

Omnibus Accounts: Indispensable Tools
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It is reported that China is considering a pilot program to allow outbound futures business. This will be a big step forward not only for Chinese futures industry, but also for global futures markets considering the potential impact associated with this initiative. There are many options can be considered for this cross-border operation taken by Chinese industry participants—brokers, regulators. Among them, omnibus accounts, the well established tools in the world's largest markets in Europe and the U.S. should no doubt be one of the most important ones.

Definition

First of all, what exactly is an omnibus account? The concept is simple. An omnibus account is a single account at one brokerage firm, called the “carry broker,” that holds positions of two or more end customers of another broker, the “originating broker.” The “carry broker” executes the trades on behalf of the originating broker who passes on the orders from the end customers. For example, a U.S. futures broker (the originating broker) might have an omnibus account with a broker in Singapore (the carrying broker) for all the trades the U.S. broker executes on behalf of its customers in futures contracts traded at the Singapore Exchange, or SGX. broker who have traded SGX products. Note that the ultimate customers do not contact the carry broker directly but deal with their broker in the U.S., the originating broker in this example.

This example could easily be reversed. A Singapore broker might use a U.S. broker to execute trades on U.S. exchanges in the Singapore broker's omnibus account. In fact, it is quite common for brokers to serve as each others' carry broker, thereby providing each other with business and a needed service.

Suppose a Chinese FCM wants to provide offshore futures products traded not only in the U.S., but also London, Japan, and Singapore to its clients, it will take significant time and great efforts for the Chinese broker to get its memberships in all exchanges just named. As we shall see, the easier and more practical arrangement is for the broker to have omnibus accounts at carrying brokers who has access to U.S., London, Japan, and Singapore markets.

Customer Confidentiality

It is also important to point out that even though the originating broker may have option to choose whether or not sharing clients' account information with the carry broker, the latter generally does not know the identities of the end-customers. After all, the carry broker is a potential competitor of the originating broker, who would find it intolerable to reveal his most important assets—the identities of his clients and information about their trading patterns. Even if the carry broker does not appear to be a competitor today—because of restrictive local regulations or because it is a strictly local broker—that could change tomorrow if the carry broker decides to expand into other markets—including that of his client, the originating broker.

Origin

It's not clear exactly when omnibus accounts originated but the need for them was doubtless felt already in the early days of futures markets in the U.S. as soon as more than one exchange became active. Most brokers specialized in servicing particular types of clients in the early days. Exchanges sprang up in key centers of the industry they served, such as grains and livestock in Chicago, Cotton in Louisiana, and precious metals in New York. If a broker's expertise was grain, it would be a member of the Chicago Board of Trade and its customers would be grain market participants. However, from time to time a customer might have wanted to trade in eggs at the Chicago Mercantile Exchange or cotton on the New Orleans Cotton exchange (which no longer exists, by the way). Rather than join the CME and NOCE exchanges to meet demand for just the occasional trades at those exchanges, the broker would establish a relationship with a broker at the CME and NOCE and open an omnibus account. In the days before cheap telecommunications it was expensive and impractical to join an exchange without the large volumes to justify it. In today's globalized economy, cheap telecommunication makes cross-border trading easy but the same logic applies to the decision about joining an exchange. Without expertise in the local market and large volumes to justify the investment in operations, compliance, management, legal expenses and so on, an omnibus account makes much sense.

Benefits to Clients

An active risk manager such as a Chinese grain and food processing company managing risks in several world markets might need to access three or four markets in different parts of the world. An omnibus account would allow the company to open just one account with just one China-based broker. Otherwise, opening an account at each exchange with a separate broker would create a host of challenges: foreign currency conversion on a near daily basis; record keeping based on multiple formats; regulatory requirements; fluent speakers of the language for each of the markets; and the need to monitor the financial condition and reputation of all the brokers. Omnibus accounts also enable to the client to take advantage of cross-margining opportunities, thus using his capital more efficiently.. Finally, there's the fact that local regulations may not allow direct access to some of the markets on which the client needs to trade. An account with a local broker keeps the relationship local and allows the broker to deal with the challenges just listed. Omnibus accounts thus drastically reduce costs and increase efficiency. In a word, they provide one-stop shopping.

Benefits to Originating and Carry Broker

It's not just the customers who benefit from omnibus accounts. Today, not even the world's largest broker is a member of every exchange considering that there are today over 70 exchanges around the world in spite of all the exchange consolidation that has occurred (The U.S. had 11 futures exchanges in 1984; today, there are only a few remain, and CME has over 90% of the market share.) How can the broker satisfy a client's request to execute a trade at an exchange where the broker is not a member? The broker has to have a relationship with another broker who does have a membership on that exchange, and the only practical, cost-effective way for the broker to do that is by opening an omnibus account. In fact, according to common practice even affiliated brokerage firms in two or more different jurisdictions use omnibus accounts with each other for simplicity.

Actually, the carrying broker benefits from the arrangement as well. Risk management is a broker's biggest challenge, and the biggest challenge within risk management is evaluating client suitability, their financial condition, and then monitoring their trading. If a broker gets concerned that a customer may be having a problem, the broker will need to get in touch with the customer immediately. All these challenges are much more difficult if the customer is far away, in a different time zone, subject to foreign laws, and speaking a foreign language. Hence, a carry broker would often much prefer not to accept a referral customer on a fully disclosed basis. How much easier to have as your customer an originating broker you know and trust, whose financial statements you have reviewed and whose financial condition you can monitor, and who is responsible for the performance of all the end-users in the omnibus account.

Regulation

Regulation of omnibus accounts of course varies from country to country. U.S. regulations, as in most countries are focused on protecting local clients. For example, regulations prohibit U.S. clients from opening accounts in foreign market unless either the foreign broker has registered with the CFTC. Alternatively, the CFTC may issue a finding that the regulations in the foreign country are comparable to U.S. regulations (a "Part 30 exemption"), in which case the U.S. customer may open an account with a foreign broker. The CFTC does not restrict or prohibit foreign brokers or customers from opening accounts in the U.S. However, the U.S. regulator does require U.S. exchanges and brokers to abide by applicable rules and laws against such violations as money laundering or market manipulation. Information on products that have received exemptions from the CFTC can be seen at this website:

<http://cftc.gov/international/index.htm>

Objections to Omnibus Accounts

Why do some countries prohibit omnibus accounts? The reasons are in general related to inbound business, not outbound business. Regulators in some countries, such as India, believe that the omnibus account could conceal the identities of ultimate customers. This, they fear, would pose risks that some distant, unidentified trader could try to manipulate a market and escape detection. India's restrictions on the use of omnibus accounts for inbound business had unintended consequences. Because India prohibits direct foreign access to its markets, local brokers offer equivalent products to foreign customers over-the-counter—the so-called "P-Notes." These local brokers then hedge their OTC positions using local futures. The Indian authorities prohibited P-Notes in October of 2007 but later lifted the ban when the credit crisis drastically reduced liquidity on the local markets. P-Notes or their equivalent make the end-user identification problem more difficult because they add a layer between the local market and the end-user and weaken the regulators' tools for accessing data about the end-users.

The experience of the developed market exchanges shows that the omnibus account structure need not be a barrier to regulatory oversight. To go back to the example above, Should Singapore regulatory authorities have concerns, they can get information on the end-user by telling the local carry broker to require the originating broker to provide the desired information directly to the exchange and regulatory authorities. If the originating broker or end-user refused, the regulator would require the account to be closed and

could impose penalties on the local broker. Consequently any local broker accepting omnibus accounts will have built into its agreement with the originating broker the requirement to provide end-user information when required by the local exchange or authorities. In practice, therefore, omnibus accounts do not hamper the regulatory abilities of the local authorities.

Most regulators, including the CFTC, don't wait until they have a concern to get information on large foreign traders. They have a large trader reporting requirement whereby information regarding the positions exceeding a certain threshold must automatically be reported on a daily basis. These large trader positions include those of customers in omnibus accounts. The large trader reporting requirement works because if the local broker refuses to provide the information the regulator would force the omnibus account to be closed and possibly impose additional penalties. In the U.S. both the exchange and the regulator (and the NFA) receive the information on the large traders. In China, presumably the CSRC could work with the exchanges on comparable arrangements.

The use of omnibus accounts for Chinese outbound business would not pose a barrier for Chinese regulators from monitoring the trading of Chinese customers using outside markets. However, the omnibus account structure provides the Chinese customer with added confidentiality because the foreign broker carrying the omnibus account does not know the identity of ultimate customers if such arrangement is chosen. If a Chinese client's positions exceed a specified threshold size, the foreign exchange as well as the foreign regulator will require disclosure regarding the identity of the ultimate customer and the nature of its trading. Confidentiality of such information is strictly maintained. There have been no reports of violations of confidentiality in the U.S. for three decades at least.

Omnibus Accounts in Asian markets

The following table shows which Asian markets now allow omnibus accounts:

Markets	Omnibus Allowed	Omnibus Not Allowed
Australia and NZ	Yes	
China		No
Hong Kong	Yes	
India		No
Japan	Yes	
Korea		No
Malaysia	Yes	
Singapore	Yes	
Taiwan	Yes	
Thailand	Yes	

The table shows that seven out of 10 major Asian futures markets now allow omnibus accounts for inbound business. The three that do not are Korea, India, and China. India

and China do not allow outbound futures business, with limited exceptions in both cases. Korea does allow the use of omnibus accounts by outbound business.

Singapore, which has had a futures exchange for 25 years, allowed omnibus accounts for inbound and outbound business almost immediately. They consciously developed their market, including market practices and regulations, on the pattern of the U.S. Australia's ASX similarly followed the U.S. and European model and adopted early. Other Asian markets were a bit slower. TAIFEX, for example, started allowing omnibus accounts in March 2006, eight years after it was established. "We wanted to allow omnibus account in order to provide an easy method for Foreign Institutional investors to access Taiwan's futures markets and thereby increase liquidity and volume on the exchange," said Foo-Shiung Ho, who was President of TAIFEX at the time and is now Chairman of Yuanta Futures, one of Taiwan's leading brokers. In 2007, the first full year the new rule was in effect, volume in omnibus accounts was 2.53 million, almost 1.9% of TAIFEX total volume. This past June the exchange asked the regulator to approve measures to simplify reporting requirements and reporting frequency. This new measure had not yet been approved as of this writing.

Challenge

In omnibus account structure, in general, the "originating broker" must be responsible for margin control and risk management. There is nothing special for most FCMs in western countries. But in some Asian markets risk management experience may be limited, posing special challenges. For example, all U.S. markets, like most futures markets around the world, use SPAN to calculate margin, but in China SPAN is not being used. So if a Chinese FCM wants to do business with a U.S. FCM through an omnibus account, it will need to upgrade its margin and risk system in order to calculate margin for U.S. products for its clients.

Alternatives

Are there alternatives to the omnibus account discussed above that achieve the same objective? One was already mentioned: the originating broker could simply open a new account at the carrying broker in the name of the end-customer, a "fully disclosed" account. This is generally not a preferred option. First of all, as noted above, the customer usually doesn't want the trouble of opening an account with another broker, especially one in another country and time zone, because the customer then has the responsibility of dealing with what is to him a foreign broker, time zone differences, currency conversion, and so forth. The customer's reluctance stems not just from inconvenience, but from the difficulty of researching the reputation and capabilities of broker in another country where the regulations, institutions, and language are unfamiliar. The benefits of one-stop shopping would be lost. Second, by opening the account in the customer's name the originating broker risks losing business. The carry broker could now market not only its futures brokerage services but any other services it or its affiliates can offer. As a second alternative, perhaps the originating broker and the carry broker could create a joint venture to carry the trades of the customers of the originating broker. Both sides could benefit by sharing in commissions. Confidentiality threats could be reduced via "Chinese walls" between the local parent company and the JV. This alternative may be a theoretical possibility, but any business that has looked into creating a cross-border joint

venture is aware that the costs and challenges are considerable. Legal, regulatory, personnel recruitment, management control, risk control, can be considerable. Creating a joint venture as a substitute for an omnibus account would be like using a Boeing 767 to get a package across town when a bicycle, or a motorcycle the most, would do the job.

End-users who develop some sophistication about the foreign market they are interested in might be ready and willing to open an account directly in the foreign country, such as the U.S., especially if the end-user values other services provided by the U.S. broker. When a market becomes important enough for an end-user firm, it might open a local office and open an account with a reputable local broker or even become an exchange member himself. This is a rare case, however.

Similarly, a Chinese broker might decide at some point that for economic and management reasons it would like to control the foreign broker. It could either start its subsidiary from scratch, or buy one. However, even in such cases, as already indicated above, the universal practice in the futures industry would be for a brokerage firm to have an omnibus account with its affiliate. The advantages of omnibus accounts apply even between affiliated brokers.

Indispensable Industry Tool

In summary, omnibus accounts have become indispensable tools for cross-border futures business. They make life so much easier not only for clients but also for the carry brokers. They provide confidentiality for the client. They provide efficiency and simplicity for the carrying broker doing futures business on behalf of clients in multiple markets around the world. They simplify the demands on local regulators because information on outbound business is held on the books of local brokers rather than scattered around the world on the books of foreign brokers. Every participant in the futures market gains.

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