March 20, 2020

Dear Participants (and potential participants) in the Task Force on Securities Holding Infrastructure,

This is to update you on the Task Force on Securities Holding Infrastructure to be established by the ABA Business Law Section. The Task Force has been approved by the Section's officers and we expect it to be finally approved by the Committee on Committees and Council shortly. For your information we attach the updated proposal for the Task Force that was submitted to the Section Leadership and a pdf of this memo.

Mission Statement. Attached is a draft Mission Statement that we have prepared for the Task Force. We would very much appreciate your feedback and comments on the Mission Statement.

Meeting on March 27. We plan to have an initial organizational meeting on **March 27, 2020, at 10:30am EDT**, which will be conducted on-line and by dial-in, not in person. The meeting originally was scheduled to be held at the Section's Spring Meeting in Boston, but as you probably know that event has been cancelled due to the virus concerns. Details on the meeting will follow.

Additional Task Force Participants. We have made great progress in the past few weeks toward assembling an excellent group of participants in the work of the Task Force. However, we need your help in identifying and recruiting additional participants. In particular, we would benefit from participants from the SEC and bank regulators as well as additional experts on investment companies and advisors, trust indentures and indenture trustees, and AML and sanctions compliance. Please forward any suggestions to us and feel free to explore the possibility of participation directly with potential participants.

Many thanks for your consideration. We look forward to your input and participation in the March 27 meeting.

Best wishes,

Chuck and Sandy

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NOTES: MEETING (VIA ZOOM) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE, MARCH 27, 2020

Charles Mooney (CM) convened the meeting at approximately 10:30am EDT. He noted that co-convenor Sandra Rocks had an unavoidable client conflict and could not join.

CM observed that the project to be assumed by the Task Force (TF) is one that has not been undertaken in recent years, if ever. He noted that the holding infrastructure is reminiscent of the apocryphal story of a group of visually challenged folks examining an elephant—each of whom came away with a wholly different impression of the animal's attributes. He expressed his hope that the TF's holistic approach might overcome the tendency to view the infrastructure from narrow "siloed" perspectives, although this would require efforts from everyone to climb a steep learning curve.

CM proposed that the meeting focus primarily on the draft Mission Statement—what the TF intends to do and how it will pursue its work. He suggested that the general method of operation of the TF might be to hold a series of meetings, each addressing one or more particular relevant topics relating to the infrastructure. He suggested that the first substantive meeting might deal with voting of corporate shares and related proxy issues. He also noted that some small working groups might be organized to prepare for each of the meetings.

Finally, CM emphasized that in order to attract the most qualified and representative group of TF participants the current participants would need to assist in identifying and recruiting additional participants.

The floor was then opened for general discussion.

A question was raised about the term "holding" infrastructure, inasmuch as in various contexts terminology such as "carrying" securities and "custody" of securities is common. It was noted that securities are held directly on issuers' books as well as through intermediaries and that "holding" is an appropriate and neutral term. It also was pointed out that the TF should keep in mind the need to contemplate a broad landscape that would encompass future developments and practices. After discussion it was generally agreed that the reference to "holding" infrastructure and systems is appropriate.

On working methods, one suggestion was that the TF might consider two approaches—one addressing transactional settings and the other the nature and operations of various market participants/counterparties. It was also observed that the TF should take account of the various types of financial assets involved as well as the various different types of intermediaries.

The point was made that the TF should keep in mind that the financial markets are global in nature. The United States infrastructure has a profound impact on other markets. Moreover, many of the market participants are multi-national institutions with operations and connections in many jurisdictions. It was further noted that in this environment interests in financial assets are frequently carved up in some fashion, revealing the need to appreciate that the markets often deal with pieces of assets and a variety of rights in assets.

The suggestion was made that the TF should organize a working group to address and present issues relating broadly to the various problems encountered by beneficial holders of securities in the intermediated holding system. Because discussions of the intermediated system often tend to be dominated by institutions that act as intermediaries, the issues relating to the relationship between beneficial holders and issuers of (including obligors on) securities tend to be neglected. Some examples were offered to illustrate the merits of this suggestion:

- Who should a senior debtholder sue to enforce subordination provisions?
- How should the bondholders eligible to count for purpose of an involuntary bankruptcy petition be determined?
- Who hold claims that are eligible for purposes of enforcing derivative rights of creditors against an insolvent firm?
- Who qualifies as a good faith purchaser (or the like) that takes a debt security free of, e.g., a fraudulent transfer claim?

While these are examples and some are mixed state-federal (bankruptcy) law questions, there are many issuer-beneficial holder problems that are implicated. Issues that might be straightforward in the direct holding context but not so in the intermediated holding context are of particular interest. There was no disagreement expressed as to the consideration by the TF of these various non-voting aspects of the rights of beneficial holders to exercise rights associated with securities. As an approach for the work of the TF, it was suggested that the analysis should begin with a straightforward example of a purchase of securities settled in the DTCC system and credited to a securities account.

In addition to substantive presentations and discussions, it was suggested that the TF, at some point in its work, might consider the use of survey questions submitted to stakeholders as a part of its methodology. It was also suggested that the survey approach might be considered after first listening to various stakeholders in the process of the substantive discussions and that surveys also might be appropriate for follow up work by regulators or others.

In pursuing the important goal of identifying problems in connection with the infrastructure, it was suggested that the TF also should give proper attention to potential solutions or improvements that might be promising, even if no strong consensus were to emerge. It was noted, in this connection, that the draft mission statement appropriately provides that the TF will identify and assess plausible means of addressing problems that it identifies.

It was further suggested that while the TF is predominantly composed of lawyers, special efforts should be made to ensure sufficient input from the actual stakeholders that would ultimately be implementing or otherwise affected by any changes to the current system. It also was noted that it will be important to have the SEC and bank regulators as well as major sponsors of funds involved in the work of the TF.

A question was raised as to the nature and potential distribution and use of a written TF report, as contemplated by the draft mission statement. Several observations responded to this inquiry. It was pointed out that the report would go through the Section's internal approval process and

might be published in The Business Lawyer or otherwise so as to attract widespread attention. It also was noted that there is considerable precedent for reports of the Section or its committees to have substantial influence on the course of law reforms. In particular and relevant to the work of the TF, the work of the Section and its Ad Hoc Committee provided the groundwork and inspiration for the substantial revisions of UCC Article 8 and Treasury Regulations on book-entry securities in the late 1980s and early 1990s. But even aside from a role in law reform, to the extent that the TF report could provide a clear picture of how the existing system actually works that would be an enormously valuable contribution.

It was observed that it would be helpful for the participants to have a "roster" of those participating in the TF. This would give the participants a useful understanding of "who we are and why we are here." CM noted that this would be forthcoming in due course.

The meeting was closed shortly after 11:30am EDT.

AGENDA
(Revised June 22, 2020)

Meeting of Task Force on Securities Holding Infrastructure
Wednesday, June 24, 2020, 10:00am EDT
(via Zoom)

1. Introduction: Charles Mooney and Sandra Rocks (Co-Convenors)

2. Presentation:

INTERMEDIATED OWNERSHIP AND SHAREHOLDER VOTING

Moderator:
Sandra Rocks, Esq.
Counsel
Cleary Gottlieb Steen & Hamilton LLP

Speakers:

Edward Rock
Martin Lipton Professor of Law
Co-Director, Institute for Corporate Governance and Finance
New York University School of Law

Brian L. Schorr, Esq.
Partner and Chief Legal Officer
Trian Fund Management, L.P.

Scott S. Winter, Esq.
Managing Director
Innisfree M&A Incorporated

John Coates
John F. Cogan, Jr. Professor of Law and Economics
Harvard Law School

Darla Stuckey, Esq.
President and CEO
Society of Corporate Secretaries and Governance Professionals

Lawrence Hamermesh
Executive Director, Institute for Law & Economics, University of Pennsylvania Law School
Professor Emeritus
Widener University Delaware Law School

Panel Agenda:

Rock: The fundamental misalignment of share "ownership" and share voting

Schorr and Winter: What can go wrong: Trian's 2018 proxy contest at Procter & Gamble

Coates: Summary of the SEC Investor Advisory Committee's recommendations

Stuckey: End to End Vote Confirmation Working Group discussion on vote entitlement

Hamermesh: The SEC's Proxy Plumbing Release: Where are we now?

3. Open Discussion

4. Adjournment (by 12:00 noon)

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NOTES: MEETING (VIA ZOOM) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE, JUNE 24, 2020[1]

Task Force co-chairs Charles Mooney and Sandra Rocks made introductory comments.

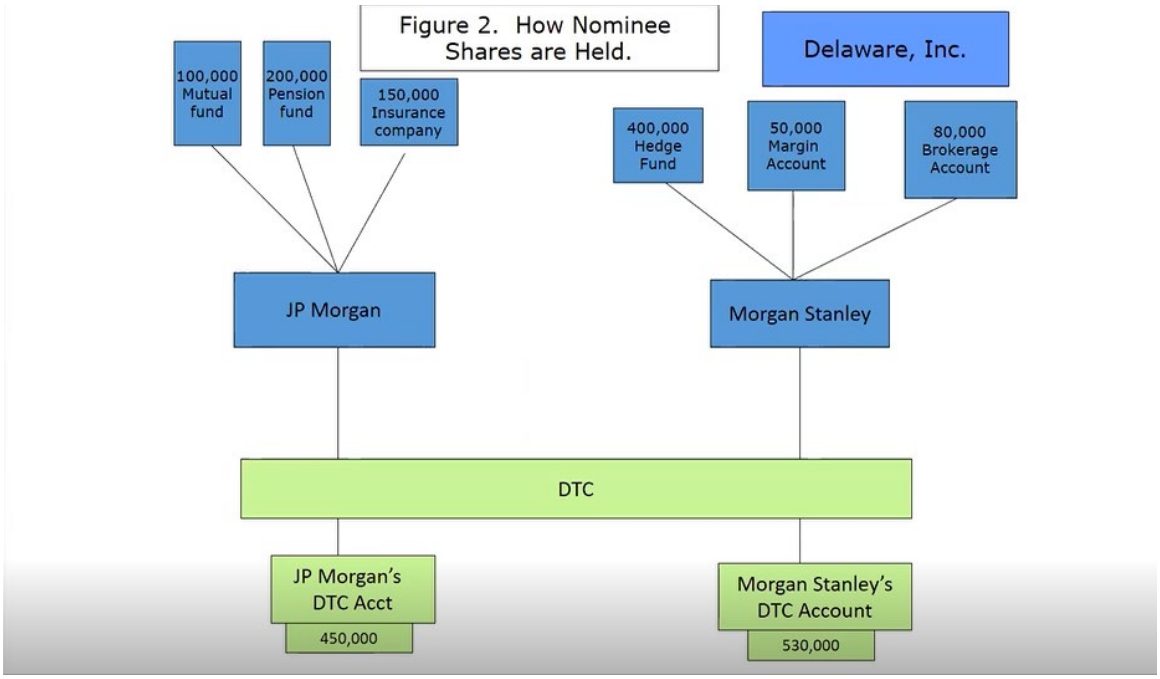
Edward Rock (ER)[2]

ER commenced the meeting discussing his experience with the relevant issues. Over fifteen years ago he began looking at this issue while researching hedge funds and corporate governance and control. Along the way, he saw issues of overvoting and empty voting, leading to his "Hanging Chad" article. In his view, little if anything has changed with respect to these issues over the last fifteen years.

ER then opened a series of slides to discuss "Intermediated Ownership and Share Voting: The Core Problem." Under Delaware law, voting is fairly simple: the company sends proxy documentation to registered owners who execute the proxy and send to the tabulator who tabulates with respect to the share register and reports and outcome. In practice, however, things look more complicated:

[1] Notes prepared under supervision of Charles Mooney; any errors are his.

[2] Martin Lipton Professor of Law, Co-Director, Institute for Corporate Governance and Finance, New York University School of Law.



Several things however can go wrong as these systems become more intricate. The first group that ER noted are the Pathologies of Complexity. These include the issues of 1) a lack of "vote confirmation" or "end-to-end audit trails"; 2) when materials don't arrive for the shareholder; and 3) when votes are not counted. The Pathologies of Complexity can both influence actual voting results, but also limit the ability to prove whether or not a shareholder's vote was even counted. The second group of problems raised by ER are the Pathologies of Ownership. Here, ER included the issues of overvoting in which too many votes are submitted. The third and last group of problems are pathologies of Misalignment of Voting Rights and Economic Interests. Entities use the existing flaws to "game the system." The most common issue noted here was empty voting.

In theory, however, there is an "easy" fix: a Central Registry, which could be within a Securities Depository. ER believes this type of system would be ideal if we were building one from scratch and noted China as an example. He argued the approach would be best with dematerialized shares and pure book entry record keeping, thus giving up on certificate ownership. He further addressed the value of daily clearing to keep records up to date. This type of system would raise numerous advantages such as vote confirmation, audit trails, increased accuracy in vote counting, faster transaction clearing, reduced distribution time, and a shortened time between record date and meetings. There are no clear disadvantages in ER's opinion. The system would look like the following chart:

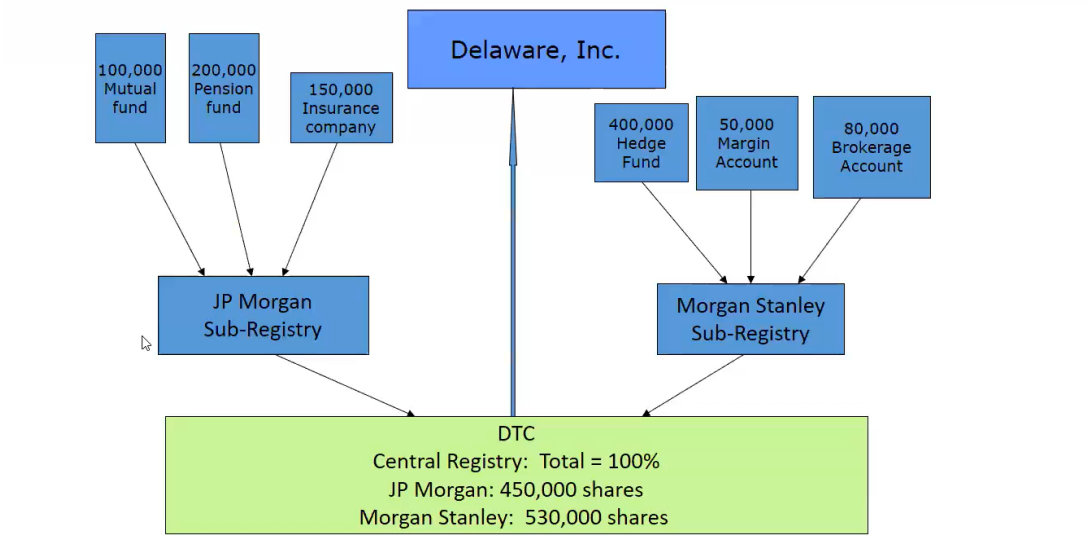


Fig. 4. Share holding in a pure book-entry system

Next, ER discussed why we don't have a system like this if it is so clearly advantageous, especially because we already have the technology and there are not any evident legal barriers. He pointed primarily to political forces limiting changes. Entities including broker-dealers and service companies gain so much from the current layout that they are incented to keep the status quo.

ER concluded by opening a question to the group for consideration: "If the first best solution is not possible, what are the second-best solutions?"

Brian Schorr (BS)[3]

BS spoke about the Proctor & Gamble proxy battle from 2017 as a case study of the voting issues at play in our current system. Before the eventual settlement, putting someone from Trian on the board, about 2 billion votes were cast in this proxy contest, leading to a .25% margin in the results of the election. He believes this high-profile case shined a light on the issues of the existing system.

The first issue BS saw was overvoting. Voting instructions were received for more shares than were held on the record date. In fact, during the P&G case, the overvoting issues were not reconciled until after the announcement of a certified preliminary result, leading to a recount. This necessary due diligence is incredibly costly to large corporations such as P&G, but it is necessary to having assurance of the proper voting outcome.

The next issue BS noted, related to the chain of custody. There is no way for beneficial owners to confirm their shares have been voted. As a result, there is burdensome uncertainty if there is a

[3] Partner and Chief Legal Officer, Trian Fund Management, L.P.

break in the chain of custody. Brian pointed to one example in which a financial institution held shares in a portfolio separate from the vast majority of its other shares. Those separate shares were not just in P&G, but in a wide array of companies. Because of a break in the chain of custody, those shares were excluded from the tabulation for voting for all the businesses represented by shares in that portfolio.

Lastly, BS raised a "paperclip problem"[4] and separately, the issue of empty voting with respect to employee stock ownership plans.
All-in-all BS learned a couple of key things from the process. The first is that a shareholder's ability to participate in director elections is fundamental to corporate democracy as it is the primary mechanism to hold directors accountable. Second, he learned that the current system makes an accurate vote incredibly difficult in a close proxy context as it is both onerous and costly.

Scott Winter (SW)[5]

SW began by providing more context to the P&G proxy contest.[6] He then reiterated BS's point that this situation shined a light on the problems in the current system, noting that the problems are overlooked because the vote outcomes are rarely influenced by these inefficiencies in the process.

SW pointed to three key issues. The first is the sloppy documentation in the chain of voting authority of shares held by banks and brokers. The issues arise here during common situations, including M&A, changes by clearing banks, and general sloppiness. Second, he discussed the lack of knowledge and education of the proxy staffs at intermediaries today. Broadridge has taken the reigns leaving proxy staffers without the same understanding of the process as their pre-Broadridge counterparts. The last issue he noted related to registered shares. They need expertise to tabulate hundreds of thousands of votes across different media (hard copy, telephone, internet, etc.). It is difficult, however, because people are often voting more than once, transfer agents maintain files differently, and shares in general are not held in the same ways. SW is optimistic that the problem can be solved. He believes that to do so, we need to clean up respondent bank proxies (i.e., collecting voter instructions downstream from the DTC direct participants), meaning someone needs to be held responsible for it. Additionally, we would need to standardize how transfer agents manage their shares and educate proxy departments at intermediaries.

John Coates (JC)[7]

[4] Hard copy votes not initially counted because documentation was not paperclipped together as corporation did not provide paperclips, staples, etc.
[5] Managing Director, Innisfree M&A Incorporated.
[6] $200B market Cap; far less than 10% ownership per stakeholder; >250k registered owners; 3M beneficial owners; 150k+ participants from employee benefit plans; street shares held by 750 banks and brokers (<250 through DTC = 95% of street shares)
[7] John F. Cogan, Jr. Professor of Law and Economics, Research Director, Center on the Legal Profession, Harvard Law School.

JC echoed the issues discussed earlier then focused his time on the Investor Advisory Committee 2019 recommendations. First, he believes that the SEC should mandate everyone over whom they have authority to effect end-to-end confirmation. He said the issuers would probably be the best for driving the rest of the system, but it could still be done through transfer agents or broker-dealers. Second, the SEC should require reconciliation more generally, including off-cycle rather than just for elections, because the system would be more easily fixed without the pressures of the election itself. Lastly, he recommended a couple of studies into whether shareholders are functionally defaulted into being objecting beneficial owners as part of their agreements with broker dealers.

JC concluded by noting that companies have a hard time individually and through organizations putting up the money to fix the system because there is little incentive outside of a proxy fight. Ultimately Delaware, SEC or maybe the ABA will need to take on a leadership role in resolving this. SEC could start this process by enforcing existing rules with more seriousness. One example would be to more heavily fine entities that fail to manage records and reconcile more efficiently. Additionally, Delaware could begin by requiring companies to continue a meeting until 99+% of the shareholders are given an end-to-end notice of the vote, so the Board is not authorized to act until the meeting is completed.

Darla Stuckey (DS)[8]

Before providing an overview of the progress of her working group, DS noted that she believes that undervoting is a bigger problem than overvoting. The tabulators only have the information that DTC has which often does not match with what the broker sends, and votes won't be counted unless they can be matched to particular shares.

DS's working group does not have the authority of the SEC but does have the goodwill of numerous industry participants from across the space. The group includes tabulators, issuers, custodians and more. For now, they have focused their attention on the beneficial side rather than the registered side and have kept to US meetings rather than expanding to international ones. Additionally, they have created an operational subcommittee with participants from around the space with the goal of getting the operational people from each side talking. That subcommittee has created several scenarios of focus.[9]

Larry Hamermesh (LH)[10]

[8] President and CEO, Society of Corporate Secretaries and Governance Professionals.

[9] The scenarios include: Nominee holding, registered and beneficial, but wants to vote all beneficial; multiple DTC numbers but broker reports under only one; multiple depositories; failed trades; beneficial positions held in international depositories; custodians that do not have a DTC account, but contract with DTC participant.

[10] Executive Director, Institute for Law & Economics, University of Pennsylvania Law School; Professor Emeritus, Widener University Delaware Law School.

LH questioned what would happen if we had a simple system in which beneficial owners of shares could vote easily and directly with very low transaction costs. He speculates that there may be low levels of shareholder participation because retail investors participate at low levels now. He went forward presenting the idea of "rational apathy," questioning how important it is for shareholders to vote and how often they must vote to maintain the benefit of holding directors accountable. LH raised the example of Minnesota corporate law, in which directors hold indefinite terms, but can be voted out if 3% of the ownership requests a vote. Would this help alleviate the issues of the current system?

General Discussion:

Comment 1 – It is extremely expensive to be a DTC participant. In her experience, a custodian bank's default is to disclose to the issuer, but it is worth exploring if bank custodians have different defaults than brokers.

Comment 2 – In her experience, the agreements with between broker-dealers and investors all have non-objecting beneficial status as the default.

Comment 3 – He is convinced that there are always going to be cases in which the margin of victory is less than the margin of error. Can't there just be a rerun of the election when that is the case. This may protect from large costs of infrastructure changes. Additionally, there will be drawbacks to direct registration with the beneficial owner. It is currently easy for an owner to buy/sell/transfer without worry over how things are held. There are also owners who wish to maintain their anonymity. *ER response* – One of the advantages to a central securities registry is that it facilitates buying and selling shares. Complexity doesn't come from the central registry, but the build-ins. He thinks that is the core issue here and why the SEC was right to embrace proxy plumbing. Furthermore, situations like P&G look terrible and hurt the legitimacy of corporate law. *JC response*- If people knew the narrowness of anonymity in this context, fewer people would choose it. It only means issuer doesn't know who you are, but tax authorities, regulators, other entities can discover it.

Comment 4 – Voting by shareholders is essentially bundled. While there are plenty of uncontested elections, there are also numerous shareholder proposals and governance proposals to be voted on, so simply limiting the instances of voting can have negative effects. Many of these votes put certain shareholder proposals in the mainstream.
A lot of the comments flagged the idea of a more transparent and effective confirmation process. So far, the proxy plumbing debate hasn't been creative. For example, 14b and the role of intermediaries and the responsibility of the issuer may be good areas to consider place the responsibility. This placement of the obligation could lead to a market-based response. If mutual funds have to vote, then what does it mean if you don't know if your vote was counted accurately? But if mutual funds demanded accurate counts then market participants might respond.

Comment 5 – He noted examples of Germany in the 90s and China more recently that included more transparency, but the institutions essentially pressured those States to use a

more American approach. He believes that US policy spreads around the world in this respect. He also believes that the SEC may consider reforms if there is a change in administration. Lastly, he noted that Blockchain may not be necessary but could inspire more interest in making the change to more transparency, so it could function as a political tool.

Charles Mooney – He concluded the meeting speaking first to procedure. We know we won't resolve all the issues in this meeting, but within this task force, we will be following up with a refined working group to make recommendations. He encourages others to continue to engage with the meetings to hear the different perspectives of those involved. These different views will help because a cost benefit analysis is going to have to look at a wide array of things, especially if we need to maintain the flexibility in financing that we have now. On the anonymity front, the DTC is the key and its owners, the broker dealers and the banks, will therefore be keys. The issuers will be partners.

NOTES: MEETING (VIA ZOOM) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE ON AUGUST 11, 2020[11]

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AGENDA
Meeting of Task Force on Securities Holding Infrastructure
Tuesday, August 11, 2020, 12:00pm – 2:00pm EDT
(via Zoom)

1. Welcome and Introduction: Charles Mooney and Sandra Rocks (Co-Chairs)

2. Presentation:

BENEFICIAL OWNERSHIP IN THE INTERMEDIATED HOLDING SYSTEM: LITIGATION AND BANKRUPTCY PROBLEMS AND PITFALLS

Moderator:
Edwin E. Smith, Esq.
Partner
Morgan Lewis & Bockius LLP

Speaker:
Thomas Moers Mayer, Esq.
Partner
Kramer Levin Naftalis & Frankel LLP

Commenters:
Sandra Rocks, Esq.
Counsel
Cleary Gottlieb Steen & Hamilton LLP

Edwin E. Smith, Esq.
Partner
Morgan Lewis & Bockius LLP

3. Open Discussion

4. Adjournment (by 2:00 pm EDT)

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Charles Mooney (CM) and Sandra Rocks (SR) opened the meeting, introduced the program, and turned the meeting over to Edwin Smith (ES).

ES began by introducing the goal of the meeting. He noted everyone's general familiarity with UCC Article 8 and the indirect holding system. The system seems to work nicely within Article

[11] Notes prepared under supervision of Charles Mooney; any errors are his.

8, but when we start to deal with other issues that have generally arisen with directly held securities, there are some tensions. He then introduced Tom Mayer (TM), whose role during the meeting was to tee up the issues for discussion.

TM noted that as a bankruptcy lawyer he sits at the intersection of securities law, commercial law and bankruptcy. He is in the trenches seeing problems in practice. He began by providing his historical perspective. His view is that once upon a time there was a law of bills and notes. It was not just to govern the transfer of bills and notes from one owner to the next, but to protect holders with respect to their dealings with the issuer. One of the things benefits of being in the market for debt securities in particular was that if one were a subsequent holder of that security, one bought it with the comfort of knowing that it could be enforced against the issuer […TM lost connection].

Issue 1 - Enforcement

TM: In the Article 8 indirect holding system the beneficial holders of debt securities are not creditors but holders of security entitlements against their brokers. Under UCC 8-207(a) it's only Cede & Co. [nominee of DTC] that has the right to sue [under the book-entry only global note structure]. How does a bondholder holding security entitlement enforce its rights against the issuer? How does it sue?

TM believes the current mechanic is very difficult. First, he notes that there are trust indentures. The theory is that the indenture trustee does the enforcing, but he thinks that method is imperfect because the trustee does not always do what they're supposed to do for both good and bad reasons. Second, TM notes there are lots of securities without indentures. As an example, he points to the municipal bond area where general obligation bonds often do not have indentures. Puerto Rico (PR) has fiscal agents not indentures. He explained that one would need a proxy from DTC in order to sue. He then asked the group how difficult this is to obtain and how long it takes.

SR responded by explaining there are several lines of analysis here. She appreciates the point that not every bond issue has an indenture. She then remarked that some of the difficulties in case law dealing with suing and exercising rights are attributable to the indenture, including collective action clauses and the limitations as to who can act as a contract matter. She explained that the task force should separate out that indenture component and focus on what it is about the intermediated system itself creates roadblocks in this context.

ES liked TM's point about getting a proxy from DTC. In his experience there are two ways to deal with that issue. The first is to get documentation from DTC and from the broker. The other is to deliver out the security to the entitlement holder, but this can be done only in the rarest situations. He, however, questions how easy it is to get the paperwork from DTC quickly.

Aimee Bandler (AB) then sought to clarify the process. It's not overly complicated to get a regular litigation authorization, but in terms of intermediated holdings, DTC can only accept instruction from a participant. So if one holds at a level below a direct participant, it's interest must be identified at that level. It is not only possible to get litigation authorization to a

beneficial holder, but it can be a straightforward process. There is even flexibility to expedite based on circumstances.

In response to AB, TM questioned why the law doesn't provide that the beneficial holder opportunity to sue directly?

ES suggested that 8-202(f) might be read that way.[12]

SR followed by noting that even if the law so provided there would still be the practical problem of identifying the beneficial owner. One can hold a security entitlement through an intermediary that is separated by multiple levels from Cede & Co. and would still have to prove the connection with the security.

Robert Schwartz (RS) offered that it is a question of the terms of the underlying security. Corporate law statutes generally do not grant rights to beneficial owners.
TM argued that the holder is supposed to have certain rights that it may exercise whether or not the indenture trustee wants to exercise them. The right to sue for past due principal and interest is foremost in this respect. In bankruptcy court it is regular practice for beneficial holders to show up. He doesn't see why there is any greater impediment to someone showing up in court as a beneficial holder. They should have a right to sue. Why shouldn't the statute say that? If one has proof of beneficial ownership, should not they be entitled to sue under UCC Art. 8?

CM in response pointed out that holdings credited to an entitlement holder's securities account statement may or may not reflect their actual beneficial holdings. This is a much more acute problem with equities, which are subject to more shortfalls in the holdings of intermediaries. The data necessary to calculate exactly the holdings of all entitlement holders exist in the system as a whole, but nowhere is there a centralized statement of net holdings. When the issue is a person's status as a beneficial holder and not the exact number or amount of the security, the account statement is highly unlikely to be in error.

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[12] [CM note: UCC 8-202 deals in part with defenses that may be raised against the issuer of a security. Subsection (f) provides:

> If a security is held by a securities intermediary against whom an entitlement holder has a security entitlement with respect to the security, the issuer may not assert any defense that the issuer could not assert if the entitlement holder held the security directly.

Under UCC 8-207(a) the registered owner of a security has the exclusive power to exercise the rights of an owner. Read literally, 8-202(f) would preclude an issuer from raising as against an entitlement holder the defense that the entitlement holder is not the registered owner—a defense that the issuer could not raise against a direct holder. This presumes, however, that the entitlement holder could prove not only that it has a security entitlement but that the entitlement is actually "with respect to the security." That literal reading and the 8-207(a) defense do not appear to be contemplated by the explanation of subsection (f) in official comment 5 to 8-202. Moreover, that reading would undercut substantially the principle established by 8-207(a) on the integrity of an issuer's registration books.]

Lois Radisch (LR) attempted to realign the discussion by commenting that in the intermediated holding structure there are tiers of interests. The fundamental rule is that each entitlement holder has an entitlement against its intermediary. It does not matter how far down the chain of intermediated holdings they are; the holder has an interest that is a combination of contract and property interest and is a right against the intermediary maintaining the account. She requested the group to come back to this because the discussion gets caught up in talking about "securities" or "holding securities" or "owning securities," and using the terms beneficial owner and holder. Attention needs to be on what entitlement holders actually hold and own.

Carl Bjerre (CB) pointed to the example of Luxembourg statutes that do expressly provide a right for securities account holders to bring an action to enforce rights under securities. It seems the creators of that statute were perfectly comfortable proving that direct right.[13] Whether Art. 8 does provide this right is at best unclear. He concluded by adding that it's one thing to preclude defenses and another to provide a cause of action.

David Aman (DA) added that even with debt securities, there may be more securities of an issue credited to entitlement holders' accounts than there are securities issued. Allowing anyone who is an entitlement holder to sue without having gone through the process of actually allocating the securities to the entitlement holders could be problematic. He would probably prefer DTC's solution of having an efficient process for the allocation [i.e., a certification of beneficial holdings, as discussed above] than allowing the entitlement holder to bring suit without any the authorization from the actual registered holder.

Robert Coughlin (RC) believes indenture trustees would probably favor beneficial owners having more direct rights against issuers. But, part of the reason they are accused of not acting is there are a variety of holders with many different interests and different classes among them. Additionally, other impediment for holders exist even at the record owner level at which there may be contractual provisions limiting these direct rights.

George Geis (GG), then returned to the question of whether there has been a specific instance of a problem here or whether this is all theoretical. He brought forward an analogy to appraisal rights. With appraisal rights one can point to specific examples where people have been beneficial holders trying to assert their appraisal rights and something got crossed in the wires communicating that up through the chain. He noted an instance in Iowa where appraisal rights were not granted because of these obstacles. GG then asked whether there is a tangible concern here and if there is, whether it can be resolved through private contracting?

TM asked how one determines the time when a security is held. There is plenty of corporate law doctrine that says you can only sue when you are a holder on a specific date. He argued in that vein, Cede & Co. is always the holder. By that logic, anyone can always file a derivative action even if they only bought the beneficial interest yesterday. How would one police that? In the bankruptcy context there is also doctrine that equitable subordination cases can only be brought by creditors who were such at a specific time, but this does not fit well into Art. 8 system and the status of Cede.

[13] [CM Note: Luxembourg counsel recently confirmed to CM and SR that it is highly unlikely that securities credited to securities accounts would not accurately reflect those held at the CSD level.]

AB explained in response that if DTC asserts appraisal rights or gives litigation authorization it is as of a specific date. Only on occasion does it give retroactive authorizations.

Mike Manning (MM) spoke to operations specifics in the asset-backed securities market when he was involved. One would get a medallion guarantee which gives a specific date. It was always an issue because notices would go out a few weeks before the voting date, leaving concern that someone would vote, and the security would move after that.

ES returned to GG's questions. He has dealt with this on a couple of occasions. In one, the DTC documentation resolved the issue right away. The other was foreign litigation. The issue was raised as to how entitlement holder was a creditor and an expert was required to speak in relation to Art. 8. All-in-all it required a great deal more explanation.

TM then asked the group if a broker-dealer has customers some of whom have permitted rehypothecation and some of whom have not, does the DTC know that?

SR with confirmation from the DTC staff on the call, explained that DTC would not know unless there is an instruction to move them on DTC's books.

Marlon Paz (MP) added that it is important to note in the broker context that brokers typically engage in stock loans under the master security loan agreement. It provides for allocation of voting rights, so the lender (in this case, typically the broker-dealer but possibly the beneficial owner) would waive the right to vote and provide consent to similar actions so long as the securities are on loan.

RC in response to the question of experience explained that he has never seen a beneficial owner be unable to sue a trustee, but the only situations he has seen where a beneficial owner could not sue are in appraisal rights. He pointed to the Dell merger case as an example. In that case, there was a systems problem where clear instructions to vote against were not passed through correctly. The court was convinced that the petitioners intended to vote against but only because the holder had unusually detailed records.

DA followed up on MP's comment, saying the customer is not a party to the mass security lending agreement, but the customer's broker is. He then noted the question assumes the broker would have identified whose shares are lent and whose are not. This is a misperception. Brokers have securities in a good control locations. They may have securities in other locations and then there are securities as to which they do not have control (e.g., loaned out). They have an obligation to maintain a certain quantity of securities in their control, but that allocation is still not one-for-one.

Issue 2 - Enforcement of Subordination Clause

TM - What if an entity holds senior debt and wants to enforce a subordination clause against the subordinate debt holder? Who do they sue? DTC?

AB addressed this question, explaining that Cede & Co. is often named as a nominal defendant and record holder. They typically do not take any position on the merits but will make distributions as ordered by the court.

TM then asked if distributions have already been made in violation of the subordination provision, is DTC indemnified? To which AB responded, "yes," and continued: DTC would inform participants that they have been wrongly given distributions and ask for them for a return if the court asks DTC to debit the relevant accounts. It would all depend on the specific litigation.

Issue 3- "Protected Purchaser"[14]

TM - Once upon a time a holder of bond who receives the bond without knowledge of the defense of the issuer could enforce that bond without being hit by an issuer defense. Has this survived the indirect holding system?

CB responded to the question by creating a dichotomy between the current regime and the older one. Today society is worried about the indirect holding system. Looking back, the older regime since 1994 or even the 1960s was concerned primarily with the direct holding system. He thinks the issue we're discussing is at least worth talking about under the direct holding system that we have under Art. 8. 8-303. That section provides what is loosely equivalent to holder in due course provisions in direct holding system for securities. He believes it is much less clear that defenses can be passed along to purchasers for value even in the direct holding system. If it is not clear in direct holding system, then it's even less clear in the indirect holding system.

TM then compared UCC 8-302 with the comparable negotiable instruments provision, 3-203 (former (F), and New York, 3-201). The language is substantially different. F-201, which deals with the shelter principle, says that if his predecessor could assert rights under the negotiable instrument then he would have the same rights. But, 8-302 does not say that. He looked to the comment under 8-302 for more clarity but found none.[15] The effect of this is dangerous because for the holder who bought before an insolvency proceeding started, it would be worth more in their hand than for a subsequent holder who bought after the case.
R
S explained that in the drafting process for 8-102(a)(1) [defining "adverse claim"] the group looked at it as a substantial narrowing of the concept of adverse claim from the way it was under Articles 3 and 8. There is strong case law under the old versions of Art. 8 and he doesn't know if it survived the change limiting the scope of adverse claim.

SR added to BS's point. She thinks the older cases were getting at negative covenants in associated contracts that said one is agreeing not to transfer their rights. The drafters were

[14] [CM Note: This is the term used in UCC 8-303(a), which is the successor to the previous Article 8 term, "bona fide purchaser." 8-303(b) provides the "take free' rule for certificated and uncertificated securities. It does not apply to security entitlements.]
[15] [CM Note: Current 8-302 (as did the pre-1994 version) provides that "a purchaser . . . acquires all rights *in* the security that the transferor had or had power to transfer." (Emphasis added).]

providing that this is a property concept. One doesn't need to take free because it's a different analysis.

TM posed a new question to the group: Assuming an indenture has 9-403 language in it (i.e., a waiver of defenses as against assignees). Who is entitled to enforce that language? Who does the assignment refer to in an indirect holding system?

ES suggested that it may resolve the problem to refer to any "subsequent entitlement holder" rather than an "assignee" in drafting. He qualified the statement noting that maybe that would only protect the purchaser for value, leaving a need for a shelter principle for other transferees.

Issue 4 – Counting in Bankruptcy Proceeding in an Intermediated Holding System

TM - Bankruptcy lawyers don't just worry about total amounts of debt securities that vote "yes" or "no"—there are numerosity requirements in the statute. (E.g., If there are more than 12 creditors then more than 3 must vote in favor in order to file an involuntary bankruptcy petition.) How do you count that in an intermediated holding system? Have DTC folks ever issued a proxy to authorize the filing of an involuntary BR? Do holders count independently in an involuntary situation in this system?

AB responded that from the DTC/Cede & Co. perspective, anyone can ask for authorization but as far as she knows they have never been asked to provide authorization for someone to file an involuntary or for DTC do it directly.

TM then added that courts have hinted at the idea that 3 holders would count as 3 creditors, but it remains an area of concern. He then asked how the votes would be counted for a decision on a plan in a Chapter 11 case. In order to get class approval on a plan, the class needs at least 2/3 of the total amount of claims and greater than 1/2 in number of claims. How do you count numbers with beneficial owners? TM suggests that practically speaking, the plan proponent sends out master ballots to broker-dealers through DTC, and the broker-dealers go to entitlement holders to get their votes. He understands that this is not done by numbers of natural persons or entities, but by accounts (e.g., if a customer has 4 accounts, they count as 4 creditors). At that point everyone just prays it's not a close vote. People try to solve this problem by ignoring it.

Issue 5 – Filing with the SEC

TM – This is not as much an Art. 8 problem as it is an SEC problem, but it is definitely an indirect holding problem. There are almost no companies that as a matter of legal requirement actually have to file Ks and Qs because they don't have enough holders to justify it. What the SEC says is that they measure holders by participant listings at DTC. A company needs 500 beneficial holders to require registration of securities. This gives companies the ability to go dark virtually whenever they want. Dozens of companies shortly before or after BR used this ability to go dark. This can have dramatic consequences on Chapter 11 cases. The system doesn't work very well if the companies stops filing Ks and Qs because that means it stops keeping records under Sarbanes-Oxley, so it can't be a public company coming out of BR.

RS believes this only refers to companies in bankruptcy whose securities have been delisted. If the securities are listed the company is required to file. BS believes it would be better here to solve for this with securities law or bankruptcy law.

TM adds that it's crazy that a company that has thousands of investors in its securities can go dark because it has fewer than 500 participant listings in DTC. Virtually all companies have fewer than 500. AB confirms that there are only 300 participants listed in DTC.

Issue 6 – Avoidance and Bankruptcy Code 502(d)

ES - Bankruptcy Code 502(d) provides if a creditor has two claims against a debtor and one is subject to an avoidance (e.g., a preference) while the other is not, the claim that is not avoidable cannot be allowed unless the avoidable transfer is returned or otherwise resolved. There have been situations in which the creditor has taken the claim not subject to the preference and tried to sell it to someone else on the theory that they would be able to cash out without the claim being disallowed. Lately courts have not allowed the creditor to "wash" the claim—buyer takes subject to the 502(d) risk.

TM says he has run into this a couple of times. He explained that if one holds 10 claims and they receive a preference on one, all 10 are disallowed until they kick back the preference. In the securities space this becomes a nightmare if it is, for example, a creditor's predecessor in interest that received the preference and the creditor subsequently bought the bond. The potential for mischief here is great. TM then pointed to a more specific hypothetical with respect to indentures' grace periods. An issuer can withhold payment of interest for 29 days under a 30-day grace period. The issuer then could pay on the 29th day and 80 days later file for BR and seek to avoid the preferential payment of interest. TM believes that an investor should be able to transfer a bond free and clear of such avoidance claims in a publicly traded securities market.

TM continued by noting the issue of preference is relatively easy because 502(d) is an auxiliary means of for recovery. The creditor that received the preference remains liable for it. What is trickier is equitable subordination (and other remedies that impair the claim itself) and whether 502(d) or something similar should apply to those. He pointed to Enron case as an example. The UCC has a mechanic here that could be useful. According to TM, under Article 9 [CM: see 9-404(a)(2)], if one buys a claim unrelated to the claim as to which an avoidable transfer was made and after a lawsuit to avoid the transfer has been launched against their seller, the buyer would take the claim subject to the avoidance claim. Is there any problem with that? If one buys prepetition, they would be okay. If they buy after they may be at risk if there is an avoidance problem. TM asked whether there would be a staleness issue under Article 8 [CM: see 8-203], but that issue was not discussed further.

ES responded questioning if this is a problem to be addressed under Art. 8 or otherwise with respect to the indirect holding system. It sounds to him like it should be addressed in 502(d).

Issue 7 – Setoff

TM - Under an indirect holding system, does a beneficial holder of a debt security under Art. 8 who also owes money to the issuer have the ability to effectuate a setoff?
David Aman tied a new piece to this issue. If one tries to get the securities actually transferred to make it a direct holding in order to try to avoid that problem, then they face the issue that the transfer may be sufficiently proximate to the insolvency that the setoff may be disallowed on that basis.

Issue 8 – Redemption by Lottery

Kristin Going (KG) - With Puerto Rico, for example, bonds that have a PIK (payment in kind) interest feature are required by DTC rules to be redeemed by lottery and not pro rata. DTC will run a process where the distributions end up as close to pro rata as can be and are generally pretty close. When broker dealers are informed of the lottery process, they utilize their own lottery processes that are not close to pro rata. Some bond holders are getting paid interest payments in full and others nothing based on broker dealer algorithms.

At this point, ES questioned the rationale for not using pro rata, but the DTC team present did not know the answer off-hand. SR speculated that it may be due to rounding difficulties.

General:

David Donald (DD) returned to a point raised in the share lending problem discussion. From the theoretical point of view, it seems to be the largest problem in the indirect holding system, giving broker-dealers and banks the power to issue securities of their customers by creating security entitlements anytime they book a credit of securities to an account. In a BR scenario have we seen a case where these intermediaries have created irresponsibly and out of balance a lot of securities? Where claims don't match up?

TM answered by noting there are rights offerings in BR cases. People who started this practice wanted to raise money by doing a rights offering. The debtor will come out of bankruptcy powered by its new securities. Only those people of record at the disclosure statement date can participate in the rights offering. When it comes to consummation of the plan and one finds that the claims have traded and those holding claims don't match up with those claiming to be entitled to participate. It has been a mess. There are better ways to deal with it, as with an exchange offer for the old debt.

SR spoke to the ability of broker-dealers to create securities by having more shown on their book than for the underlying issue. She heard about that more in the context of voting problems, not as much about it when the company was actually in bankruptcy.

DA responded to the question saying he doesn't think there is a problem from the fact that the brokers offset on the long side of their stock record is not always held at DTC. This is a virtue of the indirect holding system that brings important flexibility that we would want to preserve. Brokers cannot willy-nilly create shares.

CM added that the insolvency case may be the least problematic for this kind of overissue in that sense. The idea there is that there may be a scarcity of securities and we're trying to identify the people that are "supposed" to have securities and let them share in an equitable fashion among all of the pool of securities. So, there is actually a rational basis for saying one has a securities claim even if there is no property there because we are asking all people with similar claims to share equitably.

CM then began the closing of the meeting by speaking more generally about the TF. The charge was to look at problems that arise from the infrastructure including legal and regulatory and any tweaks to the infrastructure that could solve problems. The last meeting about voting of shares was speaking to what we can do in our procedures to adapt given our current system to have an accurate vote. This meeting brought out another approach. Although Art. 8 often does a great job of adapting to the infrastructure, we've noticed a number of "glitches" in the system. It got us thinking about what changes in law might be needed.

From here, ES and CM closed the meeting by thanking TM and others for their participation.

NOTES: MEETING (VIA ZOOM) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE ON SEPTEMBER 15, 2020[16]

AGENDA
Meeting of Task Force on Securities Holding Infrastructure
Tuesday, September 15, 12:00pm – 2:00pm EDT
(via Zoom)

1. Welcome and Introduction: Charles Mooney and Sandra Rocks (Co-Chairs)

2. Presentation:

BROKER-DEALER OPERATIONS IN THE INTERMEDIATED HOLDING SYSTEM: CUSTOMER PROTECTION RULE, MARGIN LENDING, SECURITIES LENDING, REHYPOTHEFCATON, REPOS, AND MORE

Moderator:
Marlon Paz, Esq.
Partner
Mayer Brown LLP

Presenters:

Lawrence Kornreich, Esq.
Vice President and Senior Counsel
Goldman Sachs

Michael A. Macchiaroli, Esq.
Associate Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

Commenters:

Brandon Becker, Esq.
Managing Director & Deputy General Counsel
Depository Trust & Clearing Corporation

Erika D. White, Esq,
Counsel
Davis Polk & Wardwell LLP

3. Open Discussion

4. Adjournment (by 2:00 pm EDT)

[16] Notes prepared under supervision of Charles Mooney; any errors are his.

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Charles Mooney (CM), co-chair, opened the meeting. He noted that co-chair Sandra Rocks (SR) would join a bit late due to an unavoidable conflict. He then introduced the program and turned the meeting over to Moderator, Marlon Paz (MP).

MP opened the discussion by introducing the experts on the panel (see Agenda, above). MP noted that the meeting would deal with the holding of assets through broker-dealers (BDs) and in particular the BD operations and business models. Central to the conversation would be the SEC financial responsibility rules and the customer protection rule, SEC Rule 15c3-3. The latter responds to a congressional directive to strengthen the BD financial responsibility to their customers when holding customer assets, including securities and cash balances. For example, BDs must protect credit balances and securities it holds for customers. The goal has been for BDs to hold the assets securely and to enable orderly liquidation of a BD in the event of insolvency.

MP invited Larry Kornreich (LK) to introduce the basics so everyone is on the same page throughout the meeting. LK began by introducing that the BD holding structure, which was developed in accordance with SEC financial responsibility rules, specifically customer protections rules 15c3-3, c2-1, and c3-1. These rules are designed to protect a customer in the event of a BD failure. The goal was to ensure there would be enough assets held to satisfy the net equity claims of all customers. 15c3-3, the primary focus of LK's introduction, applies to SEC-registered BDs with certain limited exceptions. He noted that United States BDs hold customer securities on an omnibus basis at central securities depositories and with sub-custodians.

LK explained that, under 15c3-3, there are two requirements. The first is the possession and control requirement. BDs are required to obtain and maintain fully paid and excess margin securities. Excess margins are securities in value greater than 140% of the customers debit. This reflects that a BD can reuse securities up to 140% of a customer's debit. When reused, the asset remains credited to the customer's account and part of their claim in liquidation. According to LK, possession really means physical possession of the certificate, while control means that the BD can obtain the security promptly without payment of money or value. The rule defines good control locations, such as DTC or certain banks or other BDs. If a BD does not have possession and control as required, the BD must take specific actions to remedy the situation within explicit time-periods based on the circumstances provided. During these recovery timeframes there can be a segregation deficit, meaning there are fewer assets in segregation than the BD would otherwise be required to have in its possession or control. LK noted that it is typical for these deficits to be allocated to customers based on internal BD methodologies. Unfortunately, due to these deficits a BD cannot ensure that a customer will have full voting rights to its securities, whether due to its activity, margin loans, or other holder activity. As a result, there is never a guarantee that they will have full voting rights.

The second requirement, according to LK, is the reserve account. A BD is required to deposit into an account at a 3rd-party bank either cash and/or liquid treasuries in the amount of the net credits (amount derived from customer activities). 15c3-3a includes the formula used for calculation, which must be run on a weekly basis, but is often run daily. The formula calls for

use of the net basis across all customers rather than a customer-by-customer basis. This serves the same purpose as the possession and control rule that there should always be securities in the possession and control or in the reserve account to support the net equity claim. LK reiterated that the focus is on BD insolvency and customer protection in that context. LK concluded on this subject by adding that 1) affiliates may subordinate their claims even if they would otherwise be customers, while other customers cannot waive their customer status; and 2) Financing counterparties are not considered to be customers.

LK then addressed the "Rehypothecation Rule," which prohibits BDs from using customer securities in its proprietary business. 15c2-1 and 8c-1 govern the treatment of securities that are not required to be in the possession and control of the BD and the use of those securities in secured borrowings. The first principle to this rule is that BDs cannot comingle customer securities with other customer securities in a pledge without informing the customer. That said, customers are usually informed in the account-opening agreement. The second principle is that BD cannot comingle customer securities under the same lien that applies to the proprietary securities, and BDs cannot avoid this requirement by disclosure. The final principle for protecting customer assets is that the total amount that the BD borrows against customer securities cannot be more than total amount of borrowings by all of the BD's customers.
The last area discussed by LK was the Net Capital Rule, 15c3-1. It requires BDs to maintain a certain amount of liquid assets to meet their obligations, which, again, facilitates liquidation. It requires net capital to be held in excess of minimum amounts. There are two approaches to making this calculation. The first is the basic method which says aggregate indebtedness cannot exceed 1500% of net capital. The second is the alternative method which mandates net capital in excess of 2% of customer receivables under the reserve calculation.

Before moving to the next speaker, MP noted that there are numerous levels of protection in this system. He specifically noted the backstop of custody requirements, such as auditor oversight requirements and the Securities Investor Protection Act of 1970 (SIPA). He then introduced

Michael Macchiaroli (MM).

MM provided some historical context for the various BD financial responsibility rules. In 1934 Congress provided several provisions to attempt to protect customer assets in the hands of BDs through a hypothecation rule (8c of Securities Exchange Act). The SEC could prevent loans where there would be comingling under a single loan to a BD. Additionally, loans against customer securities could not be greater than the aggregate indebtedness of the customers to the BD. Essentially, BDs could not borrow more than what they were owed. The issue here is that the rule left a few gaps. First, it didn't account for fully paid securities. Second, it didn't deal with stock loans. Third, it left definitional problems (E.g., what is a customer?).

MM then discussed SIPA. SIPA created SIPC against the backdrop of liquidations, mergers, and the demise of a substantial number of large BDs in the late 1960s. SIPC was the primary liquidator, leaving protection of customers up to $500K. He noted that SIPC is a corporate and not a government agency and serves to protect the cash and securities of customers. In its history very few customers have failed to recover the value of their assets. SIPA provides customers with a proportional interest in a pool of all customer securities and protects against losses up to

the additional $500k. MM noted that Congress added provision 7d of SIPC which gave the SEC additional authority to deal with custody and use of customer securities. It led to a special study on unsafe practices by BDs which became the basis for the net capital rule and for rule 15c3-3. MM mentioned the 1975 amendment which required the SEC to adopt rules to protect the assets of customers in the case of loans of customer securities. The goal here is to create cushions of capital. It forces the BD to be more efficient in tracking customer assets. MM noted that the free credit balances of customers range between 300-400 billion dollars now, which is small compared to 10 to15 years ago because of the sweep provisions that sweep funds from BDs to banks and investment companies ($1.5 trillion). According to MM, the problem now relates to borrowing fully paid securities of retail customers. While we have a rule to protect such customers, it is not clear how the rule works and whether customers would be protected in a SIPC liquidation. MM then concluded with a final point noting that compliance requirements (e.g., compliance reports) for BDs help to ensure that a BD is in compliance with 15c3-3, because auditor validation is required. it.

MP asked MM to comment with respect to BDs carrying assets that are in the CFTC bucket? There has been a lot of work coordinating between MM's office and the CFTC office. MM responded that many assets the BDs are carrying are not equity products (not DTC eligible securities). Alternative investments such as hedge funds have been a peculiar problem, and it can be difficult to understand the BD custody in those situations. For futures, the CFTC has objected so far to putting them into a securities account, which the BDs would like to use as a hedge. The SEC staff is working with the CFTC on that and on swap rules that would be consistent.

Brandon Becker (BB) then explained that the DTCC team is very much interested in developing a more efficient and digitized settlement process. He noted that, beginning in 2016, DTCC issued several white papers about these developments. BB provided a few examples, including a white paper on digital tokens, another on DLT securities, and a couple of project papers addressing the possibility of using DLT for private placement issuances. BB further explained that there are some benefits to the current system, including that it facilitates netting and does so in an efficient manner. BB thinks some of the ideas being discussed with respect to a direct holding model may not take advantage of the benefits of netting. Instead, while a direct holding model might result in systems that may be technologically secure and offer a measure of immediacy, it would also require large sums of money moving continuously between parties. BB does not think that this issue about funding has been adequately addressed.

BB also explained that the current SEC regulatory structure is built around protecting customers and their assets in the event of the insolvency of a BD. The regulatory structure is not built around shareholder voting. BB stated that, even so, there is not much of a history of voting difficulties. However, he does think that the dematerialization of securities is a worthwhile goal. In this new COVID world, it is critical that the industry find opportunities to eliminate the vestiges of physical certificates and to ensure that transactions can be conducted efficiently while limiting in-person and/or manual touchpoints.

BB noted that with respect to non-DTC eligible assets he does not have the same focus or concerns, but the goal is to make assets fungible.

MP noted that it seems that the market for non-DTC eligible assets, such as alternative investments, seems to have exploded but is unable to take advantage of some of the benefits that DTC could offer. BB responded that investors always seem to be chasing yield in a 0% interest-rate environment, and this is just another example of seeking whatever yield they can find. BB shares MP's concern that more and more people are taking on more risk than they should.

Erika White (EW) then addressed an area not yet mentioned that was seen in the Lehman situation. In Lehman the issue that came up involved foreign BDs and the uncertainty among customers as to who their intermediary actually was. Many thought they were customers of US BDs, but the were, in actuality, customers of a UK BDs. This led to litigation and eventual settlement. She asked LK about enhanced client brokerage models and how they generally operate. She was curious if this has been addressed to give more transparency to customers.

LK explained that under margin rules in the US there is Regulation T and FINRA rules which historically limited leverage in the amount of financing that a US BD could provide on securities. What one saw was assets moving assets overseas to avoid some of these requirements. One part of this was FINRA Rule 4210(g), which is the portfolio margin rule allowing US BDs to give leverage at about 6-1 which is sufficient for most customers. The Lehman situation and the recession left uncertainty in the products and many customers realized their asset protection was not what they had thought it was. So more assets were moved toward portfolio margin. Some firms use foreign BDs or banks to provide financing while others may use a US bank or a second US BD. But, the basic concept behind all of the arrangements is that the secondary entity can provide financing that isn't being provided by the first as the second is not subject to Regulation T for example. When this happens the customer's loan is directly with whatever entity provided the loan.

David Aman (DA) (FINRA) mentioned that arranged financing may come from a relationship where the customer starts as one of a US BD but then no longer has that status. Either the customer obtains financing from a foreign entity or its own arrangement with another US broker which leaves it not as a customer, so they do not have the same customer protections. The documentation is quite clear for borrowing clients. Since 2008, the clients are far more aware of these rules and protections. LK agreed, noting that those who are still on arranged financing are seemingly aware of the tradeoffs and accept them.

EW then reiterated that the calculation for 15c3-3 is done on a weekly basis or potentially more often. As the firm gets into more trouble, they are asked to do these calculations more often to limit the likelihood of failures. SIPA gives the court the ability to allocate from the BD general estate to the customer estate to fill any shortfalls. Even if there is not a perfect match of assets and customer claims at the time of failure, there is some flexibility to satisfy SIPC's goal that customers recover their assets.

MM agreed but noticed that one difference with the Lehman situation was that the BD was always in great shape and highly liquid. The problems were with other affiliates. There were only 100-120K customers of the BD. The retail investors were all moved out and assumed by another firm early, leaving only the institutions. which led to some of the issues and litigation that arose.

MP then asked Phoebe Papageorgiou (PP) (American Bankers Association) to briefly address what will be on the agenda for the next Task Force meeting on bank custody. PP cited some similarities and some differences with respect to BDs versus bank custody. She explained that one key difference is that the bank side is based in a more contractual relationship, while the holding of crypto assets and voting issues may be similar. She then posed a question to the group: Are there situations in which BD customer's account statement reflects certain assets and their valuations although the assets are not technically held in a custodial capacity?

DA responded that there has been a practice for BD to show certain assets "below the line." The FINRA guidance regarding customer account statements does address this, and they are revisiting it with the hope of providing clarification. But he does not think the issue is limited to "below the line" assets for two reasons. First, there is a practice of having a variety of alternative-type investments represented as being in the custody of the firm (there is some guidance there under 15c3-3). Second, BDs and banks act as custodians for IRAs where these assets are being purchased for the IRA which creates the need for parameters and requirements which allow them to be in custody of the IRA custodian.

MP then invited open discussion.

CM favorably reacted to BB's comments regarding the various approaches to DLT and blockchain in securities trading and settlement. Netting will need to be a topic of focus as it could be a potential risk area. However, he noted that problems related to voting, AML, and the bondholder enforcement all post-settlement issues. In general, he observed that when one considers potential reforms to the holding infrastructure it is important to be careful not to lose sight of the benefits to the customers and the industry of the existing flexibility. But in preserving that flexibility, he wondered if the tail might be wagging the dog. So he posed the questions: In considering the kinds of mismatches between aggregate credits to customer accounts and securities held by BDs at DTC (shortfalls)s, what percentage of margin accounts would involve such shortfalls and what percentage of the aggregate margin securities are the shortfalls? And if it is narrowed further to margin accounts where there are actually loans outstanding to customers, what would the percentages be for those accounts and the shortfalls? His impression is that they would be fairly small and if changes are made, they'd only need to preserve that small area of flexibility.

DA responded that if the percentages are small that might be evidence in the other direction—that the system isn't broken and does not need to be fixed if these are only small issues in the current framework.

MM commented that it is a very small percentage with respect to short differences.

DA noted in response that short differences are not the only area where flexibility needs to be maintained—for example, rehypothecation.

MP observed that the BD model in part depends on some of this complexity to fund its operations. There is a lot of liquidity provided by the model itself that does create a service to the

capital markets. There is a good provided in the way the machine works. If we're talking about direct holding of securities or taking away those intermediaries, a lot could be lost along the way. There is a lot of funding from sweeps programs that also goes to BDs. The holding of assets is part of the business model for a BD. While this is at times looked down upon, it is in many ways similar to how the system works in banking. PP echoed this point from the banking perspective, acknowledging the similarities.

MM - BDs cannot use funds of customers in their own businesses like banks. But BDs can earn interest on funds, which has been a key revenue component for many firms. This now has become a problem because of the low interest rates.

DA noted that the interest earned passes through to customers, but the bank also pays the BD a fee with respect to the funds. MM indicated some uncertainty but will check on that.

MP commented that this is an area where there are a lot of linkages. The BD does properly get a benefit but the industry as whole may not view this as proper. There are customer assets that are being used by the BD that bring forth a benefit that is not entirely passed through to the customer. But again, he asked whether that different from what banks do.

Karen Saperstein (SIPC) noted that in some BD-bank relationships the BDs are passing on the records of customers to banks. One of the reasons for these account arrangements is for customers to be able to conduct securities trades while giving them extra security by having funds in an FDIC-insures account. PP mentioned that the bank-related issues will be discussed in more detail at the next meeting.

MP, CM, and SR made closing comments, thanked everyone for their participation, and looked forward to the next meeting.

NOTES: MEETING (VIRTUAL) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE ON SEPEMBER 25, 2020

AGENDA
Meeting of Task Force on Securities Holding Infrastructure
ABA Business Law Section Annual Meeting
September 25, 2020
11:00am – 12:00 PM EDT

1. Welcome

2. Report on Meetings of Task Force

3. Future meetings, organization of TF, preparation of report

4 Open discussion

5. Adjournment (12:00pm EDT)

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Charles Mooney (CM) and Sandra Rocks (SR), co-chairs of the Task Force (TF), opened the meeting. CM summarized topics covered in earlier meetings (June 24, 2020, shareholder voting; August 11, 2020, litigation issues including enforcement of bondholder rights; September 15, 2020, broker-dealer operations and regulation) and upcoming October meeting on bank custody issues. He noted future meetings are TBD, but they are now organizing a small group on AML, sanctions compliance, terrorist financing, and related issues and that will be a future topic. SR suggested that a future meeting would consider central clearing operations and in particular the DTCC organization and its approaches to new technologies. CM noted that this session would focus on clearing and settlement and also the post-settlement holding infrastructure. The floor was then opened for general discussion, including on the future work of the TF.

Asaf Raz (AR) mentioned that the TF should consider the role of state law (e.g., Delaware) in connection with any efforts to provide direct rights to individual shareholders. AR suggested that one session of the TF might be devoted to these state-law issues. CM agreed and indicated that a future session also might consider increased direct holding and less intermediation and the potential role of DLT (including blockchain). He noted that one obstacle might be the unfriendly interface between an investor and a blockchain [e.g., a public-private key cryptography-based platform], which in practice has resulted in investors relying on intermediation and custodians.

CM also noted the Delaware 2017 amendments embracing DLT for shareholder records, but observed that merely permitting Cede & Co. (DTC's nominee) to hold on a blockchain would not affect the status quo.

Marlon Paz raised the issue of "deliverables" for the TF. He observed that the TF meetings were developing some very substantive "chapters" for a final report, whatever shape that takes. We

should begin to put pen to paper to develop "building blocks" to get an idea of what the entire product might look like in the end. For example, this work should consider that the practices for holding some classes of securities may differ substantially from those for other assets (such as digital assets). We should consider getting "peer review" input from the TF members for these chapters. In this way we could begin to accumulate these building blocks that would be available for developing our final work product.

CM noted that he and SR were developing a nascent outline of what a report would look like and suggested that some meetings be devoted to a discussion of the approach that a report should take, perhaps pre-worked by a smaller representative group. He doubted that the nature of the TF group would accommodate a strong consensus for definitive recommendations, however. But he also suggested that perhaps advocates of the status quo on the holding infrastructure ought to shoulder at least some burden of demonstrating that material modifications are not needed.

SR suggested that it might be necessary to engage in some prodding to encourage these debates. CM noted that inasmuch as the SEC is unwilling to do anything with respect to broker-dealer custody of digital assets, it is not surprising that the SEC would not be out front in taking on issues relating to shareholder voting, for example. Paz agreed expressed optimism that prodding the SEC and others supporting the status quo could add great value. There was support for the idea that a future meeting be devoted to presentation of proposals for infrastructure modifications (mostly by academics) and critical evaluations of the proposals by TF participants.

CM suggested that he thinks that the principal expertise in this areal lies within the DTCC organization but that most proponents of reforms push back and argue that the goal should be to replace DTCC with DLT/blockchain systems. Lois Radisch (LR) (a former DTCC official) explained that she supported a session exploring the roles of DTCC component organizations and other clearing corporations. This is fundamental to understanding the current system as well as new developments and initiatives and would be an important step in our work. CM and SR agreed. CM observed that even in a system that he had argued for that would facilitate more direct holding he would be worried about a system that did not have the expertise and experience of DTCC behind it. He indicated that 2021 would see the TF having discussions about controversial proposals and ideas that would implicate business models of market participants.

SR asked LR whether DTCC is considering the prospect of dealing with digital assets (DAs), noting that broker-dealers have expressed interest in these assets and the SEC has not facilitated it. LR responded "yes" and noted that historically DTCC had been receptive to dealing with new assets and that underlies the Article 8 revisions that contemplate financial assets that are not "securities." She also noted that some issuers of new products have over time expressed interest in their financial assets being held in the DTCC system.

CM noted that a "simple" solution would be for a DTCC entity to connect with DAs and everyone else would hold in the intermediated system. But he observed that this would "kick the can down the road" and was not the future. He argued that DTCC could follow some other CSDs in recognizing the role it could play in connecting investors directly with issuers and seamlessly allowing financial assets to flow in and out of the direct and intermediated systems.

LR explained that the DTCC is product of the development of the markets in the U.S, and that the concept of a central registry was never a part of that. She also noted that the US market is much larger and more complex than many other markets, but she acknowledged that new technologies are relevant here. CM noted that of course the services provided by broker-dealers and banks would not go away but that a question is whether they need to be in the chain of legal title to provide those benefits.

There was general agreement that the TF was on the right track in continuing to examine the current institutions and market structures, develop the structure and form of a report, engage with various infrastructure-related proposals, and begin to put meat on the bones a report. There was not support for creating more subgroups in the short to medium term but might be in the future. For example, at some point a subgroup might be asked to prepare a first draft of a report on shareholder voting. However, Janis Penton cautioned against perpetuating the "silos" of knowledge and interest that the TF is attempting to overcome (for example, how different is shareholder voting from bondholder voting).

CM and SR then thanked those in attendance and closed the meeting.

NOTES: MEETING (VIA ZOOM) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE ON OCTOBER 27, 2020[17]

AGENDA

Meeting of ABA Business Law Section Task Force on Securities Holding Infrastructure
Tuesday, October 27, 2020, 12:00pm – 2:00pm EDT
(via Zoom)

1. Welcome and Introduction: Charles Mooney and Sandra Rocks (Co-Chairs)

2. Panel Discussion:

BANK CUSTODY: DOMESTIC AND GLOBAL ROLES, REGULATION AND OPERATIONS IN THE INTERMEDIATED HOLDING SYSTEM

Moderator:

Phoebe A. Papageorgiou, Esq.
Vice President, Trust Policy
American Bankers Association
Washington, DC

Presenters:[18]

Leonard J. Morreale, Esq.
Of Counsel
Emmet, Marvin & Martin, LLP
New York, NY

John R. Siena, Esq.
Senior Vice President
Brown Brothers Harriman
London

Rachel Turner
EMEA Head of Investment Managers & Insurance
BNY Mellon
Dublin

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[17] Notes prepared under supervision of Charles Mooney; any errors are his.
[18] Steven P. Wager, originally scheduled to present, was unable to participate.

Charles Mooney (CM) and Sandra Rocks (SR) opened the meeting with brief introductory comments on past and future meetings and future plans for the Task Force (TF).

Phoebe Papageorgiou (PP), moderator of the panel, introduced the program by noting that bank custody is an important component of the securities holding infrastructure, with more than $100 trillion of assets held in more than 13 million accounts with more than 300 banks that provide non-fiduciary custody services. Most bank custodians use other banks as sub-custodians to take advantage of the large infrastructure costs and the economies of scale that larger banks offer. Bank custody represents how the majority of financial assets are held by the investing public. She noted that the discussion would provide a useful follow-up to the last meeting's consideration of broker-dealer operations. Clients of bank custodians include registered investment companies, private funds, bank common trust funds, collective investment trusts, retirement plans, insurance companies, corporations, endowments, and foundations. PP then provided an overview of some of the services provided by bank custodians, including (i) safekeeping, (ii) settlement of transactions, (iii) processing of corporate actions, (iv) income collection, (v) tax reclaim filings, (vi) securities lending (enhancing returns for clients), (vii) depository services, (viii) lending. Banks' roles as a fiduciary, custodian, or insured depository have implications for clients, such as upon the failure of a bank.

PP then introduced the panel, explaining that Steven Wager was unable to participate.

Leonard Morreale (LM) next addressed the legal and regulatory framework relating to bank custody. Custody is a core and well-understood banking function (e.g., a safety deposit box). Custody of securities involves some unique challenges because securities portfolios are actively traded. Bank custodians facilitate securities transactions by recording them and managing related accounts. Additionally, banks provide certain administrative services to customers such as proxy voting.

The private-law framework in the US is Art. 8 of the Uniform Commercial Code. It was initially designed to address the rights and obligations of the various parties transferring or receiving securities. LM described the indirect holding system as a multi-level pyramid of securities intermediaries. He noted the responsibilities of these intermediaries to record by electronic book entries on their books and records the interests that their customers have in securities. He provided an overview of the key concepts of Article 8, including a security entitlement, entitlement holder, securities account, and securities intermediary. [Details of LM's thorough overview are omitted in this summary.]

LM next explained that bank regulation is primarily focused on the safety and soundness of banks as a whole. This involves examinations to ensure the risks associated with the banking business are managed. Although custody is a relatively safe activity, there are risks that include credit risks, risks related to sanctions compliance, and others with respect to a bank's reputation. In the context of securities regulation the securities law and SEC rules apply. For registered investment companies, such as mutual funds, SEC rules under the Investment Company Act of 1940 are important. Section 17f of that Act and rules under that section deal with how registered investment companies are to maintain the securities they hold. For example, that Act provides that the assets are to be held in a good and safe locations such as with a US or foreign custodian

bank. The Act also regulates the terms and conditions of the agreement between a custody bank and its investment company customer and the requirements for contracts regarding foreign securities. Custody agreements are primarily global in nature. Banks will often rely on global networks of sub-custodians to facilitate the holding of securities for customers.

LM then walked through at a high-level the structure of typical custody agreement, which establishes the contractual relationship between a bank and its customer. Banks are agents of their customers for purposes of holding assets and taking instructions. Banks will often utilize securities depositories such as DTC. The custody agreement addresses the obligations of the bank with respect to actions or omissions by sub-custodians and it will attempt to limit the bank's exposure. It will also address actions that are or may be taken with or without instructions from the customer (such as carrying out mandatory exchanges, participating in proxy voting systems, etc.) The agreement also addresses the bank's role in facilitating trades, the bank's responsibilities with respect to corporate actions, and the treatment of deposit accounts.

PP then gave the floor to John Siena (JS). He noted that custody may involve two paths. One is access to US securities such as through DTCC. The other is with respect to cross-border transactions that provide access to securities located anywhere else in the world. Cross-border holdings typically involve the use of sub-custodians. The relevant assets are mainly book entry securities (security entitlements in the US) and "ringfencing")concepts are particularly relevant here because these assets in custody are not to be considered general assets of the securities intermediary. The UCC defers to insolvency law and it is important to keep in mind the relevance of the insolvency implications for intermediaries and its impact on customers.

JS explained that the holding system in the US depends on intermediaries fulfilling their obligations under the UCC and bank and SEC regulations. But we should also consider the importance of other applicable state laws and common law elements. This overlay is particularly important in explaining the different regimes that apply to a foreign entities.

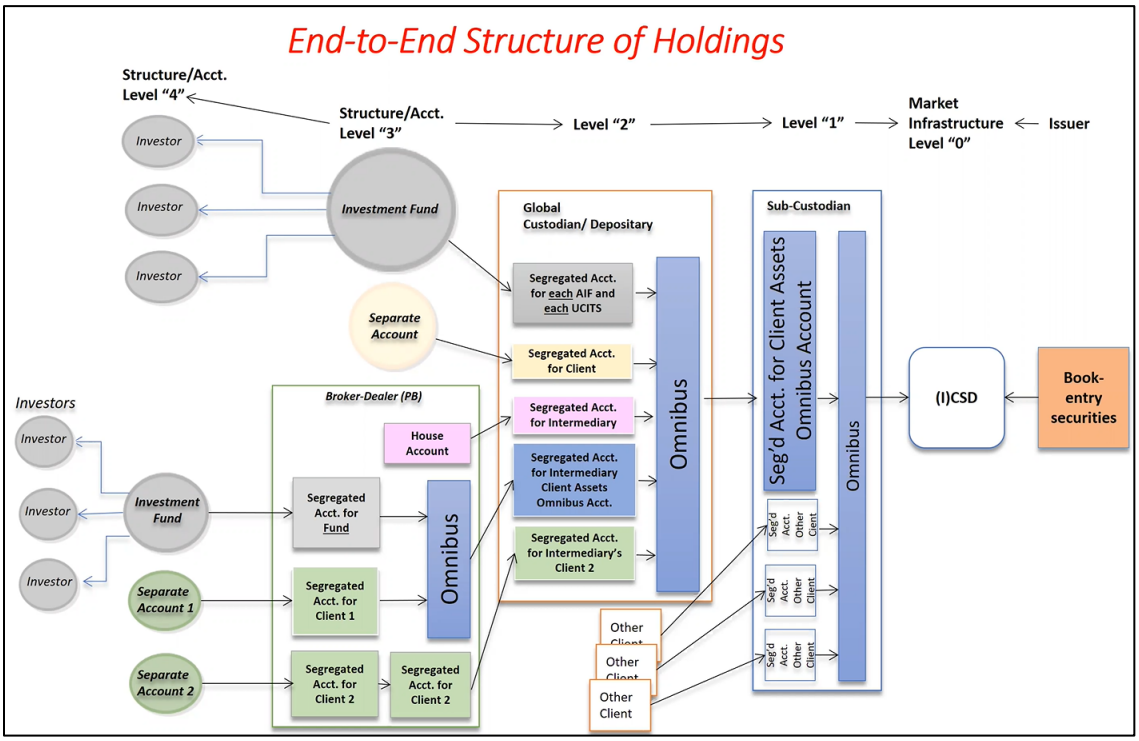
JS pointed out that for bank custody much depends on the terms of the agreement between the customer and custodian. The agreement must balance many different elements. One fundamental difference between bank custody and broker-dealer (BD) custody is the terms of the agreements. For example, there is rarely if ever a rehypothecation or reuse allowance for a bank in the custody agreement unlike those with a BD. As to why this could be the case, JS suggested that one aspect could be the residual effects of the Glass-Steagall Act. There was a desire to separate the securities industry from banking industry and to place limits on bank activities in connection with investment securities. Conversely, unlike banks BDs are prohibited from accepting deposits. Banks have a unique role, however, because of their integration in the financial system. Their role as part of the money supply gives them special significance.

Banks have an extremely voluminous body of regulation touching on everything they do. Consider for example various Federal Reserve Board regulations. One example is Reg D (reserve requirements on deposits and other liabilities). Another is Reg U (margin loan requirements), which applies to banks and non-bank potential lenders. The goal of Reg U is to place very strict limits on the degree to which banks can be seen to be lending to facilitate purchasing and holding of securities. Other provisions of the Federal Reserve Act should be mentioned. For example, if

a ’40 Act investment company is being serviced by a bank, that investment company may be treated as an affiliate in some situations. If the bank is seen to be lending money to facilitate securities settlement activity, that also may raise an issue under the Federal Reserve Act. There is a wide body of banking law and regulation in this space which generally does not apply to BDs. Additionally, bank custody agreements, like BD agreements, have provisions meant to protect the custodian from various risks and liabilities. JS finally discussed Reg R promulgated under the Exchange Act. It is crucial in that it provides the dividing line between proper banking activity and brokerage. It carries a variety of exclusions that give safe harbors to banks and exempts them from various registrations. Its custody exemption and provisions on accommodation trades are also critical.

JS concluded his discussion by speaking to the insolvency context. From the UCC perspective, 8-503 and comment 1 effectively make clear that the UCC will defer to insolvency law. There is specific reference to Bankruptcy code and other insolvency law. However, the key difference between banks and BDs is that banks are outside the scope of the usual bankruptcy regimes. In the case of banks, they are subject to resolution regime administered by the FDIC or state regulators. Bank insolvencies are less complex in the context of securities custody because banks do not reuse customer assets the same way BDs do. He then recommended a couple of resources for comparing the two regimes: “What happens when the broker goes bust?” and “2008 Congressional Research Service Report.”

Finally, JS offered the following slide that illustrates the structure of securities holdings and certain roles of BDs and banks custodians.



PP next asked Rachel Turner (RT) to lead the discussion on cross-border services of bank custodians. RT began by reiterating the point made by PP earlier with respect to the large value of assets held by bank custodians. RT recently read a PwC report that indicated that the fund management industry would grow to $145 trillion by 2025. This is evidently a systemically important business around the world.

RT explained that many banks such as BNY Mellon are now viewed as globally systemic because of their role in the financial systems. They are crucial to maintaining asset flows around the world. As such, there is a symbiotic relationship between the more well-known names in the banking industry and the sub-custodian network. Sub-custodians now cover over 100 markets and would cover more if not for various limitations in many countries because of political or financial obstacles (e.g., sanctions). This network helps navigate the various needs across the numerous markets because the global custodians need to manage all of those markets. The global custodian role is to find markets in which they can hold without the use of a sub-custodian and other markets where it makes more sense to hold through a sub-custodian network. Custodian banks provide several services, including settling trades, holding assets, settling cash related to trades, processing FX trades, collaborating with local tax authorities, and handling corporate actions.

RT noted that within the global custodians there are network teams that ensure selection of an appropriate sub-custodians for a market. They run regular compliance and standards checks, monitor for insolvency and reputation risks, and note any emerging risks (e.g., cyber). The key is making sure they are meeting the needs of their clients. Global custodians assume a role as an advocate for their clients, especially in connection with investments outside a client's comfort zone (e.g., new markets). Global custodian banks deal with obstacles in different markets such as local client money rules.
Although much of today's discussion has addressed traditional assets such as trading and settlement of stocks and bonds, RT explained that global custodians are moving to modernize global custody with digital and data solutions. There has been a move in this direction especially during the COVID pandemic as 80% of the sub-custodians BNY Mellon works with now take scanned documentation. Digital assets are another way forward, and US and European authorities have begun to consider how digital assets will be treated. Custodian banks are considering the changes that may be necessary to support this developing landscape. Fundamental changes in core processes (now reliant on custody chains) will be needed to deal with digital assets when there may be no omnibus accounts. The assets could be Bitcoin, tokenized asset connected with a fund, or something completely different.

PP then opened the floor of general discussion.

JS expressed concern about the inconsistency across different governing regimes for digital assets and how that could cause problems and burdensome costs for the banks. RT added that cannabis securities are another example of inconsistency because in some states those securities are criminal.

Ed Smith (ES) (Morgan Lewis & Bockius) expressed interest in the choice-of-law comments from JS and RT, noting that the Hague securities convention was designed to deal with these

types of issues, but only a few countries have adopted this convention. He asked whether anyone thinks that this convention has any legs towards resolving this issue or whether there seems to be too much resistance. JS responded that it could offer a solution if it were widely adopted, but the views in the UK and Europe appear to differ from those in the US under Article 8.

Erica White (EW) (Davis, Polk & Wardwell) asked JS a question with respect to rehypothecation: Under Art 9 to the extent banks do have a security interest, don't they have a right to repledge securities? They cannot dispose of the collateral, but they can do a simple repledge. Do banks actually do this? David Aman (DA) (FINRA) added that Article 8 also allowed modification by agreement of the limitations on the intermediaries' disposition of the collateral. JS responded that he may be too conservative but he believes that banks must be quite careful before assuming they have these types of reuse rights. Maybe some have a more liberal mindset about this, but he does not believe it is widely done even if allowed to a limited extent.

CM then reiterated that the goal of the TF is to identify any problems related to the infrastructure. He invited anyone to raise problems that they could share with the group or to send comments to him and SR later. He noted that ES is chairing the ALI/ULC Emerging Technologies and the UCC Study Committee that is discussing a new UCC article on digital assets. He also mentioned that UNIDROIT in Rome is undertaking a parallel effort regarding digital assets and private law issues.

JS explained that one consequence of the indirect holding system is that the CSDs do not know (and do not want to know) who the underlying clients are. They consider the credit risk as relating only to the participant and take security interests in the participant's assets. He suggested that in effect this is analogous to a "repledge" of a customer's securities and is ultimately for the benefit of the customer. This point should be addressed in the bank custody customer agreement.

PP raised the situation in which the bank as custodian is placing cash in its depository side and must post collateral on the uninsured portion of the deposit. She asked whether there is a similar situation and requirement for a CSD to fully protect its customers (participants).

ES added that he has often been troubled by how cash can be held as a financial asset. He's wondered if a claim for cash that a custodian has against a sub-custodian should be treated as a financial asset. Is there a security entitlement for the benefit of the customer? These are little nuisances, but he can put together his thoughts for CM and SR.

SR responded that she understands that the banks will treat cash as a financial asset only when held on the trust side. This may relate to what PP noted earlier that when the cash is held on the trust side and it is being treated as a financial asset it is generally collateralized.

CM pointed to the definition of financial assets from Art. 8, which includes property dealt in on financial markets. It would be a stretch to argue that funds are not property dealt in on financial markets.

PP explained that if a bank fails the FDIC is ultimately going to step in to resolve it and probably will treat “cash” as a liability of the bank as it would for other deposits.
SR then closed the meeting by thanking PP and the panelists. SR and CM will keep everyone in the loop on future plans.

NOTES: MEETING (VIRTUAL) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE ON APRIL 23, 2021[19]

Email Message to Task Force Participants
April 18/19, 2021

Dear Task Force participants:

The Task Force will hold a meeting at 11:00am, Friday, April 23, 2021, in connection with the ABA Business Law Section Virtual Spring Meeting. Access will be available to all who register for the Spring Meeting. The meeting will consist of a brief status report by the chairs followed by an open discussion.

We are in the process of organizing our next stand-alone meeting, which will focus primarily on DTCC operations relevant to our work. We are hopeful that the meeting will be held in late May and will notify you of the details as soon as they are finalized. The meeting following that, tentatively scheduled for June, will address AML and other compliance issues.

Best wishes,

Chuck and Sandy

* * *

Charles Mooney (CM) and Sandra Rocks (SR), co-chairs of the Task Force (TF), opened the meeting. CM and SR summarized topics covered in earlier meetings and current plans for future meetings (see message quoted above). The floor was then opened for general discussion, including on the future work of the TF.

Robert Wittie (RW) inquired about DTC's initiatives involving blockchain technology. SR mentioned DTCC's related White Paper and ongoing work on moving to T+1 settlement, which will be discussed in the May meeting.

CM noted that in due course a draft report on shareholder voting will be circulated as a template for considering the TF's future report. He observed that earlier work leading to revisions to UCC Article 8 generally accepted as a given the intermediated holding system and focused on adapting the private law to more realistically work with that system. However, meetings of the TF so far have identified problems other than those relating to conflicting rights to and under security entitlements under Article 8, which have largely been resolved. Instead, these problems to be addressed by the TF generally relate to the rights of entitlement holders vis-à-vis issuers (e.g., voting and exercise of security-holder rights).

[19] Notes prepared by Charles Mooney; any errors are his.

Marshall Grodner (MG) observed that it was excellent that the TF will be focusing next on the DTCC/DTC back office operations. He noted that when work within the Section had focused on control agreements [under Articles 8 and 9] it was discovered that adjustments in approaches were necessary to accommodate bank operations. In this connection he noted that in addition to DTC there are other players involved. SR supported this observation. SR also noted that in discussions with Lois Radisch (LR) [formerly deputy general counsel of DTCC], who would be the moderator of the upcoming DTCC-focused meeting, they agreed that at a later stage it would be useful to bring into the discussion clearing organizations outside of the US, such as Euroclear and the Canadian depository.

Kenneth Kettering asked whether the TF had a website and the means of communicating with participants. A discussion followed about the problems relating to the TF and the ABA website and ABA Connect (problems compounded by the sponsorship of the TF by seven standing committees). Janis Penton (JP) requested that the TF members be notified of a link to the proper site when it has been identified. CM noted that many participants are not members of the Section or even the ABA and that he would also recirculate how to access the TF's Dropbox site as well as attempting to migrate information from the Dropbox site to the ABA Connect site. MG and CM agreed to look into the situation with ABA Connect going forward.[20]

Concerning the ultimate structure of the TF's report, JP observed that most of us are working in our "silos" of interests/expertise. However, we are discovering that there is a great deal of commonality (for example common issues between shareholder voting and the exercise of bondholder rights). She expressed the hope that the report would focus on these common issues so that solutions could be more holistic and less driven by silos of specific areas.

CM responded that discussions have made clear one significant common problem in the exercise of shareholder rights and bondholder rights: There is no single definitive source of information as to the identification of beneficial owners. Therefore, various shadow communications networks have emerged as necessary to connect the dots. While some improvements have been made, efforts to rectify the problems associated with shareholder voting over many years, notwithstanding attention (albeit modest) of the SEC and recommendations of its Investor Advisory Committee, have failed. He expressed hope that the TF report would identify plausible solutions beyond the generally inadequate shadow communications efforts. Those might include, for example, more transparency in beneficial ownership while accommodating both privacy and confidentiality concerns and the NOBO/OBO rules. Unlike earlier efforts mentioned (revising Article 8 and developing control agreements), the TF is not constrained by the assumption that the existing "system" cannot be changed to reflect broader needs of society.

LR responded that from DTCC/DTC perspective they have consistently seen over the years that there are various constituencies involved and that in particular there is a very deep divide between debt and equity interests. This distinction extends to the differing characteristics and

[20] Later in the meeting MG intervened to note that he posted a link to the TF's ABA Community in the Zoom chat. (That link is: [https://connect.americanbar.org/businesslawconnect/viewdocument/securities-holding-infrastructure-t?CommunityKey=b330262e-c82a-4cfe-8f94-66c727210dd8]. However it is not yet populated. At that point Robert Schwartz (RS) observed, with examples, that the ABA website "is chaos." MG agreed to work with the ABA to see that the TF has a Connect site linked to all of the sponsoring committees.

laws that apply to these distinct types of securities. She concluded that it will be interesting to hear from the different constituencies and to see if there is a way to meet the differing interests.

Robert Buckholz (RB) suggested that any aspects of the TF report that addresses shareholder voting, and in particular the SEC's proxy rules, would benefit greatly from the input from John Coates [Acting Director, SEC Division of Corporate Finance; Professor, Harvard Law School]. CM responded that Coates was a presenter at the TF meeting in June 2020 and would be invited to participate in the report process.

Joseph Torregrossa (JT) reminded the group that the Fed has a substantial infrastructure for the Fedwire securities services and that this topic might be considered in a future meeting. JT suggested that one difference is that the lending system for the NY Fed (and other reserve banks) relies heavily on securities that are held as collateral. They would not want any interference with these arrangements from entitlement holders on the tiers below the Fed level. This might be in common with the interests of banks but may differ from those of the DTCC. SR responded that we have not heard of concerns about the Fed infrastructure, perhaps because voting and default [i.e., the exercise of rights including enforcement] are not significant issues. CM concurred and noted that connections between beneficial owners and the issuers of treasury and agency securities do not present the same problems as in the DTC-based system. SR also noted that, similar to the DTC's DRS system, one area to consider would be the Treasury Direct system and the mechanisms provided form moving securities in and out of that holding system for purposes of trading. RS raised the question about the volume of use of Treasury Direct and the costs operation, which should be considered. SR suggested that it would be helpful to add someone from Treasury to participate in the TF.

Lewis Cohen (LC) asked about the nature of problems with the current infrastructure that have been identified so far and suggested that this would provide some ideas about potential solutions. CM responded to LC's inquiry: As to shareholder voting a communications system developed involving Broadridge and others that seeks to match up beneficial holders with issuers in the proxy system. But it seems that no one is satisfied that it works well [i.e., in any close contest, which is the only time it really matters]. CM also noted that an analogous situation exists relating to enforcement of bondholder rights. There is a method whereby DTC can issue a certification as to an investor's holdings with a DTC participant, for example. [Note that a certification as to the balance of an investor's holdings with its intermediary does not necessarily accurately reflect the investor's actual holdings because, for example, that intermediary's holdings at DTC might be less than what the intermediary has credited to its entitlement holders. So this synthetic communications system is a poor fit with the legal regime as was the old version of UCC Article 8 with the intermediated holding system.] In general the issuers need to deal only with holders on their books, which means Cede & Co. in the present context. So as already mentioned the source of the problems seem to be the absence of any definitive single source of determining beneficial ownership. Perhaps the synthetic systems could be improved, but that approach so far does not seem promising. The TF will need to confront other possible approaches, keeping in mind that the TF has no power to effect change and regulatory intervention may be necessary.

JP emphasized that the TF report would provide a great service by describing how the intermediated system operates as it currently exists. Many do not understand even the general structure much less the details. Also, some who know well some aspects are unfamiliar with the operations outside of the "silos" of their particular areas of expertise. CM agreed, noting that the SEC Investor Advisory Committee's report on shareholder voting contains an excellent overview of the system, but only as it relates to that particular context.

Edwin Smith (ES) observed that he imagines that some recommendations for amendments to UCC Article 8 may emerge from the TF's report. He noted that it would be premature for the current ALI/ULC project on UCC and Emerging Technologies [which ES chairs] to consider any recommendations that eventually might emerge from the TF. Given the holistic approach of TF, ES observed that any such recommendations should be coordinated with the overall report of the TF. SR responded that the TF is nowhere near making drafting recommendations. She also noted that the UCC Em Tech is fairly far along in its work on digital assets and the TF has much to cover and digest before making any recommendations. CM observed that at the August 2020 meeting [for which ES was the moderator and a speaker] several ambiguities were identified as to the application of UCC Article 8 in the context for the exercise of bondholder rights in both the direct and indirect holding contexts. The TF report certainly will highlight those issues. However, given pending litigation concerning Puerto Rico and Venezuela matters and the need for further study and input any proposals for revisions must await further work.

LC then called attention to the consideration of financial market infrastructures on a global level, including the 2012 BIS/IOSCO Principles for Financial Market Infrastructures.[21] He encouraged the TF to bring these developments and discussions on the international level into the dialogue within the TF.

CM noted that the scope of the TF work generally focuses on post-settlement holding of securities. However, he asked LC to comment on developments (including those relating to distributed ledger (including blockchain) technology) relating to trading and settlement as well as post-settlement holding. In particular he asked LC for his views on the feasibility of focusing on the post-settlement issues separately from trading and settlement. LC noted that inspired by the paperwork crisis in the past it took the financial and legal communities some time to develop the infrastructure that now exists. Similarly, now in the face of inaction by regulators, decentralized finance (or DeFi) is providing some solutions that are growing in popularity. DeFi inherently fuses trades and settlement ("atomic settlement"), which cannot happen in the current legacy systems, and along with that DeFi exchanges have emerged. And there is some risk for regulation and legal systems if these developments are not integrated, as these developments will continue in any event. So it is difficult to consider the issues only in the post-settlement context without recognizing ongoing other developments.

SR responded to LC by suggesting that the TF should consider devoting a meeting to these developments. She noted that while the TF cannot address everything at once, it also cannot have blinders to the ongoing developments outside of the post-settlement contexts. MG pointed

[21] Bank for International Settlements, Committee on Payment and Settlement Systems and International Organization of Securities Commissions, Technical Committee, Principles for Financial Market Infrastructures (April 2012), https://www.bis.org/cpmi/publ/d101a.pdf.

out that the Comm Fin committee's Fintech subcommittee co-sponsored a program on DeFi at the BLS Spring Meeting (at which LC was a speaker) and the TF probably should coordinate with these other groups in pursuing this topic. In addition, MG suggested more generally that the TF should consider the preparation of an article in Business Law Today focusing on its work.

In closing the meeting, CM observed that the TF is to complete its work in mid-2022. In that connection in the next few months the TF will begin to focus on drafting a report. Ultimately the TF will need to consider whether it should recommend that the SEC and perhaps other regulators undertake a serious study of infrastructure modification. CM noted that the next meeting will be held on May 26, 2021. He thanked everyone for their participation and the meeting was adjourned.

NOTES: MEETING (VIA ZOOM) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE ON MAY 26, 2021[22]

AGENDA

Meeting of ABA Business Law Section Task Force on Securities Holding Infrastructure
Wednesday, May 26, 2020,11:15am – 1:15pm EDT
(via Zoom)

1. Introduction: Charles Mooney and Sandra Rocks (Co-Chairs) [:05 min]

2. Presentations: [1:00 hour]

DTCC AND DTC: YESTERDAY, TODAY AND TOMORROW

Moderator:

Lois Radisch – Introduction / History of DTCC/DTC
Former Deputy General Counsel, DTCC

Speakers:

Aimee Bandler – Securityholder Services
Executive Director and Associate General Counsel, DTCC

Michele Hillery – Accelerated Settlement
Managing Director, General Manager Equity Clearing and Settlement, DTCC

3. Open Discussion [:55 min]

4. Adjournment (by 1:15 pm EDT)

* * *

Charles Mooney (CM) and Sandra Rocks (SR) opened the meeting with brief introductory comments on past and future meetings and future plans for the Task Force (TF).

Lois Radisch (LR), moderator of the panel, introduced the program by presenting an overview of some basic facts and history. DTCC is the holding company of multiple clearing organizations and other critical businesses. DTCC was organized around the turn of this century to consolidate three clearing organizations at the time: The Depository Trust Company (DTC), the central securities depository (CSD), National Securities Clearing Corporation (NSCC), and Fixed Income Clearing Corporation (FICC). This presentation is focused primarily on DTC and

[22] Notes prepared by Charles Mooney. Thanks to Aimee Bandler and DTCC staff for excellent and extensive editing assistance in preparing the final version of these Notes. Any remaining errors are Mooney's.

NSCC, which work closely together because NSCC performs clearing functions and the securities that are the object of those functions are held by DTC. DTC holds legal title to the securities, which are registered on the books of the issuer (maintained by its transfer agent) in the name of the DTC nominee, Cede & Co. It is this coordinated infrastructure that supports the entire public trading market for securities in the U.S.

DTC and NSCC were originally formed out of the NYSE and the AMEX arising out of the infamous paperwork crisis in the late 1960s, which involved problems associated with large volumes of deliveries of paper securities certificates and increasing processing delays. It became clear that there was a need for a safe and secure national system for the prompt and accurate clearance and settlement of securities transactions. DTC and NSCC were born out of the need to protect the securities transactional environment. In the mid-70s, federal legislation followed through amendments to the '34 Act to enable and support this structure and a national market system. DTC operates within the structure of UCC Article 8, Investment Securities, which was last substantially amended in 1994 to reflect the indirect holding model as it evolved.

A key driving force in the development of the clearance and settlement structure has been the need to settle transactions efficiently by delivery of securities against funds, and free transfers when necessary. Originally, DTC was set up for next-day funds settlement, because that was the way that checks cleared in those days. But as the Fed moved to same-day funds settlement, so did DTC. On the clearance side, for NSCC and the market generally, developments have been driven by technology, finance, and credit concerns, which have consistently shortened the settlement cycle from T+5, to T+3, to T+2 currently, and now looking to move to T+1. DTCC is very much interested in this move and that will be the subject of Michele Hillery's presentation today.

It is understood that this TF is focusing on the intermediated holding structure up and down the holding chain and, in particular, transparency and the rights of investors and beneficial owners of interests in securities. Aimee Bandler's presentation is intended to help translate how DTC has developed an efficient system for handling the interests of the parties at the different levels and how DTC meets those needs.

Aimee Bandler (AB) then introduced Michele Hillery (MH), Managing Director, General Manager of Equity Clearing and DTC Settlement Services at DTCC. As General Manager, Michele has direct responsibility for the day-to-day management of equity clearing for trades executed on the major U.S. exchanges and other equity trading venues. Among other responsibilities, she also oversees DTCC's ongoing efforts to collaborate with and build industry support for modernizing and transforming clearing and settlement, including plans to accelerate settlement to T+1 within the next two years delivery of new capabilities that will optimize capital usage and streamline operations and deliver an improved client experience.

MH explained that DTCC has a broad agenda for increasing efficiencies in the clearing and settlement space, but she will focus on accelerated settlement for this presentation. MH noted that shortening the settlement cycle has been on DTCC's agenda for many years. But going back to 2014 or so, the industry view was that moving to T+1 would be more than it could handle at that time, so T+2 was implemented. Recently there has been a similar round of conversations

with the industry. The industry feedback was that T+0 would be a step too far at this time but moving to T+1 would be an appropriate goal.

There are many reasons to shorten the settlement cycle, but it essentially boils down to the reduction of the risk that exists with outstanding unsettled trades. Because NSCC steps in and assumes the settlement risk as a central counterparty (CCP) and guarantees settlement, it has to account for that risk. NSCC assesses the risk (and applies several risk calculations) that a member, whether on buy side or sell side, will fail to settle (deliver or pay), and become insolvent. Based on the assessment, NSCC calculates the clearing fund charge on the member counterparties to cover that risk. Typically, the longer the period of risk exposure (i.e. between trade and settlement date), the higher the clearing fund charge will be.

In a recent study over a 3-month period, DTCC saw that by reducing the settlement cycle by one day, NSCC could potentially reduce clearing fund charges by approximately 40%. As such, shortening the settlement cycle would reduce NSCC's risk exposure and would offer members more capital efficiency because it substantially lowers their costs of clearing. But the key benefit of shortening the settlement cycle is the reduction of systemic risk, legal risk, market risk, etc.

DTCC has taken a very collaborative approach with the industry community to address accelerated settlement. DTCC concluded that T+1 was a more realistic immediate goal but that the industry should be striving for T+0. DTCC presented its position on accelerating settlement and moving to T+1 within two years, and on eventually moving to T+0, in a recent white paper.[23] The next step is to engage the industry in a deep and meaningful way. DTCC, in collaboration with SIFMA and the Investment Company Institute recently engaged Deloitte to organize industry working groups to dig deeply into the migration to T+1 and to build support. DTCC also wants to finalize a timetable, having proposed completion by the second half of 2023. DTCC believes that the goal of T+1 would be easy for some segments of the industry but may be more difficult for others. The plan is for the working groups to engage over the summer and reach some conclusions by September. Some of the considerations of the working groups involve securities lending and some necessary changes in the recall process for securities lending, handling errors and fails, and issues around prime brokerage. DTCC will also want the working groups to confirm that there are no significant problems relating to IPOs and secondary markets, corporate actions or various other areas. As far as the ultimate timing of the change to T+1, DTCC is waiting to see what conclusions come from the working groups, but DTCC believes that sooner is better, and MH remains optimistic about the late 2023 goal.

LR thanked MH for her presentation and turned the meeting over to AB to address various operational aspects.

AB noted that she is often asked questions about how a beneficial owner can assert its securityholder rights with respect to securities that are ultimately held in a DTC Participant account at DTC (whether that beneficial owner is a DTC Participant or the customer of a DTC

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[23] DTCC, Advancing Together: Leading The Industry To Accelerated Settlement (Feb. 2021), https://www.dtcc.com/-/media/Files/PDFs/White%20Paper/DTCC-Accelerated-Settle-WP-2021.pdf.

Participant or the customer of a securities intermediary further down the holding chain from the DTC Participant). AB first presented an overview of DTC's proxy service, which is the link between issuers and DTC Participants for securityholder identification, communications, and assertion of rights. In terms of issuer services, DTC provides information to issuers and agents with respect to the DTC Participants to whose accounts their securities are credited. DTC also provides authorization for the issuer to accept certain actions, such as voting, from a beneficial owner of interests in securities that are registered in Cede & Co.'s name. For example, DTC provides issuers with SPRs (securities position reports), and Omnibus Proxies. AB explained that an SPR is a report that can be requested by an issuer or trustee of a security, or an authorized third-party agent of the issuer, that lists the positions of DTC Participants with respect to a CUSIP of that issuer, as of a specific day. DTC can, of course, only identify securities credited to accounts of DTC Participants and not the further credits by those Participants to accounts maintained for their customers, or for such positions maintained by securities intermediaries further down the chain. This, we understand, is a key transparency concern of this Task Force but is not one which can be resolved at the DTC level.

AB then explained how the omnibus proxy process worked. When an issuer or its agent sends DTC a timely meeting announcement for a securityholder meeting, DTC provides the issuer, promptly after the record date, with an Omnibus Proxy. The Omnibus Proxy includes an SPR for the record date positions of Participants, as well as the contact information of those Participants. The purpose of the Omnibus Proxy is to authorize each Participant holding a position in the security in its DTC account on record date to vote its shares directly. The ultimate beneficial owners may be further down the holding chain, and further tabulation happens outside of DTC.

AB next turned to DTC's securityholder services, which provide a mechanism for a beneficial owner to assert its securityholder rights with respect to securities held on its behalf by a DTC Participant in its DTC Participant account. The need for these services arises from the fact that securities deposited at DTC are registered in the name of Cede & Co., and so it is Cede & Co. that is the legal owner of the securities on the books of the issuer, and not the DTC Participant or its customer. The service works as follows:

1. The beneficial owner that wants to assert a securityholder's right for securities held on its behalf by a DTC Participant at DTC instructs the DTC Participant[24] to onward instruct DTC with respect to an authorization of the beneficial owner to assert its securityholder rights directly, or for Cede & Co. to assert the securityholder right on behalf of the beneficial owner.

2. The DTC Participant submits an instruction letter to DTC, directing it to cause Cede & Co. to execute a letter pursuant to which Cede & Co. either (i) asserts the securityholder right on behalf of the beneficial owner or (ii) authorizes the beneficial owner to assert its securityholder right directly, but only with respect to an amount of the security credited

[24] AB noted that if the beneficial owner's broker dealer was not a direct DTC Participant, the beneficial owner would instruct its broker dealer to instruct the broker dealer's securities intermediary and so forth up the holding chain until the DTC Participant is so instructed by its entitlement holder to instruct DTC.

to the DTC Participant account that is identified to DTC as beneficially owned by the beneficial owner. The authorization only extends to the rights that Cede & Co. has as the legal owner.

3. The DTC Participant's instruction must include a copy of the letter or demand that is the subject of the request. DTC provides some sample templates of common Cede & Co. letters on its website for the convenience of its Participants. These may be found at: https://www.dtcc.com/settlement-and-asset-services/issuer-services/proxy-documentation.

4. The DTC Participant that so instructs DTC is solely responsible for the accuracy and legal sufficiency of any Cede & Co. letter. DTC does not make any determination, legal or otherwise, on what language or form is needed in order for the right to be asserted or for an authorization to be acceptable, and recommends that the DTC Participant consult with its own counsel. Each DTC Participant indemnifies DTC accordingly.

5. Assuming that the DTC Participant submitted the instruction and the Cede & Co. letter appropriately, Cede & Co. executes the letter and returns the copy to the Participant.

AB's next topic was the DTC Direct Registration System (DRS). First, AB wanted to give an example of how the DTC FAST (Fast Automated Securities Transfer) program works, because the FAST program provides part of the infrastructure for the DRS program. AB gave the following example of how FAST works: Assume that an individual investor holds a physical certificate for shares registered in its name. The investor wishes to transact in the securities so it deposits the physical certificate with its broker dealer, which may or may not be a direct DTC Participant. For purposes of this example, we will assume it is a direct DTC Participant. The broker dealer deposits the certificate with DTC, which credits the broker dealer's Participant Account and sends the certificate to the transfer agent (TA) for the securities to be reregistered in the name of Cede & Co. If the issuer is not in the FAST program, the TA will cancel the certificate and issue a new certificate for the securities in the name of Cede & Co. The TA sends the new certificate to DTC, which DTC then maintains in the certificate in its vault and credits the securities to the Participant Account of the depositing Participant. If the issuer is in the FAST program, the TA cancels the certificate, and instead of issuing a new certificate registered in the name of Cede & Co., the TA reregisters the securities in the name of Cede & Co. and adds to the amount of the security held by the TA for DTC on the TA's books and records. The amount of a security held by Cede & Co. on the books of the FAST TA is called the DTC FAST Balance. The FAST TA is also required to maintain a FAST Balance Certificate, which is a single certificate that reflects the current FAST Balance for Cede & Co. in that security.

AB then turned to the DRS program. AB explained that the dual purpose of the DRS Program is to eliminate the transfer and maintenance of physical securities as well as to provide investors with a flexible alternative to holding securities in street name (e.g., with a broker dealer). A DTC-eligible security can have one of the following statuses: Non-FAST, FAST (non-DRS), DRS eligible (certificates only and is not in DRS, but has the ability under its terms to be issued uncertificated), DRS-Participating Certificate/Statement (can be issued in certificated or

statement form), or DRS-Statement Only (which means no certificates can be issued, and only be issued uncertificated).

For a security that is DRS Statement Only, the TA does not issue any certificates but instead issues securities in book-entry form only and permits direct registration of the security on the TA's books in either the name of Cede & Co. or of another holder which may be an investor or its intermediary. With respect to direct holding by an investor, the investor does not receive a certificate representing its holdings, but instead receives a statement from time to time from the TA that reflects the investor's book-entry holdings at the TA. As the registered holder on the books of the transfer agent, the investor can directly assert its securityholder rights. If the investor wishes to transact in those securities in the market for clearance and settlement through NSCC and DTC, the investor can instruct the TA to transfer the shares into the name of Cede & Co. for credit to the DTC Participant account of the investor's broker-dealer. Operationally, the TA debits the shares from the investor's book-entry holdings at the TA and credits Cede &Co. FAST balance. DTC, in turn, DTC credits the Participant account.

AB explained that a security can be DRS-eligible if it is permitted, under its terms, to be issued in uncertificated form, and allows for direct investor holding in book-entry form. Most, if not all, DRS securities are equities because a lot of DTC-eligible debt is held BEO (book-entry only). BEO debt is evidenced by a global note either held by DTC or held in custody by the Trustee for the benefit of DTC and typically does not permit direct investor holding.

AB indicated that, as part of its dematerialization effort, DTC is working on encouraging TAs and issuers to make their securities DRS participating and to stop the issuance of certificates. AB then concluded her overview of the DTC mechanisms for the exercise of securityholder rights by beneficial owners.

LR thanked AB for her presentation. LR then clarified some of the terminology used in the presentation for those who may not be familiar with some of these terms. "DRS" refers to the Direct Registration System, which means what it says—the investor may be directly registered as the owner of the security on the books of the issuer. In that case, the beneficial owner is not intermediated through DTC although DRS offers flexibility for going in and out of direct and indirect holding. FAST (Fast Automated Securities Transfer) program is the link between DTC and the TAs for holding securities in the name of Cede & Co. TAs operate in two capacities in FAST—on behalf of the issuers in maintaining the register of ownership and also on behalf of DTC (Cede & Co.) as we have described.

LR then opened the floor for questions and discussion.

SR reminded the meeting that two earlier meetings of the TF—one addressing proxy issues and shareholder voting and one addressing bondholder litigation— focused in part on DTCC (and DTC) operations. AB clarified that these issues are all a part of the proxy service/securityholder rights at DTC that addresses, for example, not only proxies and shareholder voting but also the commencement of litigation, shareholder appraisal rights, and other rights. As mentioned earlier, the letters AB discussed (https://www.dtcc.com/settlement-and-asset-services/issuer-services/proxy-documentation) are drafted s to pass along rights of Cede & Co. as the registered

owner of securities beneficially owned by the beneficial owner and only up to the amount of securities credited to such a BO by its securities intermediary. DTC does not presume to know what rights it has as registered owner under the terms of a security and relies on the Participant to properly draft the Cede & Co. letter.

Thomas Mayer (TM) asked AB to confirm that in the DRS system the investor would become the actual holder of record. AB reiterated that the DRS investor is the record holder of its securities and those securities are not on deposit at DTC. But she also reiterated the flexibility for the investor to transfer the security to its broker dealer's Participant account at DTC for purposes of transacting in the security.

[58:40] Brandon Becker (BB) [Deputy General Counsel, DTCC] then asked whether AB knows how broadly DRS is used. AB responded that she did not have the numbers at the moment. She noted that usage was encouraged several years ago when exchanges-imposed listing requirements for securities to be DRS eligible.

SR asked whether debt securities could be included in DRS. AB responded that, as a practical matter, DRS securities must provide for investor direct holding. She noted that many debt securities are BEO [book entry only] and would not be DRS eligible. In BEO there is one global note for the securities issue registered in the name of Cede & Co. and no investor can withdraw any securities or have them registered in its own name. Cede & Co. is the registered owner of all of the issue of securities in BEO. The listing requirements however do not distinguish between debt and equity so if there are debt securities that could be directly held by investors, they could be DRS eligible. Also, some securities cannot be issued in uncertificated form so they cannot not be DRS eligible.

TM asked whether holders through DRS affect the count of securityholders for '34 Act purposes. AB and LR responded that an investor's holding through DRS is separate and apart from and does not count as a part of DTC's holding for these purposes. So those holding through DRS would be in addition to positions held through DTC. TM explained his understanding that DTC [Cede & Co.] would count as a record holder and the indirect holders would not be counted, which means that holding outside of DTC would increase the number of holders.

TM then asked whether a holder through DRS would be impeded by DRS in financing its position as a holder. Stated otherwise, he asked how financing takes place with respect to securities held through DRS. LR responded that this is entirely outside the scope of the DTC structure as to how a holder might finance its securities.

Janis Penton (JP) then noted that when AB discussed the FAST system she appeared to focus only on equities. She asked AB to describe how it works with debt evidenced by a global note and how notices get to beneficial owners through the LENS (Legal Notices System) system. AB explained that Cede & Co. is the registered owner of the global note for BEO debt securities and that the TA keeps a FAST balance for Cede & Co. for that BEO debt security. The benefit of the FAST program is that it eliminates the need to move maintain the global note in its vault and the need for physical presentation. AB noted that DTC is currently is working on a

dematerialization initiative for the issuance of uncertificated corporate, and later muni, debt securities so as to eventually eliminate global notes.

AB then explained that DTC Participants or non-participants can subscribe to LENS, which is a web-based portal. LENS allows access to all notices, documents, etc. that a third party sends to DTC for posting to LENS. LENS does not target beneficial owners or DTC Participants but is more of a bulletin board. DTC also receives notices that relate to events (such as a corporate action, dividend payment, etc.) that will be processed through DTC. DTC uses such notices to put the event on its system, with appropriate details and comments so that DTC Participants will be aware of the event. Participants are then responsible for further dissemination of that information to their customers who may or may not be ultimate beneficial owners; if a Participant's customer is another intermediary, it should similarly disseminate the information to its customers, etc., but that is beyond the scope of DTC.

JP noted that only subscribers can access LENS and that otherwise notices sent to DTC [Cede] are forwarded to DTC Participants. AB explained that LENS notices, etc. come from third parties, and may, in fact already be publicly available. AB further explained that DTC does not forward notices to its Participant. Upon receiving a notice, DTC will update the event in its system with the event details, and may, if there is a lot of accompanying information and documentation, refer Participants to LENS or an external site with the information. Under DTC rules, Participants are required to independently verify the information.

CM then noted that over the past year the TF has been 100% unsuccessful in getting data from the SEC and hopefully will have better luck with DTCC. Following up on Brandon's inquiry it would be very helpful if the TF could get some information on the use of DRS, who are the DRS holders, and anything that would give some indications as to why investors do or do not choose to hold through DRS—maybe because it is cumbersome, maybe because investors do not know enough about the benefits of DRS. AB responded that DTCC has launched its dematerialization efforts to encourage issuers to allow their securities to be DRS eligible and to try to ascertain why investors would not choose to hold through DRS. She is sure that they have slides with numbers, in particular percentages, and she will see what can be found in this respect.

CM followed up by noting his understanding that one reason for the outreach is to encourage issuers to opt for "statement only" and not to permit issuance of certificates. He also noted that this would make it possible for investors to choose DRS while eliminating certificates and that DRS participation is a separate issue from whether investors actually choose to hold through DRS. AB emphasized that making securities DRS participating increases the opportunity for direct holding, but agreed that it is the investor's decision on how it wants to hold its securities. DTC is not attempting to influence that decision one way or the other. LR also noted that another factor relevant to the question [of investor use of DRS] is also an answer to the earlier question as to how does an investor finance securities. Financing may be more difficult if securities are not held through the indirect holding infrastructure. There is a whole area of services offered by DTC and NSCC that are not available when holding securities in an investor's own name. CM agreed that these benefits are not currently made available to holders through DRS, which is a big issue.

Eric Schaffer (ES) noted that he has seen many of the Cede authorization letters [i.e., authorizing beneficial owners to exercise rights] but asked AB about the legal effect of such authorizations. He asked whether Cede is actually assigning its rights as the registered holder. AB responded that it depends on the form of the letter. The letter can authorize the beneficial owner to take the action that Cede as the registered holder would be entitled to take. Also, sometimes (because, she assumes, it is a requirement under the relevant securities), Cede is asked to exercise the right itself on behalf of the beneficial owner. So either approach could be taken. ES responded that this would make sense if there were only one beneficial owner for the entire issue of the security. But suppose 20 beneficial owners and Cede is the registered holder of 100%. He assumes that Cede is not assigning 100% of its rights to the holder of 10%. AB explained that the letters must specifically list the number of shares or amount of principal credited to a specific DTC Participants account, as of a specific date, which the Participant represents are ultimately beneficially owned by the specified beneficial owner. DTC confirms that the Participant's account has a sufficient amount of the security credited to the Participant's account to support the request. Cede only authorizes the beneficial owner to take action with respect to those securities to which it claims a beneficial ownership interest (number of shares or principal amount). So, Cede & Co. only authorizes a beneficial owner to the extent of that amount.

ES then asked what Cede does if, for example, one 10% beneficial owner wants to take X action and another 10% beneficial owner wants to take Y action. Does Cede have the ability to take inconsistent actions with respect to portions of the shares? AB explained that the authorization letters always specify the beneficial owner that is either being granted the authorization or on behalf of which Cede & Co. is acting. Because the authorization only extends to the amount of the security listed on the authorization as being held in the DTC Participant account fbo beneficial owner, it is up to the Participant and the beneficial owner to determine how and what rights they want to assert, and with respect to what portion of that broker dealer's position, etc. LR then hypothesized that Participant A has customer R that owns 10% of an issue on the books of Participant A and Participant B has customer Q that owns another 10% of that issue. Customer R wants to do X and customer Q wants to do not X. And it is up to each of these Participants to come to DTC [Cede] and ask for authorizations for these actions. She noted that ES's question is whether DTC [Cede] will give authorization for Participant A to do X and for Participant B to do not X. ESc agreed the issue is whether DTC [Cede] has the ability to subdivide its unitary ownership of the global note [in the case of BEO debt securities]. LR again emphasized that if she holds 10 shares of IBM with Merrill Lynch that is the most that she can do something about and that is the most that Cede would be authorizing.

SR then asked whether, if she holds 10 shares of IBM, can she vote 5 shares yes and 5 no? AB responded that "in terms of the offer, generally no," speculating that a beneficial owner voter may not be permitted to vote in that manner under the terms of an offer, but that voting is done via omnibus proxy outside of DTC. AB emphasized that the Omnibus Proxy voting process is different than the processes for authorizing different types of direct actions by or on behalf of beneficial owners.

CM then observed that in some respects this discussion has radically oversimplified the approach to the actual holdings of a beneficial owner. For example, for a variety of reasons a beneficial owner's intermediary (assume a DTC Participant) may have credited more shares (or a greater

amount) of a security to its customers than the intermediary actually holds with DTC (or otherwise). AB responded that DTC does not have a view into a Participant's holdings outside of DTC.

AB reminded the group that voting should not involve DTC/Cede & Co., and that DTC has the omnibus proxy for this exact purpose. LR then noted that we have wandered into voting issues, but heretofore the discussion has focused on actions that customers of Participants wish to take *other* than voting. The proxy system works on a proportional basis. AB noted that Cede delivers an omnibus proxy of a security to each Participant based on the Participant's holdings with DTC. This addresses in part the point that CM made earlier in that distribution of proxies in the system is best handled by the issuer.

[CM note: The discussion on the authorization letters, etc. was indeterminate in some respects and a more conclusive resolution will be sought separately.]

Lewis Cohen (LC) then took the floor, noting that in his practice virtually all of the debt securities he encountered were BEO. LC noted another ABA project about 30 years ago that addressed uncertificated securities for debt instruments.[25] Unfortunately this work seems to have fallen by the wayside and been forgotten with the sands of time. So LC expressed great interest in the DTC initiative mentioned by AB on uncertificated corporate (and eventually muni) debt securities that would eliminate global notes. LC asked AB where that stands and indicated his interest in participating in that project if possible. AB responded that DTC is working on that internally but has not yet reached out more broadly. The initiative started when the Corporate Trust Committee of the STA [Securities Transfer Association] approached DTC and asked DTC to work with them on this topic. From DTC's perspective, its role will be to develop the DTC framework for supporting the issuance and holding of uncertificated debt from both the DTC underwriting and custody perspectives and from an operational standpoint. In the meantime, DTC hopes to be accelerating work on this in the next year. As far as a peek DTC has conceptualized leveraging the FAST infrastructure to facilitate uncertificated debt. LC thanked AB and looks forward to future communications from DTCC on this important topic.

LC noted that his current practice focuses on blockchain and digital assets and asked for an overview of the intersection between DLT and what DTCC does and, for example, whether DTCC sees this as a threat to the hegemony of the organization, whether it is a good thing or a bad thing, and generally DTCC's perspective on that. AB responded that, as the White Papers reflect, DTCC is running proofs of concept in the DLT space. One project is Project Ion that addresses DVP [delivery versus payment] using DLT technology. AB reiterated what MH mentioned earlier in the presentation, that many of DTCC's constituents do not want earlier settlement within a day but instead want end of day settlement so the credits could accumulate to offset their debits, in order to maintain liquidity. So DTCC is following the technology as it continues to develop and is continuing to monitor member interest in using any particular technology with DTCC. DTCC did reach out to members when designing the proof of concept

[25] [CM note: The ABA BLS Ad Hoc Committee on Uncertificated Debt Securities produced a Report that included a Sample Uncertificated Debt Indenture. The full report (including the Sample Indenture) is posted in the TF Dropbox. The Report (without the Sample Indenture) was published at 46 Bus. Law. 911 (1991).]

for Ion. Much of the feedback was that DLT was secondary to moving from T-2 to T-1. The feedback received from DTCC is that the interest is on quicker settlement, less clearing time, less risk, rather than reinvention in the context of DLT. But it is still a priority at DTCC to make its systems more efficient and, as the technology continues to evolve, DLT may certainly play a part.

TM next asked about when Cede's instruction or authorizations letters terminate—for the date of the letter only? AB responded that the authorization does not terminate on a date certain but the letters are good only to the extent that the beneficial owner continues to hold the shares [on the books of the broker] from the date of the letter forward. If the beneficial owner sells the shares and then wishes to bring an action based on something currently occurring, the former beneficial owner may no longer have standing to bring that action. TM then asked whether it is up to the adversaries to determine whether the beneficial owner continues to own the securities. AB noted that the letter references the amount [or number] of securities, the DTC Participant, and the name of the beneficial owner. Tom then asked about a senior debt holder seeking to enforce rights against a subordinate debt holder; if both securities are directly held by Cede, does Cede have to be both plaintiff and defendant? AB did not know the answer but noted that it might depend on the structure and she emphasized that DTC would not get involved unless specifically asked by either party (or as an interpleader defendant).

CM then noted that one issue relating to the technology issues that LC raised is whether these technologies might help DTCC and its constituent organizations to do what they do better, more efficiently, more cost effectively, more accurately, and the like. Another completely separate issue is whether it is possible to have a market for competing systems for clearing and settlement and post-settlement holding. Right now, it seems that such a competitive system is virtually impossible with respect to traditional debt and equity securities cleared and settled and held through NSCC and DTC. This is an issue CM think hopes to take up in a future meeting. These are different ways of looking at things from and external or internal standpoint from DTCC. CM then asked LC if has any comment on this aspect.

LC then observed that this is an important question. For DLT to allow a single centralized entity to do what it does more efficiently is not a very exciting use of the technology and it has its own set of issues. From what he has heard externally about Project Ion, it has not gained that much traction because the benefits are fairly inchoate. What is more exciting about DLT (and blockchain) is that it facilitates more of an open or market infrastructure and we could look at what is known as decentralized finance [or DeFi] and much of what is going on there mirrors in some ways the more nascent stages of the more formalized market. Now DeFi technology is not ready to support an X trillion-dollar equities market, but it is moving very quickly. It is critical and widely assumed that efficiency can be enhanced by more competition in providing financial services as long as it is not done in a way that fundamentally disrupts the market. So LC encouraged AB and DTCC to pay close attention to some of these areas because, similarly to the consolidation that was prompted by the paperwork crisis, we are now moving again, without intention, toward a bifurcated and ultimately more efficient system. AB agreed and noted that DTCC is watching developments very closely.

There being no further interventions, LR turned the meeting over to SR and CM. CM noted that it may be necessary to convene some smaller groups for some brainstorming to pull things together preliminary to a report that presents the issues more coherently. He expressed the hope that when called upon participants in the TF will join in the work. He also invited those with an interest in working on a particular area to let Sandy and him know.

SR then noted that her colleague Patrick Fuller (PF) will be convening an upcoming TF meeting to focus on AML and related compliance issues. PF then noted that they are working to put together this meeting for June or July.

CM noted that we may focus on other issues that are raised by a fascinating article by Dan Awrey and Joshua Macey [now available in the Dropbox[on the history of regional exchanges and depositories and how they evolved into the unitary system that exists today. Those issues and those that LC mentioned in some ways merge. We also may need to revisit some ground we have already plowed, including corporate voting and corporate actions.

SR and CM then thanked LR, AB, and MH and the DTCC supporting staff for excellent presentations and discussion.

The meeting adjourned at 12:48pm.

NOTES: MEETING (VIA ZOOM) OF TASK FORCE ON SECURITIES HOLDING INFRASTRUCTURE ON JULY 21, 2021[26]

AGENDA

Meeting of ABA Business Law Section Task Force on Securities Holding Infrastructure
Wednesday, July 21, 2021, 12:00pm – 1:30pm EDT
(via Zoom)

1. Welcome and Introduction: Charles Mooney and Sandra Rocks (Co-Chairs)

2. Panel Discussion:

ANTI-MONEY LAUNDERING AND SANCTIONS: COMPLIANCE ISSUES IN THE INTERMEDIATED HOLDING SYSTEM

Moderator:

Patrick Fuller, Esq.
Senior Attorney
Cleary Gottlieb Steen & Hamilton LLP
Washington, DC

Presenters:

Paul Marquardt, Esq.
Partner
Davis Polk & Wardwell LLP
Washington, DC

John N. Giantis, Esq.
Vice President and Senior Counsel
State Street Bank and Trust Company
Boston, MA

John R. Siena, Esq.
Senior Vice President
Brown Brothers Harriman
London, UK

Timothy J. Casey, Esq.
Vice President
Goldman Sachs
New York, NY

[26] Notes prepared by Charles Mooney. Any errors are his.

Gerard Monusky, Esq.
Senior Counsel
Brown Brothers Harriman
New York, NY

James Freis, Esq.
Founder
Market Integrity Solutions LLC
Washington, DC

3. Open Discussion

4. Adjournment (by 1:30 pm ET)

* * *

Charles Mooney (CM) and Sandra Rocks (SR) opened the meeting with brief introductory comments on past and future meetings and future plans for the Task Force (TF).

CM suggested to Patrick Fuller (PF) that a useful point of reference for the discussion of anti-money laundering (AML) and sanctions compliance issues would be the comparison in this context of security holders who are registered holders on the books of issuers and those that hold through securities accounts with intermediaries. CM also noted that for many involved in the TF today's topics do not often come to the fore when we consider issues related to intermediated holding. Part of today's exercise is to enhance our understanding of the issues and problems. SR echoed these sentiments and expressed her pleasure that the TF is exploring today's subjects. SR then gave the floor to PF.

PF explained that today's focus is on AML and sanctions compliance and that he hoped for ample time for discussion at the end of the presentations. He noted that in the present context of AML and sanctions compliance the concept of "beneficial ownership" usually contemplates identifying the "ultimate natural persons" who own or control a legal entity that may be the security holder/customer of the financial institution (e.g., to make sure that the person is not Vladimir Putin or his musician). This is because the AML laws are concerned with the ultimate source of funds and what the use of funds will be, whether it is something legal or illegal. This is a bit different from the usual discussions that the TF has been having. These discussions more generally have been about the identification of the legal person that is entitled to the rights represented by a security within a complex chain of intermediated ownership (although this may be an oversimplification).

In the AML space we think about knowing your customer and your customer's customer and assessing what the customer is doing and who the customer faces downstream. It is less of an imperative to "look through" a customer that is an intermediary. This is important because one of the things that CM and SR have asked his group to think about is what would be different in a world of full transparency of ownership for securities. In particular, how would such a world

affect AML and sanctions compliance programs and what would financial institutions need to do to satisfy their regulatory obligations?

PF then provided some general background on AML. He pointed out that when the group discusses AML they are not focusing on the actual crime of money laundering, which has been a crime since the 1980s. Instead, they are focusing on the affirmative regulatory compliance obligations that financial institutions must observe in order to detect and prevent money laundering. Essentially these intermediaries have been deputized to provide intelligence on financial crimes to law enforcement.

An AML program needs to be "risk-based"—on a set of systems and controls that allow the institution to identify, assess, report, and manage the money laundering risk that a customer's business presents. PF mentioned three key aspects of the day-to-day work of an AML program. First is risk assessment, because everything is risk-based. The overall design of the program must be based on a firm's AML risk considering its products and business lines, the types of its customers and the geography of its business. Risk assessment also is relevant for individual customers and diligence and monitoring should be tailored to an individual customer's risk profile. The customer diligence obligations at the basic level involve collecting names and ID numbers, verifying identities of customers and keeping records on them.

Second, this has been extended recently to a more formal obligation to identify the beneficial owners of legal entity customers at either a 25% or 10% equity ownership threshold. But the customer is the actual account holder. So in an intermediated system, you are not looking through the account holder to the beneficial owner of the securities that are being held in the account. Instead, you are looking at your direct customer, which may be another intermediary, and asking what money laundering risk your direct customer presents. Despite this, it may be necessary to know who an intermediary's downstream customers are, not necessarily the names of customers or IDs but a general sense of who the intermediary is doing business with, in order to understand the money laundering risk that the direct customer presents as an intermediary.

Third, the last point is that this whole system is really designed to enable financial institutions to monitor customers' financial transactions, so that they can look for suspicious activity and report it to law enforcement in the U.S. in the form of a suspicious activity report [SAR]. So all the information on customers that is collected goes to the point of looking for high risk activity and reporting it to law enforcement.

With that background, PF passed the baton to Paul Marquardt (PM), who will give an overview of sanctions compliance and the challenges that it raises in connection with intermediated securities. Paul is a former partner at Cleary and an expert in sanctions and CFIUS [Committee on Foreign Investment in the United States], who worked closely with PF and SR.

PM first noted that he has not retired but now is at Davis Polk. He noted that the sanctions programs generally do not describe what diligence is required to the same extent that the AML rules do. But the sanctions authorities are aware of the AML rules that is part of why they do not prescribe so much detail as in effect piggyback on then—the AML process is also considering

sanctions and looking for transactions that violate the sanctions laws. OFAC [Office of Foreign Assets Control] is a strict liability regime and any transaction in which a sanctioned person has a direct or indirect interest is prohibited. This is so whether or not the person knew or could have known about the sanctioned person's involvement and there is not a *de minimis* exception as a formal matter. This creates nearly boundless discretion for OFAC. It is not much of an overstatement to say that everything is prohibited but not to worry because we do not prosecute everything. But to be fair to them they would say that it is a totality of the circumstances analysis and they are not in the business of playing "gotcha" with responsible institutions that are making good faith efforts. They take a maximalist approach and do not go after institutions for "footfaults" in most cases. But there is still a lot of room for misunderstanding about what is reasonable and who is making reasonable efforts. The fact that there is a bit of over-deterrence and an absence of bright line rules is more of a feature than a bug and that creates a number of challenges.

If you start with normal payment processing OFAC guidance on diligence is what you might expect. They mostly expect the institution with the customer relationship to have primary responsibility. As for diligence on parties to transactions with intermediaries, OFAC guidance generally allows intermediaries to rely on other institutions unless an institution knows or has reason to know that a transaction is prohibited. That is kind of a squishy standard and again the totality of the circumstances will determine whether something in a payment message is suspicious and whether in hindsight the institution should have spotted it. Although there is OFAC guidance one normally can rely on information that is available, but there is no clear set of guidance for the securities industry, particularly after the Clearstream enforcement action.

One of the things that OFAC did was to roll out a set of very general expectations that institutions (including non-U.S. based institutions) carry out AML-like risk-based diligence on their customers and, as PF described, on their customers' customers. OFAC is saying that institutions should be identifying risky institutions and doing due diligence on them, monitoring transactions, and restricting products and accounts to particularly risky customers.

A specific challenge for the securities industry is the problem of "what do you know" inputs and it is a hindsight assessment. The problem that institutions face is sort of a "Pearl Harbor" problem: If you sort through all the noise there is data scattered around the institution. If you put it all together and put it in front of someone it appears that it probably relates to a sanctioned person. This is a universal problem for compliance programs.

But to get closer to where this TF is focusing, it gets even more complicated as banks share information and as to when they should or must share is a bit unclear in the intermediated space. When banks get information from third parties the question becomes, because there are so many entities in the chain dealing with securities: "Who has an obligation to stop the transaction and how far should it be permitted to proceed?" For example, we have had clients approached by plaintiffs' lawyers, which actually is not at all uncommon for sanctioned persons because it is not easy to collect judgments against them. These lawyers will reach out to intermediaries or issuers and say that they have reason to believe that a sanctioned person has an interest in your securities and you should not pay them and should stop payment. Who should do that?

For a payment on a bond, you have the issuer, the paying agent, the depository, the clearing houses, and correspondent banks. Theoretically every payment in the chain is one in which a sanctioned person has an indirect interest and every payment is prohibited. It is not clear who OFAC is going to expect to stop the payment. OFAC's principle is a common sense one: It would make sense to block the payment at the institution closest to the sanctioned customer. The paying agent sends out a big bulk payment and it gets chopped up as they go from issuer to clearing house to customers to customers of customers and to individual accounts. It makes sense to segregate the payment at the bottom of the chain and hold it there. But the guidance is switching because there have been instances (and Clearstream is a good example) where someone up the chain was held liable because an entity down the chain from it passed the money on to the sanctioned person.

So the main question that arises from the OFAC perspective, as there is more and more transparency as to the ownership chain, is how to allocate the responsibility. How far can the money move? Where can the transactions be implemented and blocked? If an entity at the bottom of the chain fails to do what it is supposed to do, to what extent are institutions up the chain responsible?

PF thanked PM for his presentation. PF then introduced John Giantis (JG), a VP and senior counsel at State Street in Boston who covers AML and sanctions and is a former OCC compliance examiner.

JG noted that he was particularly proud of his participation as the OCC representative in 2007 in the drafting group for the FFIEC [Federal Financial Institutions Examination Council] BSA [Bank Secrecy Act] AML manual. This involved being" locked up" in room with folks from other agencies at the FDIC as we hashed out the 2007 version of the manual.

JG's first slide shows the custody institution (i.e., a bank custodian) at the top, below that the institution's direct clients and below that clients of clients [all in the tiered intermediated securities holding infrastructure]. In many cases the direct client will also be an institutional client and their client also may be an institutional client.

The second slide focuses on some of the challenges in the custody setting. Because of the nature of these clients, information as to the ultimate beneficial owner (UBO)[27] may not be available to the custodian in the course of its business. The same theme runs through services such as transfer agency, analytics, middle office product offerings, and asset management services. There are some situations in asset management services where there may be some line of sight to purchasers/sellers and UBOs, but in some secrecy jurisdictions that information may not be available. (See second bullet point.) But the theme in all of this is that the custodian can only see what it can see, whether it is sanctions or AML that may be involved.

[27] [CM note: As used here and in these meeting notes, the UBO refers to the account holder at the lowest tier (i.e., an account holder that is not itself acting as an intermediary in respect of the relevant security) in the intermediated holding system. Of course, it is possible that such a UBO is itself in fact only a nominee or agent for one or more other persons under arrangements outside of the holding system.]

At State Street, as legal support for the AML team, he has really pushed on the issues relating to the customer's customer and how to get a better understanding of the customer's customer. Of course, there is always the Wolfsberg Questionnaire[28] as well as due diligence questionnaires that State Street has developed. These are useful documents, but in case of a higher risk client it is necessary to delve further into what kind of customer is involved so there can be a proper assessment. Understanding the customer's customer helps to understand their own customer. It is not easy to ask a customer about its customers, particularly outside of the U.S. it is an even bigger challenge. But they have tried to make the questions as direct and simple and efficient as possible so that they can get the necessary information.

Another ongoing challenge, with the business folks or the business-legal folks, is answering the questions about what it is that is required to be done about the situation of the customer's customer. It is a constant struggle to balance the business needs with the legal and compliance needs. Luckily, FinCEN [Financial Crimes Enforcement Network, U.S. Department of Treasury] has provided guidance on this topic a few years back, which has been very helpful. Regulators tell them that it is very important to know about their customer's customers as best they can. But, again, they only see a small slice of a much larger transaction chain and from what they can see they try to assess the risks as best they can.

Moving to the last bullet point, a challenge for regulators is to understand how securities are held. State Street has a dedicated team from the Fed assigned to it. They understand what State Street does and its products. But at exam time the Fed brings in examiners from all over the country, and some of them have never been to State Street and do not understand the custody model and definitely do not understand the intermediated system. This is not a knock on the examiners, but they do not always understand what it is that State Street does, how it does things, what is important. Getting the examiners to understand that State Street can only see what it can see is critical to successful outcomes.

Another challenge is the increasing expectations of regulators that financial institutions are best positioned to observe and report suspicious activities. Once the information gets to FinCEN they may be able to piece together any larger picture. The last point relates to sanctions, which PM spoke about. In JG's experience with OFAC, when it is explained that State Street can only see what it can see and nothing further down the chain, OFAC basically says that they understand but that is "too bad" and that OFAC "is not buying it." It really did not carry any weight that State Street is just one part of a larger chain. So having these conversations with OFAC resulting in successful outcomes remains a continuing challenge.

PF next thanked JG for his presentation. PF then introduced and gave the floor to John Siena (JS), Associate General Counsel, Brown Brothers Harriman, London, UK. PF also noted that JS has spoken to the TF at an earlier meeting on the role of custodian banks.

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[28] *See* Wolfsberg Group Financial Crime Compliance Questionnaire, https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/Wolfsberg%27s_FCCQ_220218_v1.0.pdf.

JS noted that it might be helpful to step back a bit to give a sense of the broader pressures to which securities intermediaries and custodian banks are subjected. JS observed that when we think of AML challenges and OFAC sanctions compliance requirements and the like we tend to focus on those issues in isolation in terms of how they might affect our institutions' operational processes and efficiencies. However, we also must be aware that there are potentially conflicting considerations and possible contradictions with other areas of the law, both globally and within the U.S.

JS noted that he has chaired the European Committee of the Association of Global Custodians (AGC) for some time and it might be worthwhile to share a bit of perspective. JS turned to his first slide, commenting that most of those participating are familiar with its content but that it would be helpful in the context of this discussion to revisit the general role of the securities custodian. This role involves providing access to rights and entitlements to securities but also providing core asset servicing support for customers, whether they are intermediaries themselves or actual beneficial owners. A key point is that a global custodian operates on a cross-border basis and for this reason it comes into contact not only with U.S. laws but with other laws as well. For BBH, New York is the primary governing law for our main bank providing custody services, but we provide access to securities through our global custody network of sub-custodians throughout the world. So by definition the global custodian is exposed to laws outside of the U.S. This is a function of the chain of custody and not just an operating model. It involves other laws in terms of how securities are held and disposed of.

Finally, and especially since the financial crisis of 2008-2009, you are all aware that collateral in the form of securities has become more and more important to the safety and integrity of capital markets. We have seen a huge push toward more and more collateral being required across a variety of contexts and securities custodians are a key part of this. So when we think about AML and sanctions compliance, and who our customer is and whether or not we can recognize UBOs, this is further complicated by the fact that securities custodians are not just holding securities for a client. Clients are doing things with these assets, for example lending securities to third parties and entering into repo arrangements, whether bilateral repo or tri-party repo utilizing a third-party collateral manager. We also have situations involving OTC trading arrangements involving initial margin and variation margin, with phase five and six margin rules now coming into effect, which is going to hit a huge swath of the industry.[29] These will be new to a broad segment of the industry that will be affected by these margin requirements. So we need to think about the uses to which assets are put and not only in a static setting but also in this "dynamic" environment involving the use of assets—in particular as collateral.

JS then focused on his next slide illustrating the pyramidal structure of omnibus accounts. JS explained that omnibus accounts are used very heavily in the industry. He noted the importance of revisiting why they are used and what they are actually used for. The slide is highly simplified, but it reflects a pyramid that depicts that there are not securities holdings on behalf of BOs that are held in a granular, segregated basis all the way through the chain of custody to the

[29] *See, e.g.,* ISDA, Get Ready for Phase Five, Get Set for Phase Six (July 20, 2021), https://www.isda.org/2021/07/20/get-ready-for-phase-five-get-set-for-phase-six/ (discussing extension of global margin requirements for non-cleared derivatives).

CSD. Instead, the industry generally makes use of omnibus accounts. The slide uses the language of the Geneva Securities Convention ("account holder"): it is important to keep in mind the architecture of securities custody and that a securities custodian is typically both an account holder [i.e., of a CSD or another custodian] and an account provider (securities intermediary). Sometimes people get confused and refer to omnibus accounts as "commingled," which drives JS crazy because in his view there is no commingling. He thinks of commingling as a collection of investors that join an investment fund or structure in which investor interests in the assets are commingled, i.e., explicitly owned by the investors collectively (e.g., jointly and severally). In one sense this happens under UCC Article 8 where there are fungible securities. But every securities custodian maintains for each customer (account holder) a segregated account. While all custodial customer accounts are segregated at the account provider, sometimes customers are themselves intermediaries, which means that their account with the next account provider in the chain is considered an "omnibus account" for *their* underlying customers. So as an account provider, a custodian "A" considers the account segregated for its immediate customer, but that customer (if it is an intermediary itself) would consider its account with custodian "A" as omnibus because it holds the account for a collection of its underlying clients.

This is an important factor to keep in mind when we talk about transparency and what kind of information is available through the holding chain. The reason this is so important is that for now omnibus accounts are essential to the goal of holding securities through intermediated securities accounts globally. This is so until perhaps distributed ledger technology kicks in, as we keep hearing about the promise that there may be the ability to have segregated, granular information through a blockchain of every single retail investor's holdings. That is perhaps a separate discussion for the future, but for now the industry relies on the usage of omnibus accounts. The scale of investments on a segregated basis would otherwise just be overwhelming to the systems of individual intermediaries. This approach also is safer when you think in terms of the reconciliation requirements among intermediaries. Of course, there is reconciliation of positions on a daily basis. But reconciliation in the context of omnibus accounts, as already described, is one thing but reconciling accounts of individual human beings in the millions on an account-by-account basis would be something else in terms of the computer power needed to do that correctly. So I hope this provides some context in terms of the larger operational scale that we are talking about.

JS now moved to the next and final slide. JS proposed a series of questions that build on his previous discussion. If we are thinking about more information in the holding chain to satisfy AML and sanctions compliance requirements, the key thing is to consider how we would do that and what would be the priorities in seeking to achieve it. Given what he has described, in terms of how omnibus accounts are structured, providing information through the chain through each link of intermediaries for all customers would be very difficult. One question is: What kind of information would regulators or others be looking for? Is it enough just to have a name? Would there be more information required as to the number of shares held by the investor, potentially held at each link in the chain of intermediation? And when you start down the road of requiring transparency and information through the chain, does that actually cut against the entire omnibus account model? Would it even be impossible to employ because it would require identification of each investor? Or would this be required only on a case-by-case, one-off basis when there is a

reasonable suspicion of misconduct? These are some fairly fundamental questions that require some careful thought.

In the second part of the slide, on priority, we had a debate on these issues in the European regulation context. Here, the obsession since the financial crisis was asset protection. The general assumption in Europe was that the Anglo-Saxon model of capitalism was broken and that steps should be taken to protect investors from disappearing assets, e.g., "Madoff risk" [i.e., assets purportedly held by an intermediary either are fraudulently transferred or do not exist], and even "Lehman risk" [i.e., that assets would be tied up and difficult to trace and recover in the event of an insolvency of an intermediary]. Since then, things have evolved quite a bit, but there remains a lot of focus on these risks. So the discussion around how accounts should be held and structured has probably been more a function of investor protection than anything else: and a perennially expressed view has been that segregated positions through the chain somehow deliver more investor protection. We have been fighting about this for more than 10 years now, and for the most part we have prevailed in getting public authorities to understand that "granular" segregation through the chain would not offer more protection to investors than omnibus accounts, and in fact would create added operational risk to the massive scale of individual reconciliations that would be required. Following on from this has been the Shareholders Rights Directive 2 (SRD2),[30] which is extremely important. SRD2 is intended to provide a harmonized framework across Europe, partly because Europe is very fragmented in terms of company law and shareholder rights.

One of the questions that has emerged is how to implement the SRD requirement mandating that issuers be able to identify their owners. To some extent this depends on the definition of a shareholder, which under national law varies widely in Europe. For example, in the UK (although no longer in the EU) the "shareholder" arguably is the trustee (i.e., the securities intermediary holding in trust for its clients), although there is some litigation on this, and in other countries it may be the ultimate underlying beneficial owner, or it could be a nominee, or could be "all over the map." It has been a struggle to come to a common view under national laws—which are dispositive—as to who the "owner" actually is. In addition, important questions have been debated regarding how a shareholder identification request would actually be processed. JS emphasized that this was not a regulatory imperative from an AML perspective but rather a company law imperative to enable issuers to determine who their shareholders are. The key was to agree to market standards that were developed by a task force, which provide that a shareholder identification request is to cascade down the chain, but that the response would not need to go back up the chain but rather could bypass the chain and go directly to the issuer or its agent. This was intended to avoid the problem that JS has mentioned in terms of information radiating back up the chain and infecting everyone else in the chain with more information than they need or could possibly process (and raising data privacy concerns). There has been some pushback against this, with some believing that responses should still go back up the chain: this remains a live discussion in Europe. No custodian (including U.S. custodians) is immune from this issue because it applies to all European securities wherever they are held anywhere in the world. So we must be aware of these countervailing winds that are affecting intermediaries.

[30] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017.

The last thing JS spoke about (which his colleague Gerrard Monusky (GM) will address more completely) are the beneficial ownership register requirements that are popping up around the world in compliance with the OECD efforts.[31] We need to think carefully whether it is a good idea for the concept to be expanded further because of some of the complications already mentioned. So far it has been pretty manageable in the trust and fiduciary settings. There is always a similar question as to the dividing line between a securities account (which may be an omnibus account or a segregated account) and other structures, such as an investment fund. How ambitious do the regulators really want to be? And how necessary is further regulation in view of the fact that the intermediaries are generally highly regulated as it is.

JS concluded his remarks and PF thanked him for the presentation.

PF next introduced Timothy J. Casey (TC), Vice President, Goldman Sachs, and formerly with the SEC, who will consider the issues from the perspective of a broker-dealer (B-D).
TC explained that while at the SEC he worked with the B-D task force that took a very close look at to what extent B-Ds in the U.S. were filing SARs, on what grounds the SARs were based, and where there were gaps. The task force also looked at situations where registrants (B-Ds) were not filing SARs even though they were part of the life cycle of a trade.

From the B-D perspective there absolutely are significant problems and challenges occasioned by the absence of a single source for confirming UBO status. As you know, the last piece of legislation from the previous administration, the NDAA, which is now very much in flight, speaks to how we should assess risk in an AML program at a B-D and at other types of financial institutions.[32] And one of the key components is how useful a program is to authorities. That is the lens that I am going to speak to and to share two or three specific examples that speak to some of the challenges with the current intermediated system. These challenges relate not only to identifying problematic potentially SAR-able conduct, but also the bad actors behind that conduct, which oftentimes are the owners of securities.

Before leaping into those examples, as you are aware many of the 5,000 or so registered B-Ds in the U.S. have a business model in which they only touch or see one part of the life cycle of a trade. That is a crucial point because, as JS and PM explained very well, there may be enormous liability for what an institution does *not* see. This means that client selection and counterparty selection and risk appetite around these issues are very germane to this conversation. Also, in terms of the importance of collateral, as JS noted, collateral is very important in the B-D context as is stock lending. When one borrows a tradable security from, for example, a prime broker, the borrower's ability to interact with the security is like that of an owner. With that background we now will turn to some specific examples.

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[31] *See, e.g.*, OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, and Inter-American Development Bank, A Beneficial Ownership Implementation Toolkit (March 2019).

[32] National Defense Authorization Act for Fiscal Year 2021 (NDAA), Public Law No: 116-283 (Jan. 1, 2021).

One of the main types of suspicious activity one sees as an AML officer at a B-D is insider trading and market manipulation. In order to detect that and to report and file a useful SAR one needs to know not only who owns a security but when did they own it. That is the headline here in particular from the perspective of an execution-only B-D. If an AML officer at an execution-only B-D sees its hedge fund client trade in the right direction in advance of earnings quarter after quarter, that is suspicious and the basis for an SAR, particularly if there is a potential connection between the client and the relevant issuer. But what the execution-only B-D is actually seeing may be a hedge, and their client actually may be terrible at investing and predicting which way the issuer's earnings are going to go, but the hedge is really profitable. So the B-D files a SAR, which takes time and money, and then the SEC and FINRA read the SAR, but all of that at the end of the day was wasted. The point here is that if AML officers and others had more of a god's eye view of who owned the security, when they owned it, and what was their position, it would go an incredibly long way. This is occasioned not only by the fact that we have this intermediated system but also the fact that sophisticated clients, including hedge funds, will often interact with a number of B-Ds and will have a number of prime brokerage relationships, which compounds the issue.

TC next discussed section 314(b) of the USA Patriot Act.[33] This provision has served very well in terms of AML programs speaking to one another. It has been terrific and can solve problems like the example just presented, such as by picking up the phone or sending an email in order to determine the holdings of a particular client. But this approach is clumsy and manual and incredibly time consuming. So it may be possible to get to the right place and file SARs that are most useful to launch investigations or materially advance others. But at the end of the day it can be an incredibly manual process. This means that we are unable to focus on other significant issues.

TC then turned to another example that relates to a conversation with other members of the panel concerning conflicts. One key part of capital formation is B-D underwriting of secondary offerings of securities. One of the key processes there is the B-D, typically on the control side, calling clients and lawfully sharing nonpublic information that a particular issuer is going to launch a secondary offering, asking if they wish to participate, and reminding them that they cannot use that information (i.e., "wall crossing" the client). This happens dozens of times a day on the street. But what happens from time to time is that the underwriter B-D wall crosses a client, and that same client does not protect the confidentiality. That client, knowing that the secondary offering will dilute existing shareholders and reduce the price of the security, will actually take a bearish position on the security prior to the announcement of the secondary offering. So the same B-D, doing everything right, might be in the position of underwriting, wall-crossing a client, and then executing the unlawful bearish trade made on the non-public information. This is because the B-D executing the trade may not know that the trade coming into them relates to the same client that was crossed.

So I hope these specific examples show some of the challenges in the trenches from the B-D perspective. TC turned the floor back to PF, who thanked TC for his presentation.

[33] Section 314(b) provides for information-sharing between banks and it relieves them of any liability for sharing the information or for failing to notify the subject of the information of the communication.

PF then introduced Gerard Monusky (GM), Senior Counsel, Brown Brothers Harriman, primarily responsible for AML and sanctions. GM also served as the first chair of the AGC AML and Sanctions Committee.

GM noted that he was previously with JP Morgan in both AML compliance and legal roles, and before that at the Manhattan District Attorney's Office in the Major Economic Crimes Bureau, so he has seen the issues discussed here today from several different angles. Before getting into the AGC and what the industry does to try to handle these challenges, GM raised some other general points that are important.

When we talk about AML and sanctions laws and regulations, historically, most countries would implement set rules that would remain in place for prolonged periods of time, subject to some periodic amendments. What we have experienced over the last five years are major changes made to local AML and sanctions laws, almost on an annual basis. We've seen this recently in the U.S., with the passage of the NDAA earlier this year, which makes significant amendments to the U.S. AML regime.[34] We have also seen this in Europe, with the implementation of the fourth, fifth, and sixth AML directives, which amended the third AML directive that was in place for years. And just yesterday, Europe released a package of four new legislative proposals that are going to completely change the AML regime in Europe even further. If you are a regulated financial institution who must comply with these local laws, this is almost like trying to catch a greased up football or trying to keep up with a moving target.

This is understandable, given the rising risks that global regulators are seeing in this space, such as a lack of transparency (e.g., Panama Papers[35]) and emerging technologies (e.g., cryptocurrencies). The challenge for custody banks who implement omnibus account structures is that historically these AML and sanctions laws were written for retail banks and envision that the customer of the bank is John Doe or XYZ Corporation. They were not traditionally written for situations where (as the charts presented by JG and JS illustrated) the customer is a financial institution acting on behalf of its own customers, who may themselves be intermediaries. Current AML laws or sanctions laws do not always contemplate this intermediated situation or understand the challenges of dealing with this from a custody bank perspective. Although the primary role of custodians is to "custody" the assets of its customers, custody banks also offer a number of ancillary services, like securities lending or fund order processing, that create a number of complex AML and sanctions compliance issues as well. We saw a lot of that recently with OFAC sanctions against Russia and China and what that means for securities loaned out by a custody bank on behalf of their clients.

As a result, there are challenges of maintaining these accounts and complying with applicable AML and sanctions laws. As JG was pointing out, one can only know or see what one can see. In the context of custody banks, a custodian typically does not have line of sight of its clients' clients in an omnibus structure. Instead, it performs due diligence on its clients to make sure they perform due diligence on their clients. This is typically the case when your client is also a regulated financial institution. Most regulators recognize this point and will not expect a

[34] NDRA, *supra* note [7].
[35] *See* Will Fitzgibbon, The Panama Papers: Exposing the Rogue Offshore Finance Industry (International Consortium of Investigative Journalists, April 3, 2021).

custodian to duplicate the due diligence already performed on the UBO. To perform that due diligence twice is not an effective use of resources that could be spent elsewhere in trying to prevent money laundering and terrorist financing.

However, I would point out that there are instances where, in the omnibus structure, banks do learn of information about UBOs. This information can be referenced in a free text field of a wire payment or in certain instructions that are passed on to the custody bank. The challenge this poses for banks is what are you required to do with this information when (and this is a phrase the industry often uses) you "become pregnant" with such information. Do you have to sanctions screen that person? Negative new screen that person? PEP (politically exposed persons) screen that person? Or can the bank rely on the fact that, its customer is, say for example, JP Morgan, who already performed that due diligence on the UBO and would have informed you if there was a concern? So there is a lot of discussion around what a bank needs to do once it learns of such information. This brings us back to the question of what will happen with the increased efforts to allow people within the holding chain to become privy to information about the UBO, if the ultimate question is what are the AML and sanctions consequences of that. The answer is that the consequences are potentially serious and costly from a due diligence perspective.

To handle these challenges, the custody bank industry, through the AGC, created a special AML and Sanctions Committee that GM was asked to chair about three years ago (and has now been handed over to State Street). This group is trying to grapple with these challenges from the perspective of an intermediary. It is working to identify industry standards and to communicate and interact with regulators and respond with comments to proposed rulemakings, so that the regulators will understand the challenges custody banks face in their capacity as intermediaries with other intermediaries as clients, as opposed to dealing with retail clients and investors.

Custodians are also facing unique challenges internationally, as JG indicated from the State Street perspective. In particular, they have seen a potential conflict of law situations arise between the U.S. and China over the past year, with escalating sanctions and a tit-for-tat mentality between both countries. After OFAC issued sanctions against China, China responded by passing laws that prohibit Chinese nationals from complying with U.S. sanctions. We recently saw something similar in Europe with the EU blocking statute that was amended to include re-imposed U.S. sanctions against Iran. This creates a potential conflict for international firms that operate in both the U.S. and these countries. It also challenges the notion that a custody bank can rely on its customers to apply the same level of due diligence if conflict of laws issues exist between the two. In a less harmonized world (in the context of AML and sanctions laws/regulations), the conflict of laws situations pose different challenges for intermediaries in the custody chain. It is difficult to rely on a customer for information, for example, when it will violate local law for the customer to share that information.

So these are just some of the issues that the AGC committee is attempting to navigate through. We have had amazing interactions with the regulators to date. We have tried to talk through some of these issues and attempted to educate regulators on the nuances of what we do [as global custodians]. This is helpful for the regulators to see where we are coming from. From an OFAC perspective, we have seen certain general licenses issued to address some of those nuances. And

that type of communication will be vital as it relates to the NDAA and the implementing rules by FinCEN through the remainder of the year. For example, we saw a lot of action last week with discussion about FinCEN's intention to implement a "no action letter" regime as it relates to AML, as well as the release of the FinCEN AML Priorities. As FinCEN continues to roll out changes to the U.S. AML regime, making sure that the voices of these intermediaries and custodians are heard will be vital to ensure that the laws are not written just for retail banks, but also address the challenges we have discussed here today.

PF thanked GM for his remarks. PF then introduced James Freis (JF), who has a unique background as a former director of FinCEN and who was responsible for writing a lot of these rules. More recently JF was managing director overseeing global compliance for the Deutsche Boerse Group. He has just come back to the U.S. after a busy period in Germany and we are really lucky to be able to get his perspective. PF then gave the floor to JF.

JF noted that he would like to sum up some of the things discussed here but also to talk about the subject in a little bit different way, hopefully, that will bring some things together. When we look at AML and sanctions, the biggest question here is who is behind the economic activity, and that is why we are talking about the "chain going down." Fundamentally we are looking at with respect to AML, proceeds of crime or successful criminals; or, with respect to sanctions, bad guys for various reasons on the OFAC list. The person of concern invests their assets too, and that is fundamentally what is driving our discussion of AML and sanctions risks relevant to the securities industry. If we do not know what we are looking for then it is easy to get lost. And then of course, as GM mentioned, there are crimes unique to the securities industry, the biggest one is fraud-related crimes, but with market manipulation and insider trading as well, you are also looking at who is behind the economic activity.

When we look at some of the risks and the traditional way that the AML framework was set up and as PF laid it out, it starts with the premise of what do you need to know at the account opening and the premise of transactions in terms of value intermediation. But what we have heard about today is that the relationship in securities intermediation is very complicated.

As compared to certain aspects of banking, securities activity can be much more complicated in a time dimension. For example, in banking, a payment goes through and then you are done with that payment transaction. But, if the payment were to purchase a security, someone can buy and hold for an eternity or a 30-year bond situation. There is a lot more information that comes up in the lifetime of that holding of an interest in a security, broadly defined, such as corporate actions through payments of dividends or on coupons or from tax disclosures, which are increasingly detailed. And there could be corporate related disclosures in terms of shareholder rights or the exercise of voting rights that are passed through this system. Or there could be suitability-related issues as to whether a person is an accredited investor or whether securities can be issued in certain markets or in what markets are we not allowed to issue in--all before we get into questions of OFAC and people on blacklists and the like.

But what was not mentioned by previous speakers, but is behind the challenges in mitigating AML and sanctions risks, is that all the above types of information come from disparate sources. There is no economic incentive to put all of that together. Coming back to the time horizon

aspect, a lot of payments that are made, such as a dividend, will ultimately be released to someone who is no longer a holder of that security, as the holder may have sold that security and there are many that arbitrage around dividend days. So you are combining information from different sources and over different time periods and for different purposes. That is so different (and I think back to SR and CM who taught me this as a law student a couple of decades ago) in terms of the intermediated securities chain and legal obligations under UCC Article 8 just looking at the next level in that chain. To put it another way from the OFAC perspective that came clear after the Clearstream case (as Paul mentioned, and he and I worked on that case) the notion from a risk perspective and financial crimes is an "interest" in securities. And that could be an inchoate interest and one as to which you are not yet able to exercise the commercial or property rights, subject to whatever terms and conditions that apply. But even a type of conditional "interest" is enough to trigger some of the OFAC risk aspects. Again, that could involve a piece of information that would be pocketed someplace else and certainly is not digitalized in your account naming conventions relevant to applying UCC Article 8 rights.

I come back to the question that CM raised about why don't we go to a segregated model. To simplify for our discussion purposes, this is a comparison between the two extremes of allowing a custodian to hold customer securities in (i) omnibus or nominee accounts; versus (ii) segregated accounts, i.e., require full disclosure and segregation by ultimate economic beneficiary. We can illustrate the omnibus/nominee account by a big wholesale bank holding securities in an account at a central securities depository reflecting only that the securities are held by big bank for the benefit of its customer base (i.e., the only distinction being that big bank does not co-mingle its proprietary assets with those of its customers). At the next level down on the books of big bank would be list of which of its customers own which positions, but, again, this might include various intermediaries, such as smaller banks, broker-dealers and funds. Each of these intermediaries will have its own list of customers to which it allocates security interests on its own books. The alternative of the segregated model means that each individual account at the bottom of every chain is reproduced up the entire structure with the disclosure of the entire chain of holdings. As JS mentioned it has a lot of costs in migrating the entire industry to a fully segregated model, and this is not that easy to do.

As distinct from costs, we may also want to consider how a change as fundamental as a move to full account segregation would fit with other dynamics driving change in the securities industry. Coming back fundamentally to the services in the industry and disintermediation, if we look at the financial industry, what is driving change globally I would say (to oversimplify) is disintermediation. I would call them largely failed attempts, but CM mentioned at the beginning presentation the notion of the ledger that is held or the Cap table in the private equity of an issuer versus who is in the ownership structure. Companies usually farm out these types of things, corporate disclosures and the like, and that happens if they become a bigger company or go over a certain threshold of shareholders. Disintermediation works in certain models, but it does not work today in our global capital markets.

Another thing to throw out there is the number of public companies, according to the World Federation of Exchanges, is in the 40 thousand-plus in terms of equities, and different levels in terms of preferred equities and the like, but that is a really small number. Just compare that number to the millions of indices that slice and dice that same equity, and also consider the bond

issuances and the like of all the different tenors and all the different structures. The world that we as experts think of as securities is much different from the public in terms of thinking more narrowly of traditional shares of a publicly traded company—of which there are only 4000 plus in the U.S., again a small overall market. But the market is much more complicated than that.

The other aspect is the temporal difference. The biggest driver in the financial industry, especially when you are looking at the payments side, is speed—the movement toward real-time payments. We are still stuck at T+2 securities delivery (with T+1 support gaining traction), but a lot of people talk about collateral baskets and repos, and you can do repos for a nano second. Or, if you have baskets of collateral, you don't even know what is in the basket other than classes that meet certain criteria (and it could even be swapped out if collateral values move). In a way, what we have done historically with omnibus accounts has become even more important to continue that type of economic fungibility of economic value added which is different from the fungibility of the individual security.

During the last seven years, as PF mentioned while I was working for the Deutsche Boerse Group and with Clearstream, an international central securities depository, we could provide the services for the global custodians and the biggest players in the market because we allowed them to clear on our books outside of normal working hours in the markets around the world. You cannot do that if you are working on a segregated model. There are many very fundamental aspects of a globalizing, quickly moving world that is trying to change the notion of collateral and credit risk.

Putting this into context and speaking—as half of my career was—as a regulator, not only is there a question of educating the regulators, but we have to realize that the regulators are limited to their own jurisdictions. Individual regulators cannot address these cross-border issues. So the industry needs to come up with a response. As we have heard, the AGC and some of those here today and their institutions have been involved in something that I worked on through the International Security Services Association (ISSA)—the Financial Crime Compliance Principles for Securities Custody and Settlement.[36] JS and others have been involved in some of those meetings.

Basically, that effort is trying to address some of the conflicts issues that GM and others mentioned by moving toward the appropriate types of contractual provisions and requirements. Essentially it is very simple: If you are the higher level in the chain, starting at the CSDs, and then to the global custodians, and down to various banks, and ultimately to funds structures and potentially to end investors, if you I have contractual conditions that say a person may be subject to different national law requirements, I not only need to meet my own national requirements but **need to avoid liability for *causing a violation* by another person**. (That is about the only thing that I have not heard people say here.) But that is part of the big risk and what you are trying to avoid. So the biggest thing that comes out with dollar payments--and consider, you can have a US dollar issuer not only in the United States but essentially anywhere and the issuer can say why do I care about U.S. requirements, and the ultimate investor/customer anywhere in the world also can say why do I care--is that those dollars are going to be cleared through New York,

[36] ISSA, Financial Crime Compliance Principles for Securities Custody and Settlement (2d Revision, May 2019), https://www.issanet.org/e/pdf/2019-05-21_ISSA_FCC%20Principles_second_revision.pdf.

at least on the wholesale level. Or they could be cleared outside of New York to a limited extent, but by an entity that is subject to exposure oversight in New York and who is not going to take on that risk. That approach under the ISSA Principles of not causing a violation by others is a whole different framework than the omnibus versus segregated account debate for telling people that I am not looking to ask for names. In addition to operational challenges mentioned above, another reason I think that account segregation is not a panacea is that with names alone, you attempt to screen them and you have many false positives when you are just looking at a name list. But a fundamental aspect of AML requirements is that you are looking for things that do not make sense for that customer. You can only know that if you are close to that customer and its type of activity. It is a different type of screening. Again, getting back to this aspect of the complexity of securities intermediation data and transaction history, some of it will never be passed up the chain, and even if it did it would not be obvious as to how the data could be used to solve the problems of AML risk mitigation.

This gets particularly interesting coming back to the different uses of the term "beneficial ownership" from a corporate structure side or non-corporate equivalence trust, etc., on which the U.S. has not even started full disclosure. I initiated that proposal back in 2010 that finally got passed over the President's veto in the NDAA in January 2021, and the government still needs a couple of years to implement it. The beneficial ownership of a corporate entity and an economic interest in securities interestingly come together in one category of risk situation, but not so much in the publicly traded side but rather in the private equity side and in a lot of non-traditional investment vehicles. We see this a lot in attempts for not-yet-public corporations that have some pricing based on a small investment. So, for example, there may be a 5% investment at this value per share and then this is extrapolated to the overall number of issued shares. That is essentially what private bankers do when they extend loans to owners of actual companies based on taking that position as collateral, which is the standard way you take money out without selling equity in the company. For example, you can sell 3 shares of the company to some vehicle named after your dog and then use that as a valuation for the company as a whole. A lot of private bankers do not look at that aspect and only look at it as a credit risk and something to paper that over, but it is an easy way to manipulate the value of instruments [securities], and this is like the last step as one delves down into these more complex structures beyond the corporate activities.

I will stop it here and look forward to the last few minutes of conversation and questions.

PF thanked JF and turned the floor over to CM and SR. CM noted that this has been a fascinating discussion and SR agreed.

JS had a question for JF. JS summarized what JS thought was JF's sensible proposal to revisit reasonable reliance and contractual arrangements around reasonable reliance on a chain, rather than focusing on what information should look like.

JF responded that there are two things here. The reasonable reliance is only reasonable if you have done your diligence and you have decided on the parties for whom you are going to provide services. So, for example, BBH would not take just any customer for an omnibus account. That is one of the aspects of the global ISSA principles. Second is the ability to also request

information. And that is an aspect where the contractual agreements can cure that down the chain. If you say that to open an account with me you represent that you can do A, B, C, and D, and that includes requesting information from your customers. That ultimately gets passed down to the customers. The customer signs an agreement that provides that if the customer wishes to purchase international securities, and if there is a request that comes to the intermediary related to that ownership or beneficial interest, the customer will provide the information. Here, an analogy can be made to the way that the customer would have to respond to a tax disclosure request for securities issued in certain jurisdictions.

SR asked JF whether regulations would prevent an intermediary from requiring the customer to so agree?

JF responded that the customer can waive almost anything in connection with seeking a specific service. This is well established with payments, where there is a big difference between making a SEPA (Single Euro Payments Area) payment within the European Union with characteristics roughly analogous to a domestic ACH payment within the United States, versus a cross-border payment through SWIFT which might be subject to regulatory requirements or disclosures in multiple jurisdictions in order to be processed.

JF noted further that it is also a question of who asks, because any global regulated bank has the ability to share risk-based information, including attempts to verify that there is not a risk with counterparties in the AML side of other recognized institutions. What you don't do is send every banking counterpart a list of all your customers, as the counterpart could not do truly useful analysis of that data alone even if they wanted to.

CM then asked JF what, if anything, could be done institutionally, by way of infrastructure modification, enhancements, or improvements, that would provide more benefits in the AML/sanctions compliance area. CM indicated that it seems that the issue in this context is information—how do we get it, from where do we get it, and what do we do with it when we get it.

JF noted one thing that he tried to do but was not able to see through with the Deutsche Boerse Group. We ran the stock exchange and arguably the world's largest derivatives exchange by open interest income, and the clearinghouse, and CSD, so in certain markets he could see a majority up to the full amount of an issuer's trading at some level. Some of the market infrastructures are regulated institutions, and he ran monitoring systems across them, but they did not have the explicit legal authority to do a real "big data" approach and then bring that all together. He put together a public legislative proposal to allow them to do that which has not been adopted, even though from JF's perspective this was a risk management aspect. That is an extreme example for those markets but for any of the big institutions in the U.S. and certainly for the global custodians, they have the ability to do a type of peer review or focus across markets. Also, within limitations and with proper vetting with lawyers beforehand, there are opportunities for more of a utility type approach to share that type of big data information. This would get away from the aspect of trying to come back and pick out every individual transaction with the benefit of hindsight. So if you really want an infrastructure example to make it easier that is the way that he would go at it.

SR noted that such an approach would not be an infrastructure change in the narrower context of UCC Article 8 that would change from indirect holding to direct holding, for example, but would be more about being able to acquire data across the existing holding patterns.

CM followed by noting that instead of changing legal relationships what JF has in mind seems to be more of a move toward transparency for those who need the information. This would cut across the pushback in the U.S. (which is interesting, having heard this compliance discussion) based on an obsessive concern about maintaining privacy, which is another way of saying that we do not want people to know who the owners are. Instead, we want systems like NOBO/OBO and others to protect against people finding out who has what interests. So we are seeing a lot of stakeholders at cross purposes.

CM asked the panelists for their input and cooperation in the future as the TF puts together it final report and he invited them to continue to participate in the work of the TF.

SR and CM then thanked PF and all the panelists for their excellent presentations and discussion.

The meeting adjourned at 1:35pm.

AGENDA

Meeting of ABA Business Law Section Task Force on Securities Holding Infrastructure
BLS Virtual Annual Meeting
September 24, 2021, 2:30 pm – 3:30 pm *EDT*

1. Welcome and Introduction: Charles Mooney and Sandra Rocks (Co-Chairs)

   Documents for meeting: (i) Summary Outline of TF Final Report, (ii) List of TF Meetings to Date

2. Discuss structure and substantive content of TF Final Report (see Summary Outline)

3. Open Discussion

4. Adjournment (by 3:30 pm EDT)