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FSA consults on client asset protection: The beginning of a journey

Over the past few months FSA has turned its spotlight on client asset protection, and yesterday it published its first consultation paper (CP) on amendments to the client asset rulebook (CASS).

As a reminder, client assets are assets (including money) that belong to a client but are held for safekeeping by a firm (typically investment firms and insurance brokers) on behalf of the client under a trust. The firm may be holding the money/assets to enable the provision of brokering, trading or portfolio services, and unlike banks, investment firms and intermediaries are generally required to separate client money and assets from their own in order to protect them.

It is now clear that many firms are failing to comply with CASS, whether out of ignorance, incompetence, poor management, or all three. It is also clear that the existing regulatory regime for client assets is ill-equipped to address these failures in the event of the insolvency of those firms, which is precisely the time when clients need those assets to be returned to them promptly and in full.

The stance that FSA has adopted in 2010 around client assets is very clear – it has a low tolerance for CASS compliance failures and will intervene and take enforcement action where necessary.

At the same time the FSA (working with the Treasury and the industry) needs to improve the regulatory regime around client assets in order to restore confidence post-Lehmans. This is a significant undertaking, in which this CP is only the first step.

Putting the CP in context

FSA's CASS rulebook is finally getting its first major overhaul since MiFID. Given the current economic climate and the enhanced risk of firms becoming insolvent, some might say this has been long overdue. To put the CP in context, significant recent activity in the client assets domain has included:

- Consideration of the enhanced risk of insolvency of firms in the investments sector, and in particular the December 2009 High Court judgement on the insolvency of Lehman Brothers International (Europe) (LBIE), in which significant shortcomings were identified in the CASS regime;
- a Treasury consultation launched in December 2009 on 'living wills' for investment banks, which proposed some radical measures aimed at increasing the protection afforded to client money;
- the establishment of a specialist CASS risk team within the FSA, which has conducted several client asset investigations resulting in enforcement action;
- the FSA's Client Assets Report, which raised multiple concerns about how firms are discharging their obligations under the current CASS regime; and
- a stern letter "Dear CEO letter" sent by FSA to CEOs of investment firms and insurance intermediaries, requiring them to confirm that their firms are in compliance with CASS.

The process to restore consumer faith in firms that hold client assets (and in the effectiveness of the regulatory regime for client assets) is set to be a long haul. FSA's trajectory for reform over the next 12 months includes:

- Consulting on the appropriate use of title transfer collateral arrangements (July 2010);
- Consulting on refining the scope and increasing the standard of client asset audit reporting (Sept 2010);
- FSA's ongoing assessment of the effectiveness of insolvency-proof special purpose vehicles (SPVs) (2010);
- Consulting on a new resolution regime for investment firms (2010/2011)

- An overhaul of CASS 5 (insurance intermediation client money) (Q1 2011)

The CP contains six key proposals, which develop on some of the recommendations made by the Treasury in its 'living wills' consultation, and which we consider in turn below.

Proposal 1- Increasing re-hypothecation disclosure in prime brokerage agreements

What is proposed? The proposal is for all prime brokers to include a mandatory 'disclosure annex' in each prime brokerage agreement. This will not interfere with the contractual terms of the agreement, and 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 (i.e. uses them for its own purposes whilst it has control of them). 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.

Why is it proposed? The FSA's evidence in the wake of Lehman Brothers shows that LBIE's clients simply failed to understand the potential consequences of their prime broker's insolvency. This may be a reflection of poor standards of legal due diligence on the part of the clients when reviewing prime brokerage agreements, or lack of appreciation of the technicalities of CASS and insolvency law – most likely both. Since Lehman Brothers' collapse, the FSA has noticed that some clients have become smarter (for example they are using multi-prime models), but considers that a mandated disclosure is still necessary. Whilst FSA has stopped short of applying a cap on re-hypothecation, it has stated that it may impose restrictions on a case-by-case basis where compliance issues within a particular firm are identified.

What is the impact of the proposal? Prime brokerage firms will have to update their precedent agreements and re-paper all their existing clients to include the mandatory disclosure annex. This also means that they will be forced to locate and identify the latest enforceable versions of client agreement, which may be difficult where poor records have been kept or where version control has not been properly implemented. FSA hopes that this will encourage firms to tidy up their agreements. FSA will later consider applying this requirement to other firms that re-hypothecate client assets (for example contracts for difference and spread betting providers). In some of those firms (where retail clients are involved) risk warning notices are already in use.

Proposal 2 - Mandatory Reporting to Prime Brokerage Clients

What is proposed? The proposal is for all prime brokers to provide daily close of business statements to their clients. These statements 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.

Why is it proposed? Again, the FSA's evidence in the wake of Lehman Brothers shows that LBIE's clients did not have access to recent information about their accounts, which led to uncertainty (for example around whether instructions to pay out assets at the last minute had been executed, and what assets were actually segregated and/or re-hypothecated). The FSA claims that most prime brokers do now offer daily reporting, but still wishes to standardise this requirement across the industry to discourage firms from aggressively re-hypothecating assets of clients who enter do not normally require regular reporting. The availability of daily reports will also assist insolvency practitioners in distributing assets promptly (although there is still scope for a potential one-day lag between the time of the last report and the time of insolvency).

What is the impact of the proposal? Aside from the significant IT systems costs to implement this proposal, prime brokers may find that they are less able to re-hypothecate client assets once such activity is made more transparent to clients. This may require them to turn to other sources for working capital (e.g. to fund proprietary trading). As with proposal 1, FSA will later consider applying this requirement to other firms that re-hypothecate client assets.

Proposal 3 - Restricting the pacing of client money within a group

What is proposed? The FSA proposes limiting the amount of client money that can be deposited by any firm with intra-group institutions (i.e. banks and money market funds within the firm's group) to 20% of the total client money held by the relevant firm. This is in addition to the general requirement to exercise due skill care and diligence when selecting institutions for client money deposits (a process that the FSA has found to be lacking in rigour and substance in several firms).

Why is it proposed? The FSA acknowledges that all client money will ultimately be held as a deposit on trust, and that there is always the risk that the institution holding the deposit may fail. However, this proposal is intended to tackle the contagion risk where a firm holds an inappropriate amount of client money with other group companies. As was the case in Lehman Brothers, several companies are likely to become insolvent in any group in times of stress, meaning that clients unfairly bear the risk of the group as a whole rather than just the individual firm. The 20% level (rather than an outright ban) is, in part, intended to reflect the fact that credit risk outside a particular group that has a strong credit rating may be higher than within the group itself.

What is the impact of the proposal? This proposal (as well as those listed below) will affect all UK-authorised firms (not only prime brokers). When firms deposit client money with third party institutions they are likely to receive lower rates of interest, since such institutions will view those funds as overnight deposits, and unlike intra-group banks they will not

attribute any group liquidity benefit to those funds. Therefore firms (and their groups) will be less able to use client money as a cheap source of liquidity with which to fund operations. This is more likely to be a problem in times of stress, where liquidity is stretched. Firms may need to resort to other external sources of funding, with a consequent higher cost of capital.

Proposal 4 - Prohibiting the use of liens in custodian agreements

What is proposed? CASS currently contains guidance (CASS 6.3.3G) that states that firms should consider carefully the terms of custody agreements under which their clients' assets are held for safekeeping. This includes considering restrictions on the custodian's right to claim a lien (or a right of retention or sale) over the client assets. The FSA proposes to turn this guidance into a hard rule, so that no such lien etc. will be allowed (with the exception of a permitted lien to cover the custodian's charges that relate specifically to those client assets).

Why is it proposed? The FSA considers it unacceptable that custody liens over client assets may be so wide as to cover the firm's (or its group's) indebtedness to the custodian. Wide-ranging liens of this sort can delay the distribution of client assets in the event of the firm's insolvency, as was the case in LBIE's insolvency, and they arguably go against the spirit of UK insolvency principles.

What is the impact of the proposal? Custodians will no longer have the ability to retain client assets in respect of unrelated debts owed by a firm (or its group).

Proposal 5 – Closer regulatory scrutiny of the client assets officer

What is proposed? FSA proposes that one person in each MiFID firm should have oversight responsibility for client assets via a new controlled function. This controlled function will be a 'required function' and 'significant influence function'. Firms will be given 'CASS categorisations' (as small, medium or large CASS firms) depending on the amount of client assets that they hold (whether as money or custody assets, or both). Small CASS firms will be required to allocate the new controlled function to an existing director, whereas medium and large CASS firms will be able to allocate the new controlled function to a director or senior manager, and will need to obtain specific FSA approval for the appointment. In the case of large firms, that appointment will be subject to the competency-based approach for interviewing (see our article on governance arrangements here).

Why is it proposed? One of FSA's criticisms in its client assets report was that there is a general lack of management accountability for client assets compliance in the industry. Often, responsibility is split across a number of staff in compliance, operations, finance and/or treasury. The FSA would prefer one individual to have ultimate oversight responsibility (although several members of staff may continue to be involved).

What is the impact of the proposal? Most medium/large MiFID firms are likely to have one individual who is responsible for CASS compliance in any case. This individual will now be required to be an approved person, and will therefore be subject to the FSA's Statements of Principle and Code of Practice for approved persons, and a higher level of regulatory scrutiny and accountability. This role is in addition to the business resolution officer (BRO) role being mooted by the Treasury in its living wills consultation.

Proposal 6 - Re-introducing the client money and assets return (CMAR)

What is proposed? FSA has proposed bringing back the CMAR - a reporting framework that was in use prior to the FSA's existence (for example under the SFA). The CMAR will be reviewed, authorised and submitted by the CASS oversight controlled function on a monthly basis for medium and large CASS firms, and by the relevant director twice a year for small CASS firms.

Why is it proposed? The CMAR will give the FSA a micro and macro view of client asset holding in the UK, and may assist insolvency practitioners in the prompt identification and distribution of client assets.

What is the impact of the proposal? Firms are likely to incur a systems cost, and their client asset operations will be subject to closer regulatory scrutiny.

Useful links

To read CP 10/9 see here.

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

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