

## Omnibus Accounts

This paper sets out an outline of the issues relating to securities held by an account provider on behalf of several investors in a single account (an “omnibus account”).

### *"Omnibus" accounts and "nominee" accounts compared*

An "omnibus" account is an account opened in the name of an account provider, the securities credited to which belong to several clients of the account provider. Typically the account provider will be obliged to maintain accounts on his own books recording the interests of these clients in respect of the securities credited to the account in the account-provider's name. Omnibus accounts may contain a mixture of the account provider's own and clients' assets. In some countries<sup>1</sup> this is not permitted.

A "nominee" account is typically distinguished from an omnibus account by two features.

- (i) While a nominee may open an account for the purpose of holding several clients' securities, this is not necessarily so. Often a nominee acts for a single client, for example an omnibus account provider (who acts for many clients). Single-client nominee accounts are common when a global account provider, being foreign, is not permitted by the membership rules applicable to the local CSD to participate directly in the CSD<sup>2</sup>.
- (ii) A nominee's duties and discretions will usually be much narrower than those of other account providers. An omnibus account provider will commonly be granted discretionary powers by its client, whereas a nominee is likely to be permitted only to do such acts as are strictly necessary to maintain the client's holding of securities.

Providers of both nominee and omnibus accounts are likely to know (although it is not always mandatory under the applicable legal system for them to know) that their account-holder is acting as nominee or holding a pool of securities for many investors. Only in a few EU member states<sup>3</sup> is the "intermediary" nature of the account-holder disregarded.

### *Legal reasons for omnibus accounts*

In practice, a combination of tradition and operational and legal reasons rather than ease of settlement of transfers are likely to dictate the use of omnibus accounts<sup>4</sup>. Practice has become entrenched, so that where omnibus accounts are common, the law has tended to support their existence<sup>5</sup>. The following legal factors may be relevant in particular countries:

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<sup>1</sup> For example, Lithuania, Finland.

<sup>2</sup> This type of restriction should not apply in relation to foreign entities which are EU entities once Directive 2004/39/EC (MiFID) has been implemented in the EU.

<sup>3</sup> For example, Lithuania, Spain, Portugal.

<sup>4</sup> See section below on “internalised settlement”.

<sup>5</sup> Operational reasons reinforce this position. If, hypothetically, a CSD in a country which currently supports omnibus account providers were required to move to a direct-holding system (such as that in Finland or Greece), a vast number of new accounts would have to be opened in the CSD. This might require a complete renewal of the IT system.

- In countries<sup>6</sup> where local investors are obliged to hold their securities directly in the CSD/issuer the need for omnibus accounts only arises in respect of foreign investors who already use a global account provider to hold their securities.
- In countries<sup>7</sup> where the person who is registered at CSD/issuer level is regarded as the owner of the securities, to the exclusion (in most circumstances) of other claimants, there may be obstacles to recognition of custodial arrangements. The operational set-up is likely to have been created historically in a way which does not envisage that a CSD participant would need multiple accounts. In order to operate a separate account for each investor, the account provider would have to persuade the higher-tier intermediary to operate multiple accounts for the account provider, and pay (or charge investors for) the additional fees associated with many accounts. Instead, it may be simpler to establish an omnibus account.
- Even in countries where omnibus accounts are common (where direct holdings are not compulsory and indirect holdings are standard practice), there may be operational influences on account structures. A higher-tier intermediary may be unwilling to agree to a single-investor-per-account holding pattern, for example because the higher-tier intermediary is constrained by systems limitations on scaling up to the degree implied by each of its account provider clients having multiple accounts. Another factor is the need to have separate identifiers for each account. Where an omnibus account is used, the task of allocating securities received to buyers is carried out by the account provider. A settlement system may (but may not) be able to supply the account provider with identifiers to facilitate the allocation of securities received to the sub-accounts maintained by the account provider for its clients. Where a stock exchange operates a straight-through processing system linked into the relevant CSD, the choice of account structure may be affected by the amount of detail that the various systems can support.

In any of these cases, the technical and operational systems will have grown up domestically in a manner which suits the local legal arrangements, and may be difficult to adapt wholesale. Rather, individual market participants have developed ad-hoc arrangements to cope with local market expectations.

#### *Advantages of omnibus accounts*

The following advantages of using omnibus accounts can be stated:

1. Cost. Only one account is needed for many investors. This should reduce fees associated with (a) maintaining the account and (b) transfers, where credit and debit entries offset and the settlement processing technique permits internalised (or net) settlement.<sup>8</sup>

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<sup>6</sup> E.g. Finland, Greece, Lithuania, Poland

<sup>7</sup> E.g. Spain, Portugal

<sup>8</sup> Professor Goode (in *Legal Problems of Credit and Security* (Third edn, 2003), para 6-03) states that for account providers to pool securities is more common than segregation in single-investor accounts at the higher-tier intermediary, and more convenient, because it reduces administration in terms of actual movement of securities, if the CSD can process settlements on a "net" basis. Professor Goode's conclusion is disputed by certain legal experts.

2. Voting and corporate actions. Provided that an account provider can gather in the voting instructions for the collectively held securities (and contrary voting is permitted - see below) the volume of voting instructions required to be processed by the issuer will be significantly reduced. Likewise, for other corporate actions, the account provider will be responsible for processing the instructions and entitlements for all the investors under its account, thereby reducing the burden on the issuer.
3. Internalised settlement. Investors could "settle" across the books of an account provider instead of using the CSD. If each investor's holding is held in a separate account with an upper-tier intermediary, "internalised settlement" is impossible, since an account provider acting as lower-tier intermediary needs to process a transfer from a selling investor client to a buying investor client by means of external instructions to the upper-tier intermediary. By contrast, if an omnibus account is used, and the ordinary processing algorithms permit, an account provider would not need to issue any external instructions to settle such a transfer. Internalised settlement could reduce the cost of transfers and improve service levels (eg by offering "transfer finality" at an earlier moment than if settlement occurs at a higher tier intermediary).
4. Reduced burden for issuers. Issuers do not need to deal directly with large numbers of investors where they are required legally only to recognise the persons who hold directly from them. This shifts the burden of dealing directly with investors to the account providers. Account providers may be freer to negotiate the level of service provided to their account holders, whereas issuers will generally be required to treat all holders alike.

#### *Disadvantages of omnibus accounts*

The following disadvantages may arise with regard to the use of omnibus accounts:

1. Effect of permanent shortfalls. Assuming it cannot be made good by the account provider, a permanent shortfall on an omnibus account is bound to cause loss to some investors; the question arises how the loss should be borne. The answer to this question may range from "all investors lose any claim to anything held by the account provider"<sup>9</sup> through to "rateable loss-sharing". More complex solutions are theoretically possible, including forensic accounting to identify precisely "whose" securities were lost<sup>10</sup>. This is a highly practical question, as the insolvency of an account provider is likely to be strongly correlated with accounting deficiencies and the existence of shortfalls. In some countries a clear and simple statutory solution is provided.
2. Forced borrowing. Shortfalls are likely to arise routinely and without malpractice by the account provider, as a result of operational error (which could be error on the part of some other person). Provided that the account provider (a) is required by regulatory rules to conduct reconciliations and to take action to remove imbalances, and (b) is not insolvent, the difficulties of permanent shortfalls (discussed above) should not arise.

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<sup>9</sup> Arguments to this effect have been rejected by English courts in relation to securities, notwithstanding a long line of cases relating to tangible but apparently fungible property such as gold and wine, where absence of allocation has defeated proprietary claims.

<sup>10</sup> While in some cases this may be established on evidence, it is likely to be prohibitively expensive in a real case. See *Barlow Clowes v Vaughan* [1992] 4 All ER 22.

However, while a temporary imbalance remains, the consequence of a shortfall may be that the investors entitled to what remains will to some degree be making securities loans to any investor who wishes to dispose of the whole of its holding. Lending may be beyond the capacity of some investors and would in many cases require the consent of the lender. Regulatory rules typically require account providers to explain to investors that their securities may be utilized to satisfy other investors' instructions<sup>11</sup>.

3. Distance between issuer and investor. Where an omnibus account is used, the structure necessarily implies that securities are held indirectly. The issuer knows that the registered holder is not the investor, but not who the investors are. Corporate communications are made more difficult. Some countries<sup>12</sup> have established rules which empower issuers to stay in touch with investors where an omnibus account is used. Distance between issuers and investors also engenders delay: by the time an investor at the end of a chain of intermediaries receives notice of a vote or other corporate action, it may be very close to the last practical moment for action or even too late.
4. Corporate actions. If securities are consolidated or rights issues relate to holdings of specific numbers of securities (eg a 2-for-5 issue) the account provider will typically receive replacement or additional assets which do not divide perfectly among the investors in precisely the ratio in which the investors held the original securities. Some rounding and cash-settlement of differences is necessary, which may affect investors differentially. The outcome for many investors is likely to be different<sup>13</sup> (though not necessarily worse) from that if their securities were held in accounts segregated at the higher-tier intermediary. Investors typically confer discretion on account providers to handle this kind of situation.
5. Conflicting votes. Where an account provider holds securities for many investors, some may wish to vote in favour of a particular matter and others may wish to vote against. In theory there may be a risk in theory that the relevant legal system does not permit a single investor to vote contrarily: part of his vote for, and part against.
6. No title. If the relevant legal system does not recognise the omnibus account as a valid form of co-ownership<sup>14</sup>, there is in theory a risk that the investor has no property rights at all if the account provider pools his securities with those of other investors.<sup>15</sup>

The disadvantages listed above are likely to be more acute where the legal or regulatory system has not developed a clear code to cater for omnibus accounts. These difficulties may be

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<sup>11</sup> See article 18 of draft Regulation ESC-17-2005 implementing Directive 2004/39/EC.

<sup>12</sup> E.g., Czech Republic, Spain, Portugal, Sweden.

<sup>13</sup> Investors holding through individualised accounts will have fractional entitlements settled by the issuer. Investors holding in omnibus accounts will have their fractional entitlements dealt with by the account provider. This may involve the account provider selling the surplus securities and allocation of the net market price to the affected investors.

<sup>14</sup> There do not appear to be any examples among EU countries.

<sup>15</sup> This note does not analyse which legal system (that of the issuer's jurisdiction, of the higher-tier intermediary's jurisdiction, that of the account provider's jurisdiction, or some other jurisdiction) is relevant.

aggravated in a cross-border context where the legal solutions chosen in different countries are different, or where one of the countries involved does not "recognise" omnibus accounts.