issued in their own country and deposited in their national CSD. The reason for this is that national legal systems, national market practices and infrastructure functionalities have developed in such a manner as to accommodate this situation. The issues in most cases affect end investors from other countries, and the intermediaries that they choose to use.

The issues that arise can be placed in three broad categories:

- (i) Asset protection issues (associated with the possibility that an end investor is not recognised as the legal owner of the securities that it has bought);
- (ii) Asset servicing issues (an inability – under some circumstances – for end investors fully to participate in corporate actions); and
- (iii) Operational issues.

These issues may have multiple origins, and are frequently inter-connected. Asset protection issues may be generated by legal systems that recognise the CSD participant as the legal owner of securities, and do not fully recognise the possibility that a CSD participant is an intermediary and is not the beneficial owner of a securities position. Asset servicing issues may be generated by relevant bodies (issuer agents, tax authorities, etc) setting operational restrictions on positions held within a single securities account at a CSD. Operational issues may arise from the

reality that different CSDs across Europe have very different requirements as to CSD account structure, and intermediaries who hold securities at all the different CSDs may be unable to comply with all the requirements.

To review and to resolve these issues would be a very ambitious exercise which this paper does not attempt. Rather – and within the context of these high-level issues - this paper looks at the specific obligations and restrictions with which participants in different European CSDs are faced with respect to the securities accounts that they can open.

The two most important types of obligations and restrictions are:

- (i) Obligations to open many separate securities accounts, so as to ensure that securities positions are segregated by category of end investor, or – in the extreme case – by individual end investor
- (ii) An inability to operate many separate securities accounts (so that CSD participants are forced to handle very different types of activity in a single securities account).

Appendix 1 gives an overview of holding patterns across Europe.

5. Segregation: Objectives and Rationale

This Section sets out a possible rationale for obligations or reasons to segregate securities positions at a CSD. Such segregation may be by client of a CSD participant, whether an intermediary or an end investor; it may also in some cases be by end investor.

From a conceptual perspective, segregation is a tool to achieve certain objectives; segregation is a powerful and useful tool, but it is not necessarily the only possible tool, nor necessarily the most effective or most appropriate tool.

a. Law and Regulation

Requirements in law or regulation for segregation at the CSD level are based very largely on concerns for asset protection and transparency.

(i) Asset protection

Segregation of accounts at the CSD level may well increase asset protection if there is a risk that an intermediary in the chain, whether the CSD participant or another intermediary, be considered the legal owner of a securities position. In some cases, a single beneficiary account at the CSD level, together with an appropriate identification of the beneficiary, is a pre-condition for an end investor to be considered the legal owner of the securities, thereby ensuring that the end investor is not at risk of dispossession if one or more intermediaries in the chain becomes insolvent.

(ii) Transparency

Segregated accounts, and in particular single beneficiary accounts, at the CSD level, together with an appropriate identification of the beneficiary, allow regulatory authorities, tax authorities, issuers, and any other entity with the right to gather information about security holdings and movements at the CSD level, to identify who holds which securities.

b. Tax Processing

Segregation by end investor, by category of investor (such as by tax domicile of the end investors), or by category of activity, can bring significant processing advantages to tax authorities, paying agents, CSDs and intermediaries.

Such segregation may, for example, allow for income to be paid net of the correct amount of tax, so that relief at source mechanisms can operate, and that there is no requirement for laborious tax reclaim procedures.

With relation to transaction taxes, and for those CSDs that have a role in the assessment and collection of transaction taxes, segregation at the level of the CSD account may allow for differentiation between activity that is liable for tax, and activity that is exempt.

Such segregation may well take place at the level of the securities accounts with the CSD if the CSD, or the issuer, or an issuer agent, is responsible for the tax calculation and tax withholding process. If the responsible party is the CSD participant, then typically there is no segregation at the CSD level, but segregation may well take place in the books of the CSD participant.

c. Issuers

Issuers can impact the structure of securities accounts at a CSD through registration requirements, and can in some cases mandate registration in the name of the end investor, or impose limits on registration in the name of an intermediary.

Issuers have three basic objectives with respect to registration requirements:

- (i) Shareholder (or end investor) identification
- (ii) Exercise of control on who is entitled to vote at a general meeting
- (iii) Encouragement of long-term share ownership (by, for example, granting extra rights to shareholders that hold positions for a significant period of time).

In order to achieve these objectives, issuers have an interest that registration be in the name of the end investor, and not in the name of an intermediary.

Registration in the name of an end investor may well require that separate securities accounts be opened at the CSD for each different registration name. Were this not to be done, then an intermediary would be holding securities in two or more registration names in the same securities account at the CSD.

d. Exchanges and CCPs

Generally CCPs or trading venues have the power to instruct 'locked-in' trades over a specific securities account at the CSD. In many cases the trading party will not hold a direct account at the CSD, but will rather use an account of an intermediary.

The fundamental purpose of this functionality is to give the CCP or trading venue a degree of control over the matching of a transaction which is subject to the relevant trading or clearing rules.

Some intermediaries may prefer that such locked-in transactions settle on segregated securities accounts at the CSD. Among the possible reasons are that such instructions may bypass short position checks at the level of the CSD participant, and so may generate the risk of "drawing from the pool"; in addition, a CSD participant may be concerned

about giving an outside party (i.e. an exchange or CCP) the practical ability to instruct on securities positions belonging to other clients.

e. CSD participants / End investors

CSD participants have a specific requirement, and typically regulatory obligation, to segregate proprietary assets from client assets.

CSD participants may have a variety of legal, risk and operational reasons why they may want to open up separate securities accounts for individual clients, or for specific categories of clients. The drivers may be asset protection (such as ensuring that end investors have optimal legal protection), accessibility of securities (in case of insolvency of an intermediary), segregation of activity (such as ensuring that a specific activity is separate from other activity), and operational efficiency (such as ensuring that registration or tax or other corporate action processing is effected in the most efficient manner).

As mentioned in point c. above, a CSD participant may choose to hold in two separate securities accounts securities positions that are registered in two separate registration names.

Segregation of securities positions in different securities accounts is a tool that can be used by a CSD participant in order to distinguish between securities positions that are not totally fungible (e.g. positions that have a different registration name, or a different entitlement to a corporate action event).

End investors may have a specific concern about asset protection, and may request a specific, segregated account at the CSD in order to try and achieve a higher level of legal protection.

f. CSDs

As can be shown by the wide variety of existing CSD account structures, CSDs in themselves do not generally have specific reasons to impose particular account structures. (One proviso to this statement is that in the short to medium term some CSDs may be faced by system constraints, and so may wish to limit the number of securities accounts that they offer to their participants).

However, CSDs may fall under certain specific legal or regulatory obligations. For example, if a CSD has an obligation to act as a tax processing and/or withholding agent, then it may well require certain types of segregation by activity, by category of investor, or even by end investor. (See points a. and b. above for some more information on this matter).

6. Omnibus Accounts: Objectives and Rationale

The use of omnibus (i.e. multiple beneficiary) securities accounts is very frequent in securities holding chains. This Section sets out a rationale from the perspective both of intermediaries and of end investors as to why this is the case.

The starting point for this analysis is that all relevant data will be held at the last intermediary in the chain. The last intermediary will hold all relevant information about the end investor, will hold appropriate documentation, and will – in its own records – provide and maintain securities accounts for each end investor.

There are two fundamental principles driving the use of omnibus accounts higher up the chain of intermediaries, rather than the use of more segregated account structures. The first is the principle of simplicity, rather than complexity; the second is the principle of data uniqueness (i.e. the principle that data should be stored and maintained in one place only, and not stored in multiple locations, so that –if the data change – there not be the requirement that the update be effected in multiple locations, with the associated risk that not all updates are effected in the same manner, or at the same time).

Compared to the operation of multiple segregated accounts, the operation of one omnibus account is simpler, and less complex. 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. The operation of multiple segregated accounts involves – at a minimum – the maintenance of multiple accounts with multiple names, multiple sets of static data, multiple sets of securities balances, and multiple sets of securities movements. It should be noted in many cases that the set of static data that is associated with a securities account may well include physical documentation (such as tax documentation).

The principle of data uniqueness suggests that the relevant data should be maintained at only one location (i.e. the last intermediary in the chain) and not duplicated up the custody chain.

These two principles suggest that the operation of omnibus accounts over segregated accounts is preferable both for reasons of cost (as simplicity is cheaper to manage than complexity) and for reasons of risk (as the maintenance of data in multiple locations creates the risk of inconsistencies between the data locations).

A mirror-image of the analysis of the advantages of omnibus accounts is the analysis of the disadvantages of 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.

For a specific example illustrating this point, please refer to Annex 2.

The analysis so far suggests that omnibus account structures are associated with cost savings, greater efficiency, and lower risk. Here is a more detailed enumeration of some of the potential sources of cost, inefficiency and risk associated with segregated account structures:

- i. Account opening: it will be 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 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).

- ii. Account maintenance:
 - a. Processing and Reconciliation: there are 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
 - b. 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.
- iii. Allocation of securities trades: in the event of block securities trades being executed on behalf of multiple end investors, then 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.
- iv. 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.
- v. Matching requirements: In the event that a CSD uses securities account numbers or identifiers as a criterion for the matching of settlement instructions, then under some circumstances there is a greater potential for mismatches and failed settlements.
- vi. 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, then 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 future 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.

The cost, inefficiency and risk of such account structures will inevitably be reflected in the tariff structure, and in the willingness to provide services, of intermediaries.

Based on this analysis, there is one clear-cut conclusion. 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.

This point can be illustrated by two possible scenarios. First of all, there is the extreme scenario; if there were to be mandatory segregation by end beneficiary at all CSDs across the world, then this 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).

A more common scenario is that for most markets and most CSDs there is no specific obligation for any particular segregation, but that 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 custody¹. A typical consequence may be that a custodian bank decides to restrict its service offering for retail clients.

In short, 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.

From an end investor perspective, and once the question of access is put aside, considerations of asset protection, cost and servicing are paramount; the specific account structures used by intermediaries are of less significance.

There is, however, one relevant consideration which would lead end investors to prefer an omnibus account structure (at the CSD level) that incorporates a high level of asset protection over a segregated account structure that achieves a similar level of asset protection through the maintenance of end investor information at the CSD level. In the second case, the asset protection would depend on the beneficiary details at the CSD being fully correct and up-to-date; if this were not to be the case, then the end investor may be faced with a specific risk.

AFME members note that questions of asset protection depend not only on the service offering of CSDs and intermediaries but also – and much more importantly – on the legal environment.

7. Discussion of Reasons and Alternatives

Principles and tools

AFME members believe that the discussion of CSD account structure is not fundamentally a question of principles. They believe that the principles set out in Section 3 of this Paper meet with wide-ranging support from all sets of stakeholders. The discussion around CSD account structure is fundamentally a question of what are the most appropriate tools (with respect to CSD account structure, registration, etc.) to achieve to the greatest possible extent compliance with these principles.

This question is difficult as some tools (such as, for example, segregation by end investor at the CSD level) comply with some principles (such as shareholder transparency) but not with others (access to markets for all investors), while other tools (such as the use of omnibus accounts) have a very different outcome (such as allowing for access to markets and for efficiency, but at a potential cost in transparency). The issue of determining the appropriate set of tools is not only a question of determining the right combination of existing tools, but also a question of identifying whether new tools need to be developed.

¹ This can be explained by taking the example of a small regional bank that offers custody services to its retail client base, and that uses the services of a global custodian to access a large number of securities markets. Such a regional bank would typically prefer to hold and operate one omnibus account at the global custodian for client assets. If that regional bank decided to offer its clients the possibility to hold securities from a country with mandatory segregation by end investor at the level of the CSD, then that regional bank will have to hold at the global custodian a separate securities account for each end investor; in such a case, and for reasons of simplicity, the regional bank will typically choose to route all activity for one single client to one single account at the global custodian, rather than to two separate accounts.

Location of information – access to services

The AFME Task Force believes that this discussion of CSD account structure can be viewed as a discussion of information, of where information should be stored in the chain of custody, and of how and to whom it should be disclosed.

Information – identity of end investor, tax status of end investor, history of security positions and movements – is necessarily present at the level of the last intermediary in a custody chain (as an intermediary is under the obligation to “know its customer” and to maintain separate securities accounts per customer).

What is open to question is whether this information should be passed on up the custody chain, and – if yes – to which level (i.e. to another intermediary in the chain or to the CSD at the top of the chain).

As set out in Section 5, passing information up the chain has certain clear advantages. It is also clear, and as set out in Section 6, that there are significant direct and indirect costs and implications. One implication is that redundant information may be passed on up the custody chain; for example, segregation by end investor at the CSD level for reasons of shareholder transparency will provide information transaction by transaction; issuers may not need or wish to know all this information; their requirements could, for example, just be for booked positions at certain specific points in time, or just for positions above certain thresholds. Another implication is certain types of activity (such as securities lending) and service (such as cross-border custody for retail investors) may be discouraged or rendered impossible.

Principle of safety and soundness – legal considerations

AFME members believe that the principle of safety and soundness, including asset protection for end investors, as well as legal certainty and minimisation of risk, is pre-eminent. This means both that end investors should benefit from the highest possible level of asset protection, and that some categories of end investor should not be forced (by regulation or by circumstance) to accept a lesser degree of asset protection. This means specifically that the level of asset protection for securities held in omnibus accounts at a CSD should be the same as the level of asset protection for securities in single beneficiary accounts at a CSD (given that not all investors, including most notably cross-border retail investors, have the capability of accessing single beneficiary accounts at a CSD).

Principle of safety and soundness – operational considerations

Any segregation of business activities that involves passing information up the custody chain, such as, for example, the operation of single beneficiary securities accounts, does create the possibility for errors, and for discrepancies between the different layers in the chain, so that there is an associated increase in operational risk. At the same time, such a segregation of activities is a tool that can be used to reduce certain types of operational risk, such as the risk of “drawing from the pool” i.e. delivering on behalf of one client securities from a securities account, but using securities that belong to a different client.

One important consideration is that a segregation of activities is not the only possible tool to tackle the risk of “drawing from the pool”. Hold and release mechanisms are one other such tool, whose specific purpose is to allow CSD participants to operate omnibus accounts in such a manner that there is no “drawing from the pool”. There is a broadly accepted consensus² that

² On this point, see, in particular, the October 2006 ECSDA-ESF Standards on Pre-Settlement Date Matching Processes; the text of the Standards is available at:
http://www.ecsda.eu/site/uploads/tx_doclibrary/2006_10_05_ESSF_ECSDA_Matching_Standards.pdf

CSDs should offer such a tool to their participants, and the future T2S platform will offer a full hold and release mechanism.

Principle of safety and soundness - entitlements

This principle of safety and soundness, and asset protection for end investors, has a specific impact for the determination of entitlements to corporate events. When a record date system is used to make an distribution of entitlements to participate in a corporate event (subject - in the event of pending transactions - to the reallocation of entitlements by means of market claims and buyer protection mechanisms), there is the question of whether the distribution be based on securities positions at the CSD, or be based on securities position on any other parallel register or database. AFME has taken the position that entitlement distributions should be based on securities positions at the CSD at close of business on record date³. This position is taken on the grounds that such a system is simple and transparent, treats all shareholders equally, and does not create the risk for a shareholder who has bought and paid for securities that some part of its securities position may be entitled to participate in a corporate action, but that another part may not⁴.

If corporate event entitlements are distributed solely based on booked positions at the CSD at close of business on record date, then this has the significant advantage that a CSD participant does not have to maintain the distinction, possibly by the use of segregated securities accounts at the CSD, between “entitled” securities positions, and “unentitled” securities positions, in the event that a relevant external register or database has not been updated.

8. Conclusions and Recommendations

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

1. CSDs should offer their participants the possibility to operate multiple securities accounts, so that they have the ability to segregate activities and holdings at the CSD; such segregation could, for example, be by client of the CSD participant, or by end investor
2. CSDs should offer their participants the possibility to operate omnibus accounts at the CSD level, as mandatory segregation imposes unnecessary costs, and restricts market access.
3. CSDs, and other relevant bodies, should minimise requirements for information to be transmitted and maintained on a systematic basis up the custody chain.
4. There is a need for tools to be developed for information to be transmitted on an ad hoc basis up the custody chain. Such information may, for example, relate to the identification or to the tax status of the end investor.
5. A sound legal environment that optimises asset protection for end investors for assets held both in segregated and in omnibus accounts structures is necessary; assets held in omnibus account structures should not suffer from reduced legal protection compared to assets held in segregated account structures.

³ See, for example, the AFME response to the September 2011 ESMA Call for Evidence on Empty Voting. The AFME response is available at: <http://www.esma.europa.eu/consultation/Call-evidence-Empty-voting>

⁴ AFME believes that this position is fully compatible with the European Market Standards on Corporate Actions Processing, and on General Meetings, which AFME supports and endorses. The Market Standards documents are available at: http://www.ebf-fbe.eu/index.php?page=market_standards

6. The drivers determining an appropriate account structure at the level of a CSD are fundamentally the same as the drivers determining an appropriate account structure at any level in the custody chain, other than the level of the last intermediary.

AFME members recommend the following actions:

1. The European Commission should ensure that upcoming legislative initiatives (notably, the Regulation on CSDs and the Securities Law Directive) take these conclusions into account, and specifically create the possibility for CSD participants to operate both multiple and omnibus securities accounts at the CSD without any diminution in asset protection for the end investor. In other words, when a CSD participant holds client assets in an omnibus account at a CSD, there should not be any possibility that the CSD participant, or any other intermediary in the chain, be viewed as the legal or beneficial owner of the securities.
2. Regulatory authorities and issuers should ensure that shareholder entitlements, including proceeds from corporate actions, and voting rights at general meetings, should be based solely on booked positions at the CSD as of record date (and should not be based on positions held on any parallel register or database that is not fully in line with CSD records).
3. Any restrictions on voting rights for end investors should be monitored and controlled using the disclosure tool detailed in the Market Standards for General Meetings, as this allows individual end investors to be targeted.
4. Where issuers have the legal right to know the identity of their shareholders, an efficient and cost-effective system of shareholder identification should be set up. The Report of the T2S Task Force on Shareholder Transparency is a useful starting point for further work on this matter⁵.
5. Any regulatory steps to encourage long term share ownership, by for example creating the possibility for issuers to grant bonus rights, should not mandate segregation by end investor at the level of the CSD, but should rather build on current or future tools of shareholder identification.
6. Tax authorities should comply with existing international recommendations whereby information and documentation on individual end investors that can benefit from relief at source on income payments are not passed all the way up the custody chain but are maintained at an intermediary at a lower level.
7. Market participants, market infrastructure bodies and regulatory bodies should undertake a review of mechanisms and tools to transmit relevant information (relating to tax status, etc) up the custody chain. To the greatest extent possible such mechanisms and tools should be compatible, and integrated, with tools for shareholder identification.
8. CSDs, the Eurosystem, and the T2S Project Team, should take these conclusions into account with respect to CSD development plans in general, but also – most specifically – with respect to the plans to adapt CSD activity in Europe to the future T2S platform.

⁵ The Report is available at: <http://www.ecb.int/paym/t2s/governance/ag/html/subtrans/index.en.html>

9. Annexes

Annexe 1

Account Structure in EEA, Switzerland and the USA

Availability of CSD omnibus accounts has a high priority activity in the TARGET2-Securities (T2S) harmonisation list as the operation of cross-CSD links is not possible, in or outside T2S, without the provision of omnibus accounts services from the issuer CSDs to foreign participants (investor CSDs and intermediaries). Thus actual clarifications are ongoing in various European markets and the below state of play of omnibus accounts may hopefully be improved.

	Intermediary or Nominee Concept (1)	Omnibus Account (2)	Beneficial Owner Market (3)	Direct Holding Market (4)	Explanation / Information / Comments
Austria	✓	✓			
Belgium	✓	✓			
Bulgaria		✓	✓		Law recognises nominee concept but special regulations are missing. Omnibus accounts are market practice. New law is currently being developed (as beneficial owner market there is a lack of recognition of intermediary-nominee concept).
Cyprus		(✓)	✓		Omnibus accounts are possible for investor CSDs but not for foreign intermediaries (e.g. foreign custodians).
Czech Rep.		✓	✓		Omnibus accounts are market practice (as beneficial owner market there is a lack of recognition of intermediary-nominee concept).
Denmark	✓	✓		✓	
Estonia	✓	✓			
Finland	✓	✓		✓	Omnibus accounts only available for securities owned by foreign individuals or corporations (e.g. intermediaries)
France	✓	✓			
Germany	✓	✓			

Greece		✓	✓	✓	Greek law does not accept the intermediary-nominee concept, (holding securities on behalf of third parties) and thus the account holder is regarded as beneficial owner
Hungary	✓	✓			Separate omnibus account for non-resident corporations
Ireland	✓	✓			
Italy	✓	✓			
Latvia	✓	✓			
Lithuania	✓	✓			
Luxembourg	✓	✓			
Malta	??				No information available
Netherlands	✓	✓			
Poland	(✓)	✓	(✓)		Omnibus accounts are part of Polish law as of 1.1.2012, but many questions remain unanswered due to the lack of recognition of the intermediary or nominee concept and the liabilities in the context of the omnibus account.
Portugal		✓	✓		Omnibus accounts are market practice, but there is a lack of recognition of the intermediary or nominee concept. There are some restrictions for residents due to tax reasons and segregation for PT Bonds is requested.
Romania			✓		
Slovakia		(✓)	✓		Omnibus practice works but it is not part of the Slovakian legislation. There is a lack of recognition of the intermediary or nominee concept as the market is based on beneficial owner accounts. No omnibus account to Slovakian investors when Slovakian CSD acts as investor CSD.
Slovenia		(✓)	✓	✓	Uncertainty whether omnibus accounts can be used and for what instruments

Spain		✓	✓		Omnibus accounts are market practice, but there is a lack of recognition of the intermediary or nominee concept.
Sweden	✓	✓		✓	Omnibus accounts are accepted
United Kingdom	✓	✓			
Iceland	(✓)	✓		✓	A confirmation that the intermediary or nominee concept is recognised is pending.
Norway	✓	✓		✓	
Liechtenstein	✓	✓			
Switzerland	✓	✓			
United States	✓	✓			

(1): Intermediary Concept (some may refer to it as Nominee Concept): Recognition of this concept means that the holding of securities by an account provider acting in its own name for the account of another person or other persons is accepted in the market (e.g. account holders which are considered as beneficial owner is a lack of recognition of this concept). In markets with omnibus accounts but without the intermediary or nominee concept the advantages of multiple beneficiary accounts are not accomplished (e.g. Greece).

(2): Omnibus account: Multiple beneficiary account; it does not refer to proprietary assets and so does not infringe on the principle of segregation of client and proprietary assets.

(3): Beneficial Owner Markets: Account holders are considered as beneficial owners (segregation/disclosure is generally required).

(4): Direct Holding Markets: End beneficial owners are segregated at CSD level.

Annexe 2

Example of Complexity in a Segregated Chain

Let us take as an example a custody chain with three intermediaries between the end investor and the CSD. An end investor (a private individual, a pension fund, an insurance company) may well choose to hold its accounts with a local or regional bank; such a bank may not have the full capabilities to hold securities in all the markets in which its clients may wish to invest; accordingly, this regional bank may well use a global custodian that offers access to all significant securities markets across the globe; the global custodian in turn may well use a sub-custodian in order to access the CSD in a particular country.

If the regional bank, as last intermediary in the chain, has one hundred clients that wish to invest in a particular country, and if in that country there is an obligation to segregate by end investor at the CSD level, then one hundred securities accounts will have to be opened at the CSD level, as well as at the sub custodian and at the global custodian level. If the one hundred accounts were not opened at both the sub custodian and global custodian level, then there would be the risk (or rather the certainty) that the positions of the one hundred clients would not be booked on the correct accounts at the CSD level (as the global custodian and the sub custodian would not know on which accounts to book the positions, and the reconciliation of securities positions would be impossible).

Such a complex structure contains multiple sources of cost, inefficiency, and risk, compared to a simple structure in which, for example, each intermediary in the chain uses a single omnibus account.