Communication of the Association of Global Custodians

European Focus Committee

Subject to Supplemental Commentary

10th June 2019

VIA POST AND EMAIL (Anti-MoneyLaunderingBranch@hmtreasury.gov.uk)
Consultation on the Transposition of 5MLD
Sanctions and Illicit Finance Team (2/27)
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ
London

Re: HM Treasury Consultation on the Transposition of the Fifth Money Laundering Directive

Dear Sir/Madam:

The European Focus Committee of the Association of Global Custodians[1] ("AGC-EFC") is contacting you with reference to the consultation document on the government's proposed transposition of the Fifth Money Laundering Directive (5MLD).[2]

Established in 1996, the Association of Global Custodians (the "Association") is a group of 12 global financial institutions that each provides securities custody and asset-servicing functions primarily to institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory and market structure. The member banks are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses. Clients of member custody banks may include regulated pension funds, asset managers and investment funds, life assurance companies, other banks (who themselves may act as custodians for underlying clients) and other forms of regulated investors, all of whom are likely to have a duty to ensure the safety and security of the funds and assets committed to their care as well as a duty under law and regulation to verify the identity of clients and otherwise comply with anti-money laundering and sanctions screening requirements. Assets held in custody by members of the Association – the vast

[1] The members of the Association of Global Custodians are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company. For further information on The Association of Global Custodians please visit our homepage: http://www.theagc.com/

[2] Directive (EU) 2018/843 (5MLD) amending Directive (EU) 2015/849 (4MLD) on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018L0843).

majority of which consists of securities subject to settlement and clearing, directly and indirectly, through post-trade market infrastructure - exceed USD$110 trillion in value[3].

The AGC-EFC strongly welcomes efficient and cost-effective measures to combat money laundering and terrorism financing along with other threats to the integrity of the international financial system. Like the government, AGC-EFC members share the objectives which 5MLD seeks to achieve on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

Although the AGC-EFC welcomes the government's proposed transposition into UK law, we wish to provide some comments to address some core concerns of importance to the provision of securities custody services world-wide. We have therefore extracted relevant questions from the consultation that we wish to prioritise in this regard.

Chapter 9: Trust registration service

EXPRESS TRUSTS

64 ***Do respondents have views on the UK's proposed approach to the definition of express trusts? If so, please explain your view, with reference to the specific trust type. Please illustrate your answer with evidence, named examples and propose your preferred alternative approach if relevant.***

Scope

Our primary concern is that 5MLD requires ***all*** express trusts to be registered on the HMRC's Trust Registration Service (TRS). We note this includes UK trusts regardless of whether they have taxable consequences and any express trusts - wherever located in the world - if they incur a UK tax consequence.

We recommend providing further clarification on the kinds of non-UK express trusts the government wishes to capture. The principle in doing this would be identify the kinds of trusts to be registered with the UK on the basis that information on them may serve a useful purpose in targeting money laundering and terrorist financing. The potentially wide scope of impact of the regulation as currently proposed would seem to include forms of trusts whose registration and inclusion in UK requirements would not fulfil this purpose.

We note the government's statement in the Consultation (at 9.12) that "many types of bare trusts" may be considered "express trusts". From an English law perspective the position in some quarters has been that a segregated securities custody account may be considered a form of "bare trusteeship"[4], despite the fact these tend to be established with a "custodian" operating as a "securities intermediary" under a contract between the custodian and its customer. Customers can include: pension schemes, local authorities, financial institutions, insurance companies, investment funds, private individuals, and other securities intermediaries holding securities for underlying customers (who may also be securities intermediaries themselves), etc. We believe this approach

[3] Source: Institutional Investor, October 2016. This figure captures publicly available figures of ten out of twelve members of the AGC.
[4] Yates, M., Montagu, G., *The Law of Global Custody*, (2013 4th Ed.), p. 26 et seq.

would be highly disproportionate and ineffective in achieving the governments goals for reasons explained in our response to Question 65.

In addition to "bare trusts", the government states (at 9.20 of the Consultation):

> *For the avoidance of doubt, the government confirms that all trusts that incur a UK tax consequence will still be required to register on TRS, even if they are not express trusts or are non-EU resident express trusts that do not have UK trustees.*

Regulated investment funds are subject to regulation in the jurisdictions of their formation. FATF-jurisdictions in which these funds are established will be subject to equivalent customer identification, anti-money laundering and sanctions screening requirements. It is therefore difficult to see an added benefit of including such funds – to the extent they are formed as "express trusts" and hold UK securities and other property - in the government's proposed transposition of the directive. This is because investment in and activities of such funds in developed and developing financial centres are typically highly regulated and because, in view of their size, scale and wide distribution, their inclusion would be highly disproportionate to the purpose the UK seeks to achieve (this will be addressed more fully in our response to Question 65 below).

As a result, we recommend reduction of possible scope by eliminating structures operating as regulated and institutional investment funds in FATF-equivalent jurisdictions. This would eliminate the investors who participate in commingled investment funds that are offered, sponsored and managed by professional and highly regulated investment managers and banks providing bona fide portfolio management services to investors in the funds as a whole. Such funds typically are regulated in such a way as to ensure that control over investment activities is vested in the fund manager and not investors, thereby precluding the ability of investors to utilise such funds for any purpose other than for bona fide investment management of their invested funds.

In connection with the trust record-keeping requirement (to the extent relevant), we recommend clarification that the requirement for the registration of "beneficial ownership" only extends to a natural persons – rather than "individuals" as the UK proposes in the regulations - in accordance with 5MLD (per the references to "natural persons" in the preamble to the definition and in paragraphs (a) and (b) of the definition of "beneficial owner", particularly in the context of paragraph (b) relating to trusts). As 5MLD requires, any natural person exercising ultimate control over a relevant trust would be registered in accordance with paragraph (b)(v) of the definition of "beneficial owner".

65. ***Is the UK's proposed approach proportionate across the constituent parts of the UK? If not, please explain your view, with reference to specific trust types and their function in particular countries.***

As noted above, the government's proposed approach in the regulations is highly disproportionate.

First, we recommend that the proposals only extend to express trusts created after the new regime comes into force. As will be made clear below, a potentially massive number of number of trusts (depending on the final view taken of which trusts fall within scope) will need to be registered in a relatively short period of time which will have an immense operational impact on the industry. We believe such an approach would be appropriately proportionate by putting the industry on notice on a "going-forward" basis that those trusts that are within scope must be captured and accordingly registered.

Second, if the view that mere securities custody accounts should be considered "express trusts" were to be extended globally, then all securities custody accounts – wherever located - could be brought within scope, even (by way of example) if a UK security is maintained through a chain of custody involving multiple securities intermediaries, many of whom utilise "omnibus" accounts through the chain (which are reconciled in order to ensure the last intermediary in the chain maintains the proper entitlement for the ultimate beneficial owner).

It is our view that including such custody arrangements within the scope of this obligation will be overly burdensome to securities intermediaries – whether operating within the UK or without - without corresponding benefit to authorities in addressing money laundering or anti-terrorism concerns. There are a number of reasons for this:

- The intention of securities custody arrangements is not to disguise the beneficial ownership of the assets but are intended to facilitate the holding of assets on behalf of identified beneficiaries.
- Securities intermediaries are already subject to extensive books and records (regulatory) obligations in respect of clients they hold assets for and anti-money laundering regulation in the UK and elsewhere. There is therefore little value in also being required to register separately with the HMRC in TRS.
- Securities intermediaries as "account providers" typically have sight of their own client (as "account holders") who may themselves be acting as securities intermediaries (and in this respect as "account providers") holding by securities on behalf their underlying clients (the ultimate "account holders", or "beneficial owners") (this is the "chain of custody"). This aspect of post-trade infrastructure could lead to a substantial amount of duplicative information on the register containing the names of large entities who are holding assets underlying clients, who may or may not be intermediaries themselves.
- Such a registration requirement will necessitate additional systems, manpower and add operational complexity into an already heavily regulated environment.

In summary, it is our view that including custody arrangements within the scope of the registration obligation will result in a disproportionate regulatory burden and operational impact on securities intermediaries when compared against the benefit in registering such information in light of the information securities intermediaries are already required to record and the purpose of such arrangements.

Finally, in addition to questioning whether government's goals are actually achieved by applying the proposed regulation's requirements to regulated non-UK investment funds (as stated in our response to Question 64 above), we also ask the government to consider the usage, scale and size of these funds for bona fide purposes in highly regulated settings, making the government's proposed approach inappropriately broad.

Outside the UK, jurisdictions commonly employing "trusts" in the context of publicly and privately offered investment funds include those with common law systems, i.e., Ireland (typically taking the form of unit trusts established as UCITS funds or AIFs), Japan, Cayman Islands, the United States, Australia, New Zealand, Canada, the Channel Islands and Isle of Man, Cyprus, Malta, Malaysia, Singapore and South Africa, among others potentially.

As of the end of 2018, the U.S. mutual fund industry alone (the "registered" mainstay of "retail" investment funds in the United States) accounted for about $21.4 trillion[5]: this is almost half of all assets invested in regulated open-end funds world-wide.[6]

By way of example, U.S. mutual funds usually technically take the form of "trusts". Until 2019, all retail investment funds in Hong Kong and Singapore have all taken the form of unit trusts established under trust deeds (funds established as "companies" have only been permitted as of this year in Hong Kong, with Singapore still in the process of establishing a similar regime).

To provide a sense of scale (and regulation) of investment funds organised as express trusts as contemplated in the government's proposed transposition, we will focus on the environment in the United States below.

U.S. Mutual Funds - Background

According the Investment Company Institute, a U.S. mutual fund typically is organized under U.S. state law either as a corporation or a business trust (sometimes called a statutory trust). The three most popular forms of organization are Massachusetts business trusts, Maryland corporations, and Delaware statutory trusts (Figure A.1, below).[7] Massachusetts business trusts and Delaware statutory trusts are not necessarily considered "unit trusts" in the same way other trust funds formed under declarations of trust (or trust deeds) are. "Mutual funds" is a term that applies to all three structures, denoting colloquially their registration as "investment companies" (making them subject to extensive regulation by the Securities and Exchange Commission (SEC)) under the Investment Company Act of 1940 (the 1940 Act). Investment in and distribution of such funds are subject to other U.S. securities laws as well.

Historically, Massachusetts business trusts (MBT) have been the most popular form—in part because the very first mutual fund was formed as a Massachusetts business trust. This was a common form of organization at the time for pools that invested in real estate or public utilities and it provided a model for others to follow. An MBT is a legal trust established for the purposes of business, but not necessarily one that is operated in the Commonwealth of Massachusetts. They may also be referred to as an unincorporated business organization or UBO. Business trusts may be established under the laws of other U.S. states.

In 1988, Delaware—already a popular domicile for US corporations—adopted new statutory provisions devoted specifically to business trusts (since renamed statutory trusts). Benefits such as management of the trust and limited liability afforded to the trust's beneficial owners have led to Delaware statutory trusts being the most favoured form of mutual fund organization. A Delaware statutory trust (DST) is a legally recognized trust that is set up for the purpose of business, but not necessarily in the U.S. state of Delaware. It may also be referred to as an Unincorporated Business Trust or UBO. Delaware statutory trusts are formed as private governing agreements under which either (1) property (real, tangible and intangible) is held, managed, administered, invested and/or operated; or (2) business or professional activities for profit are carried on by one or more trustees for the benefit of the trustor entitled to a beneficial interest in the trust property.

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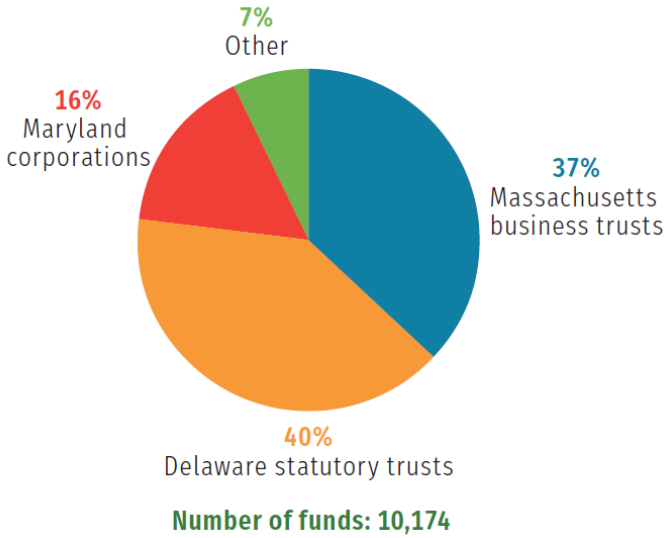
[5] "2019 Investment Company Factbook". Investment Company Institute. 2019.
[6] Id. Total assets invested in regulated open-end funds is valued at approximately $46.7 trillion.
[7] Id. Fewer than 800 funds, or about 7 percent, have chosen other forms of organization, such as limited liability partnerships, or other domiciles, such as Ohio or Minnesota.

Mutual funds have officers and directors (if the fund is a corporation) or trustees (if the fund is a business trust) forming a "board". The fund's board plays an important role in overseeing fund operations.

FIGURE A.1

The Most Popular Forms of Mutual Fund Organization

Percentage of funds, year-end 2018



Note: Data include mutual funds that do not report statistical information to the Investment Company Institute and mutual funds that invest primarily in other mutual funds.

A U.S. mutual fund is typically externally managed: it is not an operating company and it has no employees in the traditional sense. Instead, a fund relies upon third parties or service providers—either affiliated organizations or independent contractors—to invest fund assets and carry out other business activities.

Although it typically has no employees, a fund is required by law to have written compliance policies and procedures that govern the operations of the fund and the fund's administrator, investment adviser, transfer agent, and principal underwriter and that are reasonably designed to ensure the fund's compliance with the federal securities laws. All funds must also have a chief compliance officer (CCO), whose appointment must be approved by the fund's board and who must annually produce a report for the board regarding the adequacy of the fund's compliance policies and procedures, the effectiveness of their implementation, and any material compliance matters that have arisen.

Unit Investment Trusts

According to the Investment Company Institute[8], unit investment trusts (UITs) are registered investment companies with characteristics of both mutual funds and closed-end funds. Like mutual funds, UITs issue redeemable shares (called units), and like closed-end funds, they typically issue a specific, fixed number of shares. But unlike either mutual funds or closed-end funds, UITs have a preset

[8] "2019 Investment Company Factbook". Investment Company Institute. 2019.

termination date based on the portfolio's investments and the UIT's investment goals. UITs account for about $70 billion of registered (publicly offered) funds.

UITs investing in long-term bonds might have a pre-set termination date of 20 to 30 years, depending on the maturity of the bonds they hold. UITs investing in stocks might seek to capture capital appreciation in a few years or less. When a UIT terminates, proceeds from the securities are paid to unit holders or, at a unit holder's election, reinvested in another trust.

UITs fall into two main categories: bond trusts and equity trusts. Bond trusts are either taxable or tax-free; equity trusts are either domestic or international/global. The first UIT, introduced in 1961, held tax-free bonds, and historically, most UIT total net assets were invested in bonds. Equity UITs, however, have grown in popularity over the past two decades. Assets in equity UITs have exceeded the combined assets of taxable and tax-free bond UITs in recent years and constituted 86 percent of the assets in UITs at year-end 2018. The number of trusts outstanding has been decreasing as sponsors created fewer new trusts and existing trusts reached their pre-set termination dates.

Federal law requires that UITs have a largely fixed portfolio—one that is not actively managed or traded. Once the trust's portfolio has been selected, its composition may change only in very limited circumstances. Most UITs hold a diversified portfolio, described in detail in the prospectus, with securities professionally selected to meet a stated investment goal, such as growth, income, or capital appreciation. Investors can obtain UIT price quotes from brokerage or investment firms and investment company websites, and some but not all UITs list their prices on NASDAQ's Mutual Fund Quotation Service. Some broker-dealers offer their own trusts or sell trusts offered by nationally recognized independent sponsors. Units of these trusts can be bought through their registered representatives. Units can also be bought from the representatives of smaller investment firms that sell trusts sponsored by third-party firms.

Collective Investment Trusts

These are funds that are ***"unregistered"*** under the 1940 Act (i.e., they are not typically regulated by the S.E.C. like 1940 Act Funds are but instead are regulated mainly by Federal and state banking regulators). Collective investment trusts (CITs) are an alternative to mutual funds for commingled investment by U.S. pension plans and tax-exempt institutional foundations and endowments. "Collective Trust Funds" – exempt from registration under the Investment Company Act of 1940 (the "1940 Act") pursuant to Section 3(c)(11) thereof - are available for commingled investment exclusively to U.S. institutional pension plans. "Common Trust Funds" – exempt from registration under the 1940 Act pursuant to Section 3(c)(3) thereof - are available for commingled investment exclusively to tax exempt institutional foundations and endowments. Estimated assets in collective trusts as of the end of 2016 exceeded $1.4 trillion.[9]

Like mutual funds, CITs pool the assets of investors and (either actively or passively) invest those assets according to a particular strategy. Much like institutional share classes of mutual funds, CITs generally require substantial minimum investment thresholds, which can limit the costs of managing pooled investment products. Unlike mutual funds, which are regulated under the 1940 Act, CITs are regulated under banking laws and are not marketed as widely as mutual funds; this can also reduce their operational and compliance costs as compared with mutual funds.

[9] Cerulli Associates, U.S. Defined Contribution Distribution 2017: Re-Evaluating the Use of CITs in DC Plans (2017).

"Declarations of Trust" establish and govern CITs, creating a framework of operational and legal terms and conditions pertaining to the trust and the funds established and maintained under it. Terms regarding investor eligibility, subscriptions, redemptions and valuations, for example, may be found in the Declaration of Trust. In some cases, CITs may also have disclosure documents that provide additional information regarding their material terms and conditions, policies and procedures applicable to investment, and risk disclosures relevant to the investment strategy.

Descriptions of the individual CITs established under a Declaration of Trust exist in a document, which may be called a Fund Description, a Supplemental Declaration, Statement of Characteristics or an Investment Guideline, and is normally included as part of or accompanies the Declaration of Trust.

Because CITs may accept investments from only certain retirement plans or other eligible investors in order to maintain their securities and tax exemptions, their marketing and distribution efforts are more targeted and restricted than other pooled investment vehicles. Collective Trust Fund trustees – in addition to having to comply with requirements imposed by banking regulators - serve as ERISA fiduciaries (under U.S. pension legislation) to the "plan assets" invested in CITs and thus manage each CIT under ERISA fiduciary standards to the extent ERISA assets are invested in the CIT. ERISA fiduciary standards require a bank, as trustee, and any sub-advisers it may employ to assist in the management of the CIT, to act solely in the best interests of plan participants and their beneficiaries as a whole, avoiding conflicts of interest such as making decisions that may be in the bank's best interests. Common Trust Fund Trustees must comply not only with banking law requirements but also stringent restrictions established under the U.S. Internal Revenue Code.

CITs are subject to many laws and regulations, including those administered by:

- State and federal bank regulatory agencies (particularly the Office of the Comptroller of the Currency (OCC));
- The U.S. Department of Labor (DOL) (if a Collective Trust Fund);
- The Internal Revenue Service (IRS);
- The Securities and Exchange Commission (SEC);
- The Financial Industry Regulatory Authority (FINRA), to the extent the CITs are marketed by a broker-dealer; and
- The Commodities Futures Trading Commission (CFTC), to the extent the CITs invest in commodity interests, such as futures or swaps.

66. ***Do you have any comments on the government's proposed view that any obligation to register an acquisition of UK land or property should mirror existing registration criteria set by each of the UK's constituent parts?***

No response

67. ***Do you have views on the government's suggested definition of what constitutes a business relationship between a non-UK trust and a UK obliged entity?***

No response

68. ***Do you have any comments on the government's proposed view of an "element of duration" within the definition of "business relationship"?***

No response

69. ***Is there any other information that you consider the government should collect above the minimum required by 5MLD? Is so, please detail that information and give your rationale.***

No. We are of the view that a huge volume of data would be held by the government without a clear anti-money laundering / terrorist financing purpose. We consider that every effort should be made to streamline rather than expand the information required to be registered.

70. ***What is the impact of this requirement for trusts newly required to register? Will there be additional costs, for example paying agents to assist in the registration process, or will trustees experience other types of burdens? If so, please describe what these are and how the burden might affect you.***

See our responses to questions 64 and 65 above. The scale of the requirement is immense in every respect, from the due diligence required to identify express trusts, the requirement to develop and build software and manual processes to capture required information and effectively process it for registration, the additional required human resources and infrastructure and the very significant costs involved in doing so. The additional burden created by the obligation to update registers would also be very high.

71. ***What are the implications of requiring registration of additional information to confirm the legal identity of individuals, such as National Insurance or passport numbers?***

See our responses to questions 69, 64 and 65 above. Requiring additional information also adds to the diligence burden and associated costs referenced in our response to question 70. We have concerns regarding the data protection implications of being required to request and store personal data and the potential for this requirement to interfere with other obligations under data protection legislation such as GDPR as well as the further additional cost of ensuring voluminous additional amounts of personal information is held and processed in a compliant manner.

72. ***Does the proposed deadline for existing unregistered trusts of 31 March 2021 cause any unintended consequences for trustees or their agents? If so, please describe these, and suggest an alternative approach and reasons for it.***

As outlined in our response to questions 64, 65 and 70 above, requiring existing trusts to be registered places a disproportionate burden on the industry. We have therefore suggested in our responses that the proposals only extend to express trusts created after 5MLD is implemented in UK law and that the types of trusts outside the UK to be regarded as express trusts exclude regulated investment funds in FATF-equivalent jurisdictions.

73. ***Does the proposed 30 day deadline for trusts created on or after 1 April 2020 cause any unintended consequences for trustees or their agents? If so, please describe these, and suggest an alternative approach and reasons for it.***

See our responses to question 64, 65 and 72 above. Express trusts should be clearly delineated and only include trusts which are at risk of money laundering and terrorist financing which the legislation is primarily targeting.

74. ***Given the link with tax-based penalties is broken, do you agree that a bespoke penalty regime is more appropriate? Do you have views on what a replacement penalty regime should look like?***

No response.

75. ***Do you have any views on the best way for trustees to share the information with obliged entities? If you consider there are alternative options, please state what these are and the reasoning behind it.***

No response.

76. ***Do you have any comments on the proposed definition of legitimate interest? Are there any further tests that should be applied to determine whether information can be shared?***

The proposals are silent on the rights of individuals and legal entities to oppose the disclosure of their data to third parties claiming a legitimate interest. Given the volume of data (including personal data) that the government will hold, affected individuals and legal entities should be entitled to be notified of any request and have input (with a right of challenge) on the disclosure of their data.

77. ***Do the definitions of "ownership or control" and "corporate and other legal entity" cover all circumstances in which a trust can indirectly own assets through some kind of entity? If not, please set out the additional circumstances which you believe should be included, with rationale and evidence.***

No response.

78. ***Do you have any views on possible definitions of "other legal entity"? Should this be defined in legislation?***

No response.

79. ***Does the proposed use of the PSC test for "corporate and other legal entity" which are designed for corporate entities, present any difficulties when applied to non-corporate entities?***

No response.

80. ***Do you see any risks or opportunities in the proposal that each trust makes a self-declaration of its status? If you prefer an alternative way of identifying such trusts, please what this is and why.***

No response.

81. ***The government is interested in your views on the proposal for sharing data. If you think there is a best way to share data, please state what this is and how it would work in practice.***

A large volume of data including personal data will be held by government and there are currently no proposals in place on protections around it. This raises the question as to whether the GDPR and other

personal privacy implications have been considered and also the risk of the data being vulnerable to hacking and security breaches. Robust protections are required to address these concerns. Article 31(7)(a) 5MLD provides for exceptional circumstances to be laid down in national law where there is an exemption from such access to all or part of the information on the beneficial ownership (e.g. where the beneficial owners is a minor or otherwise legally incapable). It is unclear from the consultation paper what the exemptions will be in the UK and further detail is therefore required on this.

We strongly urge the government to consider addressing the items we have raised above. The AGC would be pleased to discuss the issues raised further. Please do not hesitate to contact John Siena (john.siena@bbh.com) should you wish to discuss any of the points raised in this response.

Sincerely,

John Siena
Chair, European Focus Committee
Association of Global Custodians