

## Client money: time to smarten up

Over the past year the Financial Services Authority has grown increasingly concerned about insurance brokers' compliance with its client money rules (in CASS 5 - the insurance section of the Client Assets Sourcebook). FSA has found widespread weaknesses and failures within the industry, including examples where independent auditors have given sign-off without raising major concerns. Earlier this year, two serious cases were publicly reported by FSA; one firm was banned altogether from carrying on regulated business. There have also been a number of the dreaded skilled persons' interventions.

It is clear that FSA is now taking a zero tolerance approach. The regulator is also planning to overhaul CASS 5 in 2011. This is against the backdrop of a wider review of client money in the financial sector, including bold Treasury proposals to strengthen the regulatory regime. These moves of course follow the collapse of Lehman Brothers, which sparked a rigorous, and as yet unresolved, legal debate in the Courts as to the practical effect of FSA's rules when a firm goes into administration.

Brokers need to get ready for the forthcoming changes and to smarten up their act in the meantime. FSA has found that many client money breaches are the direct result of inadequate senior management oversight and control. Staff are simply unsure who, between treasury, compliance and finance, is 'holding the baby'. In direct response to this worrying state of affairs FSA has already sent out 'Dear CEO' letters. Unusually, and ominously, each CEO was required to respond by declaring that there are no client money breaches within their firm, and by naming the individual who has overall client money oversight.

Clearly FSA wants to pin client money accountability to an individual in each firm. It has already consulted on a new client money significant influence function (i.e. an FSA-approved responsible individual) for firms in the investment sector. This is likely to be rolled out to insurance brokers in due course. If you think you might be a candidate for this role then you should think hard about whether or not you really understand how client money works in your firm. Are there any risk transfer arrangements in place? Do the banking, accounting, segregation and reconciliation arrangements comply with the rules? How are your appointed representatives handling receipts? What records are being kept? If you are not sure and were named by your CEO to FSA (or are in due course appointed to the client money function), then you may find yourself personally under FSA's spotlight.

In the course of visits to firms during 2009, FSA found a number of very basic failures. These included: having the correct TOBAs in place; having on file trust acknowledgement letters with banks holding client money; carrying out error-free calculations and reconciliations; segregating client money from broker and insurer money; and making sure that client money is not used for business purposes (such as premium financing). You may previously have been relying on your auditors to check your systems and controls and to confirm compliance with the rules. Unfortunately, auditor sign-off does not necessarily amount to a clean bill of health - FSA recently criticised audit reports as being materially weak (and not just in a few instances). Given that FSA now has a dedicated client money unit, it may be an appropriate time to examine the systems and controls under a magnifying glass.

The Lehman Brothers debate brings home the point that the client money rules are based around centuries-old principles of trust law, one of which is that the trust account must only ever contain client money. You should therefore be asking: what does the trust account actually contain? The complicated nature of insurance arrangements, with claims, premiums and return money being passed along distribution chains spanning several jurisdictions, and an industry history of mergers and acquisitions and cobbling together of legacy accounting systems, has meant that many firms are in the position of having substantial unallocated or unreconciled balances in the trust account. These cannot be ignored and if your firm is in this position you should carefully review the potential options available to deal with them. Any solution that is adopted must be sensitive to the strict fiduciary duties that the firm has as client money trustee.

It is not yet known exactly what FSA's consultation on CASS 5, due in early 2011, will contain but areas that are likely to be reviewed include: regular client money reporting to FSA, diversification of the banks with which client money is held, and tighter controls or restrictions around non-statutory trusts. The overall message, however, is likely to be loud and clear: the new client money world will be a tougher place.



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