

## Client money/assets update: 11 November 2010

2010 continues to be a busy year in the world of client money/assets (CASS), both for firms and for the FSA, and 2011 is now set to be a year of substantial change. This update focuses on some important recent developments including:

- A timeline showing key action points and forthcoming rule changes
- The new CASS operational oversight function
- The re-introduction of the Client Money and Assets Return (CMAR)
- Disclosure and reporting requirements for prime brokers
- Restrictions on placing client money within a firm's group
- A prohibition of the use of general liens in custody agreements
- Spotlight on auditors' client assets reports
- The Lehman Brothers International (Europe) (LBIE) client money court proceedings
- Restrictions on title transfer collateral arrangements for contracts for differences retail clients

### 2011 timeline for firms holding client money/assets

|                    |  |
|--------------------|--|
| Q1 2010            | Proposed review of CASS 5 (general insurance brokers)  |
| By 31 January 2011 | All firms subject to CASS 6 or 7 must have submitted a return to the FSA:<br>(i) detailing their highest client money holding and/or client assets holding during 2010, and<br>(ii) naming the individual within the firm who has been assigned responsibility for CASS operational oversight – this individual will be held responsible for CASS compliance going forward (until CF10a is formally introduced in October 2011 for 'CASS medium firms' and 'CASS large firms') |
| 1 March 2011       | Deadline for prime brokerage firms to update client agreements to include a disclosure annex<br><br>Daily client reporting commences for prime brokerage firms<br><br>Rule prohibiting liens in new custody agreements takes effect for firms subject to CASS 6 (transitional period for existing agreements to 1 October)   |
| From 1 May 2011    | 'CASS medium firms' and 'CASS large firms' will be able to submit applications for individual approval of their nominated CF10a's (must be approved by 1 October)  |
| 1 June 2011        | Client money diversification rule takes effect, limiting intra-group deposits of client money to 20% of the total client money held by any firm subject to CASS 7<br><br>The CMAR regime takes effect for firms subject to CASS 6 or 7   |
| July 2011          | Firms subject to CASS 6 or 7 should begin preparing their first CMAR based on June 2011 data   |
| 1 October 2011     | 'CASS medium firms' and 'CASS large firms' must have an approved CF10a in place<br><br>Rule prohibiting liens in custody agreements has effect for all agreements  |
| 2012 (?)           | Comprehensive review of the client assets regime, following final determination of LBIE client money case (by Supreme Court, or European Court of Justice)   |

## Client Assets Operational Oversight function

The new CASS operational oversight function is intended to address the issue of widespread fragmentation of CASS operational oversight - a key weakness identified by the FSA in the course of firm visits carried out in 2009. All too often responsibility for CASS is split across compliance, operations, treasury and legal functions, resulting in poor management oversight and control of client assets and/or client money.

The new function formalises the requirement to have a clear focus of client assets accountability on one individual, building on the FSA's Dear CEO letter of January 2010, in which CEOs were required to name an individual with overall oversight responsibility for CASS compliance. The individual holding this controlled function will have responsibility for the firm's compliance with CASS, for reporting to the firm's board in respect of CASS (and the firm's duties as a trustee), and for liaising with the FSA on CASS, including submitting the CMAR (see below).

Not all firms are required to have an individually approved person to carry out this function. The FSA will implement a three-layered stratification, under which firms of different 'CASS firm type' will have different treatment and obligations depending on the highest amounts of client money and/or client assets that were held in the previous calendar year (or that are projected to be held in the next calendar year if the firm does not currently hold client money/assets).

- 'CASS small firms' are firms that hold less than £1m of client money and/or less than £10m of client assets. They will not need to have an approved CF10a, but the responsibility for CASS operational oversight must be allocated to an individual approved to perform a 'significant influence function'. This individual is assumed to be the CF10 function holder (compliance officer) unless the firm has decided to allocate that responsibility to another 'significant influence function' holder (e.g. a director, or senior manager) and recorded that fact appropriately (e.g. in board minutes);

- 'CASS medium firms' are firms that hold between £1m to £1billion of client money and/or between £10m to £100 billion of client assets. A senior manager or director of such firms must be formally appointed and approved to perform the function, as a 'CF10a'. The nominated CF10a for 'CASS medium firms' is not likely to (but still might) be called for a competency-based interview as part of the FSA's approval process; and

- 'CASS large firms' are firms that hold over £1billion of client money and/or over £100 billion of client assets. Again, a senior manager or director of such firms must be formally appointed and approved to perform the CF10a function. The nominated CF10a for 'CASS large firms' is likely to be called for a competency-based interview as part of the FSA's approval process.

The stratification thresholds set out above might be tweaked once FSA receives more information on client money and assets holdings by 31 January 2011 (see timeline). Firms may opt for a higher CASS firm type should they wish.

Whilst the CF10a approved person regime for the larger firms does not formally commence until **1 October 2011**, the regime of individual accountability for CASS operational oversight effectively commences on **31 January 2011**, when all firms are required to name a responsible individual and report their name to the FSA (see timeline above).

The FSA will obviously expect the person responsible for CASS operational oversight to be fit and proper. Firms should consider the need for additional training for their prospective candidates, and those individuals should also be aware that this is more than just a compliance role (despite the 'CF10a' badge). The role will require an understanding of the interaction between trust law, the insolvency code and the CASS rules, as well as the nature of the firm's contractual agreements with clients to the extent that these promise certain treatment for client money/assets. Given the FSA's push to restore investor confidence following a number of CASS failures, it is also likely to be a role that will come under intense regulatory scrutiny on an ongoing basis.

It is not clear at this stage to what extent the CASS operational oversight function will have a mandated role in HMT's proposed resolution arrangements and special administration regime for investment firms. There is potentially some overlap with HMT's current proposal for a 'business resolution officer' (BRO). In times of insolvency or severe stress the CF10a (or equivalent) and BRO will clearly both have key roles in liaising between regulators, insolvency practitioners and clients.

It is also likely that the CASS operational oversight function (or an equivalent) will be applied to general insurance brokers in the course of the planned CASS 5 review (scheduled for Q1 2011).

To read CP 10/9, which proposed this new function, see [here](#). For our article summarising this consultation, see [here](#).

To read PS 10/16, in which the FSA sets out the finalised regime for this function as discussed above, see [here](#).

## The re-introduction of the Client Money and Assets Return (CMAR)

The CMAR is a reporting framework that was in use prior to the FSA's existence (for example under the SFA), and which is now set to return. The finalised CMAR form contains fields that report on numbers of clients, size of balances, location of balances, reconciliations, record keeping, outsourcing, and (most ominously) breaches. Overall responsibility for the CMAR will lie with the individual holding the CASS oversight controlled function, who will obviously be the point of contact for the FSA if any breaches are reported.

All firms subject to CASS 6 and/or CASS 7 will be subject to the new CMAR requirements from 1 June 2011, and will be required to report their June 2011 holdings in July 2011. Thereafter, the CF10a's of 'CASS large firms' and 'CASS medium firms' will be required to submit a monthly CMAR (within 15 business days of the end of each month), and the individual responsible for CASS operational oversight in 'CASS small firms' will be required to submit a bi-annual CMAR (within 15 business days of 30 June and 31 December). The content of the December CMAR will be used to determine a firm's 'CASS firm type' for the following year.

To read CP 10/9, which proposed the CMAR, see [here](#). For our article summarising this consultation, see [here](#).

To read PS 10/16, in which the FSA sets out the finalised CMAR regime as discussed above, see [here](#).

## New disclosure and reporting requirements for prime brokers

The FSA has finalised its proposed definition of a 'prime brokerage firm', which has been tweaked from the CP 10/9 proposed definition to limit its scope to prime brokers who exercise a right to use assets belonging to a client or re-hypothecate them (i.e. use them for its own purposes whilst it has control of them). The proposed definition has also been widened to include small prime brokerage firms who have such rights, but who do not necessarily offer a full range of financing services.

Firms falling within this tweaked definition are required to 're-paper' all their clients by **1 March 2011**, by inserting a disclosure annex into any prime brokerage agreements in force. The annex will not interfere with the contractual terms of the agreement, but is instead aimed at increasing the client's awareness of the risks involved in depositing client assets with the prime broker, in particular where the prime broker re-hypothecates those assets. The disclosure annex will clearly identify and explain the relevant operative parts of the agreement that relate to re-hypothecation, set out any contractual limit to re-hypothecation, and list the key risks involved, including the risk of the prime broker becoming insolvent.

It is expected the re-papering exercise will also encourage firms to take the opportunity to tidy up their client paperwork – by identifying and remedying any sub-standard documentation currently in use, for example, where agreements have not been correctly updated to reflect MiFID.

The FSA will also require, again from **1 March 2011**, prime brokerage firms to make available to clients a detailed daily statement which will include, amongst other information, up to date valuations of all loans, stock-lending amounts, futures settlement amounts, collateral and margin amounts, mark-to-market on OTC positions and the total client assets held, as well as the location of those assets, naming the relevant custodian and/or bank. The statement may be provided electronically, provided it meets the 'durable medium' requirements. In practice, the FSA claims, most prime brokers already offer some sort of daily reporting, so this rule simply codifies market practice.

The FSA has confirmed that these rules apply only to UK-authorized prime brokers, their overseas branches, and UK branches of prime brokers incorporated outside of the EEA who are subject to CASS. UK branches of EEA prime brokerage firms operating under MiFID are not affected.

To read CP 10/9, which proposed these new rules for prime brokers, see [here](#). For our article summarising this consultation, see [here](#).

To read PS 10/16, in which the FSA sets out the finalised rules for prime brokers as discussed above, see [here](#).

## Restrictions on placing client money within a firm's group

CASS currently requires a firm to exercise all due skill, care and diligence in selecting, appointing and periodically reviewing the institution where client money is deposited (whether a bank or qualifying money market fund), and the arrangements for holding this money. This is a process that the FSA has found to be lacking in rigour and substance in several firms.

The FSA is not considering formalising any due diligence requirements for firms, which means that where a bank or money market fund holding client money defaults, the question as to whether the firm exercised its duty of care in selecting that institution will be open for question. Instead, the FSA is arguably going much further, by limiting from **1 June 2011** the amount of client money that can be deposited by any firm with intra-group banks/money market funds to 20% of the total client money held by the relevant firm.

On consultation, this proposal received a decidedly mixed response. Nevertheless, in its policy statement the FSA has threatened that it will aggressively pursue its credible deterrence agenda if it finds breaches of this new diversification rule after 1 June 2011. The need to protect clients from the same type of contagion risk that has caused problems for many of Lehman Brothers International (Europe)'s clients (\$1bn of whose client money was banked with an affiliate that also defaulted) is clearly seen to outweigh any resulting negative impact on firms (e.g. in terms of liquidity and cost of capital).

To read CP 10/9, which proposed this restriction, see [here](#). For our article summarising this consultation, see [here](#).

To read PS 10/16, in which the FSA sets out the finalised restriction as discussed above, see [here](#).

## Prohibition of the use of general liens in custody agreements

In contrast to the FSA's stance on diversification of client money deposits, the FSA has conceded some ground on its proposal to prohibit the use of liens in custody agreements.

CASS currently contains guidance that states that firms should consider carefully the terms of custody agreements under which their clients' assets are held for safekeeping. From **1 March 2011** this guidance will supplement a new rule requiring a firm to ensure that any agreement it enters into for the provision of omnibus custody services does not put its client's assets at risk in the event of its own insolvency. The onus will be on the firm arranging the custody (rather than the custodian) to ensure that the agreement with the custodian is compliant.

However, the FSA has inserted some clearly defined exceptions to its proposed rule, to take into account certain market practices around settlement, and to allow clients to undertake overseas business in countries where liens operate as a result of statutory requirement and/or market practice. There is also an exception (as originally consulted) for liens to cover the custodian's charges that relate specifically to the assets of a particular individual client.

The FSA is also implementing transitional phasing of this rule, so that it does not apply to agreements executed before 1 March 2011 until **1 October 2011** (when it applies to all custody agreements entered into by firms subject to CASS 6).

To read CP 10/9, which proposed this restriction, see [here](#). For our article summarising this consultation, see [here](#).

To read PS 10/16, in which the FSA sets out the finalised restriction as discussed above, see [here](#).

## Referrals of auditors to the Accountancy and Actuarial Discipline Board

In September the FSA consulted (in CP 10/20) on auditor reports of client assets. It has proposed a number of handbook amendments to improve these reports, in recognition that it relies on auditors to gain comfort that firms have systems adequate to enable them to comply with CASS and that firms are complying with CASS, and that it has found material failings and weaknesses in a number of reports received.

The specific failings it found include: (i) simple errors, such as not signing or dating the report or quoting the wrong firm reference number, (ii) more worrying errors that reveal a lack of basic understanding, such as covering the wrong chapters of CASS or failing altogether to report on client assets, and (iii) distressing evidence that auditors are often too accepting of senior management's assertions when preparing these reports, shown for example by 'clean' reports being provided despite significant failings having been found.

CP 10/20 built on an earlier discussion paper (DP 10/3), which discussed more generally the auditor's contribution to prudential regulation. In particular, the DP considers enhancements to FSA's own enforcement powers against auditors, which could potentially be expanded to include the power to publicly censure, impose financial penalties, or disqualify either an audit firm or individuals within the firm. In the absence of having such powers (which would only be brought about by a change to legislation), it has to rely on other professional bodies to ensure its concerns are addressed.

It is notable that the two most high-profile client money failings to date were in respect of Lehman Brothers International (Europe) (LBIE) (now in administration) and JP Morgan Securities Ltd, both of whose client assets systems and compliance had apparently been signed-off by their auditors. The FSA also failed to spot weaknesses in either firm, perhaps because it was over-reliant on the auditors' reports.

In the case of JP Morgan, the issues were identified and rectified without any detriment, other than a record £33.32m fine being imposed on JP Morgan by the FSA. In the case of LBIE, the issues were not brought to light until after the firm went into the administration and, by then, it was too late. The distribution of the remaining LBIE client money is currently the subject of a complicated and prolonged court action (see our article [here](#)).

The FSA has now referred both these auditors to the Accountancy and Actuarial Discipline Board for investigation into their conduct in preparing auditor reports for the FSA. As yet, there is no suggestion that any LBIE clients will be pursuing private claims against LBIE's former auditors for irrecoverable client money, however, the eventual findings of the Discipline Board might make this more likely.

To read CP 10/20, which proposes improvements to client assets auditor reports, see [here](#).

## The Lehman Brothers International (Europe) client money court action

The FSA has acknowledged that it cannot undertake a comprehensive review of the CASS regime until a final decision is given down in the LBIE client money court action. This case was borne out of the struggle faced by LBIE's administrators in dealing with a huge shortfall in the client money balances held by the firm on administration, and a staggering number of client claims (including those from LBIE's affiliates) - see our article [here](#).

In the course of High Court and Court of Appeal hearings a number of shortcomings and errors in the CASS rules have been highlighted, as well as fundamental issues as to the extent to which the rules embrace the principles of trust law, and whether or not this is actually required by European Law. The FSA will need to deal with these urgently, but can only do so once the dust has settled.

Permission to appeal the Court of Appeal decision has been applied for in the Supreme Court. It is not yet known when the Supreme Court will decide on this application, although it is likely that the appeal will go ahead (particularly because the Court of Appeal considered that the applications were 'worthy of consideration').

Given the complexity of the case and the amount of money involved, it is possible that the final say will be had by the European Court of Justice (following a hearing in the Supreme Court and appeal of that judgment to Europe). If this happens, it will delay the FSA's proposed comprehensive review even further.

## Restrictions on title transfer collateral arrangements for CFD retail clients

**Update 17 November 2010:** Following CP 10/15, in which the FSA formally announced its intention to prevent investment firms using title transfer collateral arrangements (TTCAs) with retail clients, the FSA has now published its final rules which give effect to this proposal.

The new restrictions apply to TTCAs in relation to client money and client assets, and prevent firms from title transferring collateral that is intended to secure retail clients' obligations under any contract for difference (excluding rolling spot forex contracts). The restrictions take effect from 1 December 2010, but there is a transitional period until 31 December 2010, during which firms should repaper any affected CFD agreements and make suitable treasury and liquidity arrangements.

The FSA has confirmed with the European Commission that these restrictions would not amount to 'gold-plating' MiFID (i.e. imposing additional requirements over and above those required by European Law), and instead are in line with the protections provided for in MiFID.

The reason for the restrictions being fairly narrow in scope (and only affecting certain contracts for difference, rather than all products) is that the FSA's original cost-benefit analysis (CBA) did not take into account any other products. However, the FSA has clearly stated its intention to extend the restriction to other products once further CBA has been undertaken. Given that there is now no perceived legal issue with the restriction, it would seem likely that any remaining TTCAs with retail clients after 1 January 2011 will also eventually become prohibited if the FSA finds that the need for increased consumer protection outweighs the resultant costs to firms still using TTCAs, and outweighs any negative impact on the market if they were stopped from doing so.

To read the FSA's Handbook notice that discusses the restrictions, see [here](#). The forthcoming amendments to CASS 6 and CASS 7 can be read [here](#). To read CP 10/15, in which the FSA proposed the restrictions, see [here](#). To read our earlier article commenting on this, see [here](#).

## We are here to help

The client assets and living wills page on our Regzone contains more useful information relevant to this topic – please see [here](#).

If you would like to discuss any of the above developments, or client assets generally, then please speak to your usual CMS contact, or one of us below.

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