

## FSA gets tough on client money

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*Mez Raja, Associate at CMS Cameron McKenna discusses FSA's stance on protecting client money. This article first appeared on MoneyMarketing.co.uk and has been reproduced with the kind permission of the publisher.*

The FSA's record-breaking £33.3m fine levied against JP Morgan for client money breaches serves to highlight two fundamental truths of which clients of investment firms and their advisors should take proper notice.

Firstly, the protection of client money is of paramount importance to investor confidence in both the industry and in its regulator. The size of the fine sends a clear message to senior management in other firms that the FSA has zero tolerance for client money breaches. The regulator's galvanized client money risk team is expected to seek out and punish other culprit firms in the coming months.

Secondly, the FSA has on two separate occasions (the other involving Lehman Brothers) failed to spot monumental and long-running breaches of its own rules, which are specifically designed to secure clients' ability to recover their own money in the event of a firm collapsing. The JP Morgan breaches were only identified as a result of internal discussions that took place almost seven years after the mistakes were first made, despite independent audits being performed in the interim. The Lehman breaches were spotted only after the firm collapsed - when it was too late for rectification.

Client money is money that belongs to a client but is held for safekeeping by an investment firm on behalf of the client, under a trust. The investment firm may be holding the money to enable the provision of brokering, trading or portfolio services, for example. Unlike banks, investment firms are generally required to separate client money and assets from their own resources; they are not permitted to use client money in the course of their own business activities.

Whilst relatively few IFAs will themselves hold client money, they may advise clients to place money with investment firms such as stock-brokers, SIPP providers, structured product providers and fund managers. Not all of these arrangements will involve client money. By way of illustration, consider the situation where a client hands over money to a fixed-term structured product provider, which will be invested on a certain date in the near future with returns expected on maturity. The client money in this scenario is usually only the money that the firm holds pending the actual investment, and again on maturity the capital and investment return money that the firm holds pending transfer to the client. Client money is not the structured product itself. Where investments are bought and sold more frequently, such as in a stockbroker scenario where the stockbroker keeps a running account for his client, the client money risk will be present more often.

Where client money is being handled, a problem can arise, as per Lehman Brothers, where a firm has failed to comply with the client money rules for a long period of time and then becomes insolvent. Client money is, in theory, protected from the creditors of a firm (such as lenders) on insolvency. However, the most recent Lehman Brothers court decision (which will be appealed later this summer) has highlighted that where a firm has failed to properly identify and segregate client money, it is very difficult to trace that money so that it can be returned to the rightful clients. Money that cannot be traced will instead be included in the general pot available for creditors to fight over, rather than being counted in the ring-fenced pool set aside for clients with valid entitlements.

Note that failure to protect client money does not have the same implications as poor performance or mismanagement of an investment. Client money can potentially be completely irrecoverable if there is a rules breach, whereas poor performance may not always wipe out the total value of an investment.

To a great extent the industry is dependent on the regulator to do its job in finding and dealing with firms that are in breach. A firm that may outwardly appear to have excellent credit ratings, an experienced board of directors, independent auditor sign-off and no previous FSA-disciplinary history, might be breaking every rule in the book internally as far as client money is concerned - and may be doing so unintentionally. Without having full access to the firm's records and systems, which is not reasonably possible for the average client or advisor, it would be hard to spot any issues from the outside. There are, however, some actions that can be taken to highlight and potentially avoid some of the risks.

Most importantly, you should read the contract. Clients should fully understand what their contractual rights are in relation to money that they pay to the firm (or that the firm receives from third parties) and also to money that the firm comes to owe to them in the course of providing services (such as investment returns). In particular, if a firm offers investments but is also a licensed bank, the client may be given no client money protection whatsoever, and his money may instead be treated as a deposit. The contract should make this clear.

Certain margined derivatives contracts will make provision for 'title transfer collateral arrangements', under which a firm is, under certain circumstances and as an exception to the rule, allowed to use client money as if it were the firm's own money (and not keep it segregated). The FSA may soon stop this practice in relation to retail clients.

You should ask questions. In the midst of increasing paranoia about client money, the firms that can clearly explain in detail how they handle client money are less likely to have misunderstood their obligations in the first place – so it is worth probing them before you advise your clients to trust them with any money. Sensible questions might include asking whether the firm uses the 'normal' or 'alternative approach' – the 'alternative approach' is a segregation method that allows for the temporary co-mingling of client money and the firm's own money, and is therefore potentially more prone to risk. It is a good idea to ask where the firm keeps client money. Most firms will keep client money in a bank account, but the choice of bank can be a vital factor in increasing the chances of recovering money if the bank goes down. The FSA is encouraging firms to use banks outside their own corporate groups since insolvency in one group-owned company often has a domino effect on other group companies. It is vital to establish what risk-mitigation measures are in place, some larger firms will mitigate for temporary shortfalls in their client money bank accounts by regularly topping up the client money account with a cash buffer.

Until the FSA implements a regime in which it monitors firms' client money operations on an ongoing and detailed basis, vigilance should be the watchword. For example, client statement reviews should confirm that the figures on the statement match the given understanding of what should be happening with any client money under contract.

Client money is a top priority area for reform and more twists and turns are expected in the near future as the FSA strengthens its enforcement capability. Behind the scenes is a continuing discussion involving the regulators, the industry and the courts whether or not the client money rules work as well as they should do, especially when a firm becomes insolvent. Once a consensus can be reached on how the current rules actually work, and on how they should be improved, rule changes are likely to be pushed through with pace. Watch this space.

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