

The Client Assets Regime
Turbulence and Reform

Speakers



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Paul became a partner in the Financial Services and Regulatory Group at CMS Cameron McKenna in 2002, and now is the Head of the Department.

He specialises in financial services and insurance regulation, advising businesses in the financial services and insurance industries on a wide range of regulatory and commercial issues. Paul's clients include banks, life and general insurance companies, investment managers, stockbrokers, IFAs, insurance intermediaries and the large corporate clients of these entities. He is the author of the chapter on insurance regulation in Oxford University Press's book, Financial Services Law.

Robert Purves

Call: 2007; BA LLB (Cape Town); LLM (Cantab); BCom (Hons) (Financial Management) (Cape Town); PhD (Cantab); Former Solicitor (1994-2007)



Robert Purves is a commercial lawyer with strong specialism in financial services law and regulation. Robert began his legal career as an Attorney in South Africa (1990) and Solicitor in England (1994), before transferring to the Bar in 2007.

From April 2003, Robert was Chief Counsel, Insurance and Prudential Policy at the Financial Services Authority, the UK body responsible for the licensing, oversight and regulation of almost all financial services business in the UK.

Since commencing practice at the Bar, Robert has acted for financial services firms and individuals seeking advice on a wide range of regulatory issues, for the Financial Services Authority and for the Financial Services Compensation Scheme.

Robert's commercial practice includes advocacy in the High Court, for example in relation to transfers of insurance business under the Financial Services and Markets Act 2000), in the County Court (breach of contract claim) and before the Bankruptcy and Company Registrars of the High Court, for example on behalf of Petitioning Creditors.

Robert is a regular speaker and provider of training on financial services regulation.

SELECTED SPECIALIST EXPERIENCE

Specialist Regulatory Advice on Financial Services Business

Since commencing practice at the Bar, Robert has acted for financial services firms and individuals seeking advice on a wide range of regulatory issues, for the Financial Services Authority and for the Financial Services Compensation Scheme. Examples of the kind of issues on which Robert is instructed include:-

All aspects of EC Financial Services legislation, including insurance, reinsurance, banking and investment business directives and regulations.

The scope and content of regulation under the Financial Services and Markets Act 2000, including Collective Investment Schemes, deposit taking, investment activities and insurance business. On the latter, Robert has advised the FSA Enforcement Division, product providers and product distributors.

The scope and content of the FSA regime for the regulation of mortgage business.

The scope and content of the FSA's Principles for Business as they apply to regulated firms.

The scope and content of the FSA regime for Approved Persons

FSA corporate governance and systems and controls issues in relation to financial services business including banks.

Compliance with the UK implementation of the Markets in Financial Instruments Directive ('MiFID'), including in relation to investment research, best execution, client classification, communications with clients and client money. (See 'Reported Cases')

The interpretation and application of FSA prudential requirements applicable to insurance and reinsurance firms and the valuation of insurance and reinsurance exposures for prudential purposes.

The location of reinsurance business under UK law.

The interpretation and application of FSA rules restricting the business of regulated insurance firms to insurance business and connected business.

Money laundering issues under FSA rules and money laundering regulations, including in relation to safe-deposit businesses.

Conduct of Business issues under FSA rules, including issues relating to 'treating customers fairly' and specialist

advice on claims against financial advisers and others for breach of statutory duty under the Financial Services and Markets Act 2000.

Civil liability issues relevant to the obligation of the FSCS to compensate customers of failed firms.

The FSA's Retail Distribution Review (for the FSA).

FSA Discussion Paper 08/2 on Transparency, disclosure and conflicts of interest in the commercial insurance market (for the FSA).

The powers of a UK Recognised Investment Exchange in relation to a 'mis-trade'.

Transfers of Insurance Business and Schemes of Arrangement

Robert has regularly been instructed by the Financial Services Authority in relation to applications for the sanction by the High Court of transfers of insurance business, under Part VII of the Financial Services and Markets Act. Two important recent cases include

- *In the matter of Commercial Union Life Assurance Company Ltd and others* [2009] EWHC 2521 (Ch) (the "retribution" of the inherited estate of Aviva group companies) ;and
- *In the matter of Names at Lloyd's for the 1992 and prior years of account; In the matter of Equitas Limited* [2009] EWHC 1595 (Ch) (the transfer of 1992 and prior years insurance business in the Lloyd's of London insurance market, to a stand-alone UK insurance company.)

Instructed by the Financial Services Authority in relation to an application for the sanction of a Scheme of Arrangement in respect of insurance business, under the Companies Act 2006.

Instructed by insurance and other firms to advise on the structure and operation of insurance business transfer schemes under the Financial Services and Markets Act 2000.

General Commercial

For example, claims in contract and tort, particularly in relation to financial services contracts.

Reported Cases

In the matter of Lehman Brothers International (Europe) (in administration) [2009] EWHC 3228 (Ch) Instructed by the Financial Services Authority, led by Robin Knowles CBE QC. This case dealt with the application of the FSA's client money rules to a multi-national investment firm, and in particular with the question of whether the firm was required to "top up" any shortfall of client money, disclosed on the commencement of Administration proceedings.

In the matter of Commercial Union Life Assurance Company Ltd and others [2009] EWHC 2521 (Ch) Instructed by the Financial Services Authority, led by Tom Weitzman QC. This case dealt with a transfer of insurance business under Part VII of the Financial Services and Markets Act 2000, which included a "retribution" of the inherited estate of insurance companies in the Aviva group.

In the matter of Names at Lloyd's for the 1992 and prior years of account; In the matter of Equitas Limited [2009] EWHC 1595 (Ch) Instructed by the Financial Services Authority, led by Christopher Symons QC. This case dealt with a transfer of insurance business under Part VII of the Financial Services and Markets Act 2000 in respect of the 1992 and prior years insurance business written in the Lloyd's of London insurance market and reinsured by Equitas.

Regulatory Experience

From April 2003, Robert was Chief Counsel, Insurance and Prudential Policy at the Financial Services Authority (FSA), the UK body responsible for the licensing, oversight and regulation of almost all financial services business in the UK.

In his role at the FSA, Robert led the team of lawyers responsible for legal advice on all aspects of prudential policy relating to UK financial services firms. This included:-

Implementation of all prudential Directives in relation to insurers and other financial services firms (e.g. Solvency 1, Solvency 2, Reinsurance Directive, Capital Requirements Directive (CRD), Insurance Winding Up Directive);

Extensive drafting of FSA rules and guidance relating to prudential and other topics;

Transactional advice on the application and interpretation of the prudential components of FSA's Handbook of Rules and Guidance (GENPRU, BIPRU, INSPRU etc), including advice on the substance, drafting and FSA approval / disapproval of waivers and modifications to the prudential rules;

Transactional advice on the application and interpretation of that part of the FSA's Conduct of Business sourcebook relating to the fair treatment of insurance policyholders. This entailed advice on, amongst other things, all aspects of with profits business, insurance transfers of business, reattributions of inherited estates, approval / disapproval of management actions by insurance firms

Advice on all aspects of the regulation of Lloyd's, Equitas, members of Lloyd's and underwriting agents in the Lloyd's

market, including the drafting of the relevant prudential rulebook, the implementation of the relevant Directives, advice on transactions (for example transfers of insurance business) and advice on the regulatory aspects of the relationship between the Society of Lloyd's and its members;

Advice on all aspects of the application and interpretation of the FSA's insurance perimeter (essentially answering the question whether particular insurance business or insurance related transactions and structures fell inside or outside the scope of FSA regulation). This included advice on the regulatory aspects of Alternative Risk Transfer, Financial Reinsurance, Insurance and Reinsurance Special Purpose Vehicles and other forms of non-insurance risk financing.

Within the General Counsel's Division of the FSA, Robert led on issues relating to legal risk in the financial services industry.

Robert was also heavily involved in the development of the legal aspects of the FSA's approach to Principle-Based regulation

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The client assets regime - turbulence and reform

CMS Cameron McKenna LLP and
3 Verulam Buildings

21 September 2010

The purpose of the client assets regime

- Which types of firms does it apply to?
- Who is it designed to protect?
- What types of assets does it relate to?
- What does it require from firms?

- Not just accounting rules!
- Trust and insolvency law play key roles and must be understood

Why are client assets now on the reform agenda?

- What has been going wrong?
 - Breaches of the rules and widespread weaknesses, highlighted by...
 - FSA's CASS risk team and Jan 2010 report
 - High profile firm failure – Lehmans
 - Regulatory action (private warnings, skilled persons, enforcement)
- Why has it been going wrong?
 - Complicated (and to some extent defective) rules
 - Poor understanding and governance
 - Industry practices have not kept up
 - Over-reliance on audit for compliance assurance

Proposed reforms: governance and accountability

- FSA has found poor management oversight and control
 - Unclear allocation of duties, lack of accountability and confusion
 - Lack of communication within Finance, Treasury, Compliance and Legal
- FSA's Dear CEO letter (Jan 2010)
 - Written warranty of compliance and named responsible person
- CASS oversight significant influence function
 - Existing director for smaller firms, new CF for medium/larger
 - Competency-based approach for larger firms
- Client money and assets return (CMAR)
 - Monthly for medium/large, bi-annually for small firms
 - Gives FSA a firm-specific view of CASS positions

Proposed reforms: limiting third party risk

- Restriction on placing client money deposits within the group
 - Current requirement is for appropriate due diligence and diversification
 - Increased contagion risk if deposited within group (as per Lehmans)
 - Consulted 20% limit on deposits within group
 - Group treasury/liquidity implications?
- General liens in custody accounts
 - Custodian general liens can delay return of client assets on insolvency
 - Consulted outright ban (except in respect of charges relating to client assets)

Proposed reforms: prime brokers

- Focus on prime brokers since Lehmans collapse
- Mandatory disclosure annex in contracts
 - Gives appropriate attention to prime broker's re-hypothecation rights
 - Explains any contractual limits, and statement of risks upon PB's default
 - Re-papering costs
- Daily COB reporting to clients
 - Includes up to date loan valuations, settlement, collateral and margin amounts and client assets
 - Gives a paper trail on insolvency
 - Operational costs
- Read-across to other market participants?

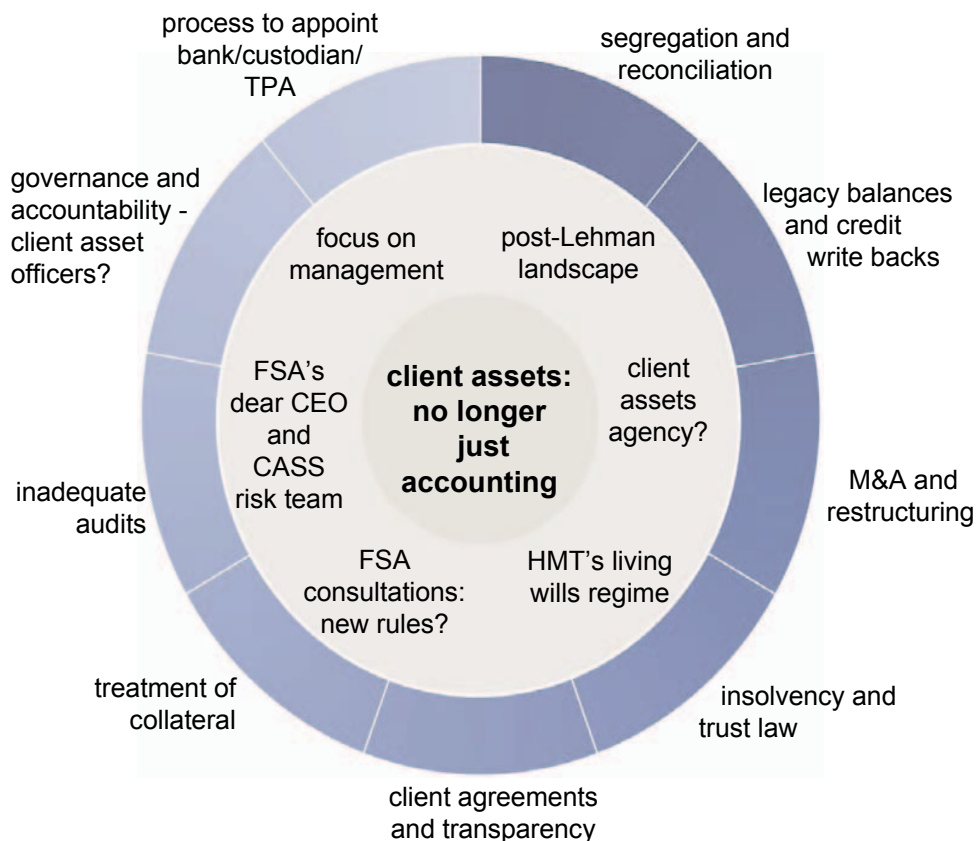
Proposed reforms: title transfer collateral

- MiFID removed client money opt-outs...
 - ...but TTCAs were a permitted exception for collateral
- FSA claims retail spreadbet/CFD firms are ‘pushing the envelope’
 - TTCAs enable firms to use client money for other business activities
 - Retail clients not in a position to understand the risks
 - Proposed ban on TTCAs for retail clients
- Can it be done?
 - Compatible with MiFID?
- Is it in the best interests of consumers?
 - May encourage low margins and risky trading

Future roadmap

- Standards of audit reporting
 - FSA reliant on external independent assurance from auditors
 - “*Significant room for improvement*” in quality of audit
- Insolvency-proof SPVs
 - Designed to ensure prompt return of client assets on insolvency
- Client assets agency
 - Where will it sit post-FSA?
- Insolvency/living wills reforms
 - Client assets trustee to work alongside administrator
 - Special administration regime (return of client assets is a key objective)
- Insurance brokers/CASS 5
- Dealing with the eventual Lehmans outcome...

Things to consider – is the trust estate safe?



Systems and controls check: are they designed and operating correctly?

Trust verification: what is and is not protected?

Dealing with legacy balances and issues

Review of client agreements

Staff/management training

Keeping your FSA supervisory team happy

Impact analysis of forthcoming changes

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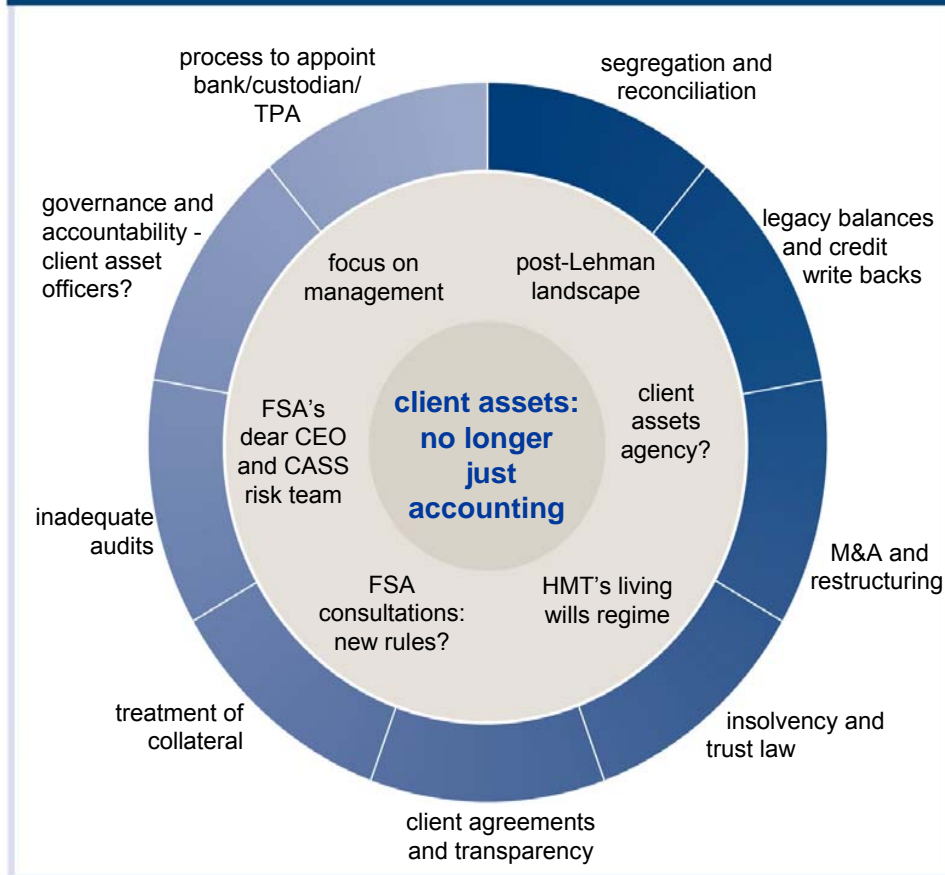
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Client Asset Protection Is the trust estate safe?



Making sure you comply Areas in which we can help

Systems and controls check: are they designed and operating correctly?

Trust verification: what is and is not protected?

Dealing with legacy balances and implementing credit write backs

Review of client agreements

Review of title transfer collateral arrangements

Staff/management training

Keeping your FSA supervisory team happy

Impact analysis of forthcoming changes

The Lehman Brothers client money appeal judgment: We're all in it together

1. Background

Since 15 September 2008, the date Lehman Brothers International (Europe) ("LBIE") went into administration, LBIE's Administrators (PwC) have been grappling with the complicated task of working out how to distribute the client money held by LBIE at the point of its administration. This task has been made all the more difficult because LBIE had consistently failed to keep client money segregated from its own house funds, in spite of the FSA's client money rules (CASS 7) requiring it to do so, in its capacity as trustee of such client money. There was, therefore, a long-running deficit in the amount available in the client money pool, as compared to the amount that was required (and expected) to be segregated at any point in time under CASS 7. The FSA failed to spot this breach. Furthermore, one of the banks with which LBIE held US\$1bn of client money for safekeeping, Lehman Brothers Bankhaus AG, has also become insolvent, thereby further increasing this deficit. In light of this 'double whammy', and in recognition that the answer to this problem lies in analysis of CASS 7 against the backdrop of UK trust and insolvency law and European law (specifically MiFID - the EU's Markets in Financial Instruments Directive), the Administrators have turned to the English courts for guidance.

In the first instance, the High Court delivered a judgment that provided an arguably straightforward answer for the Administrators, who would have (in summary) been required to include within the client money pool for distribution only those amounts that had been segregated by LBIE (ignoring the amounts that LBIE had failed to segregate), and distribute the pool amongst only the clients whose client money was actually contained within the pool (ignoring clients whose money was not segregated). Please refer to our previous article on the High Court judgment for more details (see [here](#)).

2. What were the conclusions of the Court of Appeal?

The Court of Appeal considered four key questions and concluded as follows:

1) The client money trust arises on receipt of any client money by a firm

This is in line with the High Court judgment. It means that a firm owes trustee duties to a client from the time at which the firm begins to hold such money on behalf of the client (which, in the case of payments from the client or a third party, will be the time of receipt).

This outcome is significant in the context of the FSA's 'alternative approach' to client money segregation. The alternative approach allows firms to receive client money into their own house accounts, and make appropriate adjustments (no later than the close of the next business day) to reconcile the difference between the amount that is in the client money bank accounts and the amount that it should have been segregating at the close of the previous business day. There is, therefore, an inherent inter-day risk that the firm may, contrary to its trustee requirements, dissipate the received client money before the relevant reconciliation takes place. The Court of Appeal judgment advocates the use of 'prudential buffers' to address this risk. A prudential buffer is a surplus amount that a firm maintains, either in its house account or client money account, to ensure at all times that it holds, as a trustee, the entire amount of client money that it is required to hold. The buffer is funded from the firm's own capital. At the moment, the use of any buffer is subject to a consultation process with the firm's auditors and the FSA. In future, if the alternative approach survives, the requirement to maintain a prudential buffer is likely to be codified.

A similar risk referred to above also arises where a firm goes into administration in between the point of receipt of client money and the firm's next scheduled reconciliation (which does not take place because of the commencement of the administration process). If the money that was not segregated proves to be untraceable, the claim for that money will effectively rank as an unsecured creditor claim (and not a proprietary one). The Court of Appeal judgment addresses this risk by simply requiring the Administrator to give effect to the final outstanding reconciliation.

2) The client money pool to be distributed on insolvency includes all traceable client money, wherever it may be

CASS 7 provides that, on the failure of the firm, all client money held by the firm is to be pooled for distribution. The Court of Appeal judgment overturns the High Court judgment on the point of what money should be pooled under this process.

The High Court judgment stated that the client money pool only included the client money that was held as such as at the time of administration (subject to a few permitted adjustments). The High Court judge was persuaded by the symmetry in requiring the firm to identify and segregate client money whilst in business, and then distribute the same amounts on failure. Clients whose client money was not properly segregated would still have a proprietary claim to the extent that their client money could be traced within LBIE's house accounts.

The Court of Appeal judges found this approach to be flawed. They were more persuaded by the argument that since there was only one single trust, the distribution in relation to that trust should include all the money that within it, under one single pooling.

This outcome creates forensic issues for the Administrators in terms of ascertaining the amount in the client money pool. Under the High Court judgment they would have only needed to include those amounts that were in LBIE's client money bank accounts, and in transaction accounts held with brokers and clearing houses (subject to some adjustments). Now under the Court of Appeal judgment they are potentially required not only to scour each and every account in which LBIE ever held client money (even momentarily) for any trace of this client money, but also to pursue all payments from those accounts (whether to other accounts or to third parties) to see how far the trail can be usefully followed. Trust law would lend a small hand in this process: to the extent that an account balance falls below the client money amount that it is meant to contain (or becomes overdrawn), there is no traceable client money interest in that difference (or none at all in the account), since a trust can only attach to identifiable property (and not to an overdraft). LBIE's own liquidity management process, in which surplus cash balances were constantly swept up to its parent company and paid back down to LBIE only as and when required, could also serve to destroy the trail. Nevertheless, such a process could be time-consuming, costly, and potentially make no net difference to the overall size of the client money pool. The Court of Appeal judges allude to the fact that a tracing exercise carried out on a collective (as opposed to individual) entitlement basis might be more fruitful, although this was not fully considered.

3) Any client who has a contractual entitlement to client money can participate in the distribution (pro rata)

Again, the Court of Appeal judgment overturns the High Court judgment, which on this point was naturally aligned to the issue of what was included in the client money pool.

Under the High Court judgment the clients entitled to a share in the pool were only those clients who had actually contributed to it (i.e. those that had some traceable proprietary claim to the money in the pool).

Under the Court of Appeal judgment, clients who did not necessarily have any proprietary claim to the client money pool could nevertheless potentially have a share in that pool based on a contractual claim. In other words, if LBIE was required as a matter of contract to segregate client money for them, then they could participate in the pool, even if their client money entitlement could not be traced to money that was actually within the pool. In reaching this conclusion, the Court of Appeal judges directly opposed the High Court judge in his analysis of the wording of CASS 7, in particular his interpretation of the phrase 'client money entitlement' (which the FSA unhelpfully omitted to define within CASS 7). Furthermore, the Court of Appeal judges argued that, under their approach, there is no need for the Administrators to make any final adjustments to the amount of the pool.

Consequently all clients are 'in it together' as regards the distribution of client money, irrespective of whether LBIE treated them as it should have done (by segregating their money) or did not. The value of the entitlements of clients whose money had been segregated is effectively diluted, as compared to the value of those entitlements under the High Court judgment (where the non-segregated clients could not participate in the client money pool). The 'pari passu' type arrangement that the CASS 7 distribution provisions purport to provide for is effectively guaranteed, and so the FSA may well feel vindicated. However, there are some important consequences of this outcome, which may not be so pleasing in terms of investor protection.

First, it means that any efforts made by an individual client to ensure that his client money is being dealt with in a compliant way could potentially be (for the most part) wasted energy if the firm fails to treat all its other clients in the same compliant way. In our previous article (see [here](#)) we suggested some sensible steps that a client might take, such including due diligence and increased vigilance over statements. These would have helped under the High Court judgment, but are arguably of limited use here with a non-compliant firm. A client who is diligent and pro-active may end up being no better than the client who does nothing.

In such circumstances, there is an increased importance on the firm's overall compliance with the CASS 7, and therefore the FSA's adequate oversight of such compliance. As the increasing number of client money enforcement cases shows, an investor may well be justified in feeling nervous, despite the FSA's strict new approach to CASS 7 compliance.

Secondly, the Appeal Court judgment allows clients of LBIE who were Lehman group affiliates (many of which are also in administration) to participate in the client money pool. Because LBIE carried out a significant amount of intra-group business, but failed to segregate any client money belonging to its affiliates, this will bring about a heavy dilution of the value of the entitlements of any non-affiliate clients. If those affiliates were dealing in their own capacity with LBIE, then on distribution of the LBIE client money pool those affiliates would receive an injection of cash assets, which would be available to satisfy any (non-client money) claims against them. Therefore, indirectly, the Court of Appeal judgment could potentially increase the amount of money available to unsecured creditors of the Lehman Brothers group as a whole, to the detriment of LBIE's non-affiliate clients.

Thirdly, the Administrators are given another forensic issue to deal with – how to identify the universe of clients that have a valid contractual entitlement that gives rise to a share in the client money pool, and how to value each of those individual entitlements to work out the size of each share in the pool.

The starting point for any contractual entitlement is, naturally, the terms of the contract. In the case of LBIE (and no doubt many other investment firms offering myriad prime brokerage and trading services), the contracts in use are often unclear and ambiguous. Particular types of problematic clauses may include title transfer collateral provisions, where money that would otherwise be client money is entirely transferred to the firm on the basis that it is collateral, and 'rights to use' provisions, where the firm has an option to use client money in the context of rehypothecation.

Aside from the construction of the contract, whether or not the performance of the contract gives rise to an entitlement to client money is a separate matter that relates, for example, to what exactly the transactions were, how big they were, and when they were settled. In the context of LBIE's administration this adds an additional layer of complexity.

4) Amounts owed by a firm to a client only become client money when segregated

This Court of Appeal decision is in line with the High Court judgment. The types of debt considered in this context included manufactured dividends under stock-lending agreements (with the client as the lender). The Court of Appeal's judgment means that pending a firm taking some sort of positive step towards discharging its debt to a client (such as transferring an appropriate amount to the firm's client bank account, or factoring in such debt into its reconciliation process), the debt is not crystallised as trust money. As such, on the failure of a firm, an undischarged debt does not fall to be counted in the client money pool - it is not a proprietary interest to which a trust can attach. Consequently, any outstanding debt claims rank as unsecured creditor claims on a firm's failure.

This does place some value in clients requiring a firm (for example by contract) to discharge any debts promptly (whether by direct payment or segregation) although, as above, the benefit of this may be counter-balanced by the firm's non-compliance with the segregation rules, whether generally or in respect of particular clients.

3. The approach taken by the Court of Appeal

Whilst both the High Court and Court of Appeal judgments both include a relatively high degree of textual analysis (breaking down specific provisions of CASS 7 and MiFID for example), the fact that they approach this exercise from different perspectives goes some way towards explaining the decisions described above, and their consequences.

Under the High Court judgment, MiFID was interpreted as mandating and harmonising purely organisational requirements, which the relevant authorities across the EEA (the FSA in the UK) were required to implement – there was no implicit or explicit legal safety net for clients created at the MiFID level. Under the Court of Appeal judgment, it was argued that because the MiFID client money provisions are concerned with safeguarding client assets, investor protection was an implicit intention of MiFID, and therefore its implementation in the UK (CASS 7) should be interpreted to give effect to this intention. Member States were, by implication, required to create an effective legal safety net – which is, for example, the purpose of the client money trust and distribution rules under CASS 7.

The High Court judgment also interpreted the client money rules as being drafted from a utopian perspective, in which very little regard was had to the consequences of a firm not complying with the regime. This prevented the High Court from recognising any additional protections for investors where CASS 7 fell short of explicitly providing these, and required the High Court to look to general law for solutions to the problems posed by CASS 7, as a supplement to the CASS 7 rules. The Court of Appeal took a different approach, taking the perspective that the FSA must have been concerned with the risk of firms breaching the regime, and therefore gave effect to those concerns, for example by seeking to not prejudice clients of a firm that took the alternative approach over clients of firms that took the normal approach, on the basis that the FSA could not have intended such a consequence.

Therefore, acknowledging from the outset that CASS 7 is designed to protect investors, the Court of Appeal sought to iron out the 'glitches' and 'legal black holes' that the High Court judgment could not satisfactorily address. For example, in respect of unapplied credits (segregated money which had not yet been allocated to a particular client) the High Court judgment would have required the Administrator to use LBIE's accounting records to ascertain (arguably subjectively) LBIE's intention as to which clients would be allocated such amounts. The Appeal Court judgment does not require this exercise to be undertaken, since the clients' contractual entitlements will determine their share of the pool.

Both judgments are sensitive to the principles of UK trust law and insolvency law, although the Court of Appeal is also purposive in this respect. For example, the approach taken in respect of trust law by the Court of Appeal was that "*trust law can be moulded to meet the requirements of the situation*" (para 68). This meant that the principles of trust law (such as the maxim: 'equality is equity') and remedies under trust law (such as tracing) can be purposively incorporated in a statutory trust regime which is otherwise relatively silent, to give effect to the overall purpose of that regime (investor protection). This, for example, allowed the client money pool to stretch beyond simply the amounts that had been compliantly segregated.

In terms of the practical consequences of the Court of Appeal judgment, in particular the delay in distribution that may result, and the dilution of the potential claims of the segregated clients (as compared to that under the High Court judgment), the Court of Appeal took the view that such consequences are more attributable to the circumstances of the case (myriad clients, accounts, breaches and transactions) than to the decision of the judges. The Court of Appeal sought the 'correct'

answer to the problem of dealing with a firm's failure where the alternative approach had been used in breach, rather than the most helpful answer in the circumstances of LBIE's failure.

In particular, the Court of Appeal judgment points out that this appeal was not about the claim of any particular client (for example in relation to the validity of a contractual entitlement, or tracing of their client money). Applying the conclusions that were reached by the Court of Appeal to a different firm's failure will naturally have different practical consequences depending on what has happened – these consequences may be complicated (as in the case of LBIE), but they could also potentially be very simple (for example in the case of a much smaller firm). However, when considering the complexity of LBIE's situation that the Administrators face, the Court of Appeal asserts (perhaps unhelpfully) that there is no evidence that the distribution of client money under the High Court judgment would be more timely and productive than under the Court of Appeal.

4. Where do we go next?

It is likely that permission to appeal against the Court of Appeal judgment will be sought, most probably by the segregated clients, whose share in the client money pool is now heavily diluted by the entitlements of unsegregated clients, most notably LBIE's affiliates. This seems all the more inevitable because the arguments in the judgment are very finely balanced. Indeed, as the Master of the Rolls, Lord Neuberger, points out in the context of the second question above, the court did not find outstandingly persuasive arguments on either side (para 223-224). If an appeal to the Supreme Court is permitted, this will clearly delay things further.

In any case, if the Court of Appeal judgment remains good law, or is upheld on appeal, the Administrators will need to assess its implications for the likely timing and level of any distribution, both in respect of client money and unsecured creditors. They may seek further directions from the courts as to what might be a workable solution in respect of the two forensic activities identified above, given that there is no limitation period under UK trust law (valid claims for breach of trust can be brought at any time after a distribution is made).

Against the backdrop of this case, the FSA's ongoing drive to make firms accountable to their client money breaches continues. To the extent that a firm has breached CASS 7 (however flawed it may be) the FSA will show zero tolerance. As has been shown from recent consultations, the FSA will also seek to rectify or improve its rules to the extent possible, given the potentially ongoing court process. This may include incorporating the prudential buffer as a requirement for firms using the alternative approach.

Finally, clients may be left in the unenviable position of needing to place their faith in the firms in which they deal with, and in the FSA for monitoring those firms' compliance with CASS 7. On the one hand, the overall effect of the Court of Appeal judgment is that the net of protection can be cast wider. Clients' rights under trust law will protect their interests within the operation of the CASS 7 distribution rules, so they do not need to carry out the tracing exercise themselves – subject, of course, to the extent that there remains identifiable property to which those rights can attach. On the other hand, the dilution of claims of clients whose client money had been properly segregated (as compared to the value of their claims under the High Court judgment) will seem unfair, particularly to those clients who go to extra lengths to obtain assurances through due diligence, or preferential contract terms to protect their client money, in circumstances where the firm in question is non-compliant in respect of all its other clients. It remains to be seen as to whether or not this judgment will have a net positive effect on investor confidence.

Please see [here](#) for the full text of the Court of Appeal judgment. If you would like to discuss the judgment in more detail, or have some concerns in relation to client money, please feel free to get in touch with your usual CMS contact.

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

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Client money – change please

Protecting client assets has risen up the regulator's agenda. By reviewing systems and controls now firms and clients could save themselves a whole lot of trouble

The Financial Services Authority is on a mission – to restore investor confidence. This mission has recently brought the watchdog's focus onto client money and assets with a warning of tighter rules and increased supervision following some dramatic instances of large-scale mismanagement.

Although there are already well established rules about the treatment of client money and assets in the UK cases such as the collapse of US investment bank Lehman Brothers have made it clear that firms have not always followed them. Earlier this year the City watchdog wrote to the chief executives of the top 1,000 investment companies and insurance brokers expressing concern that firms are not according adequate protection to client money and assets and announcing that it would be stepping up its supervision and enforcement in this area. It also attached its latest Client Money and Asset Report and asked the CEOs to reply, confirming compliance with their firms' obligations under the FSA's Client Assets Sourcebook (CASS) and naming the person at their firm who has oversight responsibility for CASS compliance. Requiring CEOs to give what seems to be a written warranty shows that FSA means business.

Client money and assets belong to a client but are held for safekeeping by an investment firm on behalf of the client under a statutory trust. The firm may be holding the money/assets to enable the provision of brokering, trading or portfolio services, and unlike banks, investment firms are generally required to separate client money and assets from their own. The liquid nature of client money (as opposed to assets) means that client money accounting systems in larger firms can be hugely complex. However, with billions of pounds of client money at stake at any one time, the message from the FSA is clear – it has a low tolerance for CASS compliance failures and will take enforcement action where necessary. In particular, it will look to pin the blame on senior management.

Inadequate supervision

The FSA's report and letter followed the High Court judgment of 15 December relating to the distribution of more than \$2bn of client money held by Lehman Brothers International (Europe) (LBIE) when it went into administration in September 2008.

The Court ruled that clients of a firm in administration are entitled to their share in the client money pool constituted as at the time of administration, and that if the pool were not big enough to cover each client's entitlement, the pool must be shared in proportion with the size of each client's claim at the time of administration. Central to the Court's findings was that if a client's money was not segregated properly by the firm in accordance with CASS before administration, clients would not have an entitlement in that pool and would instead have to bring a separate proprietary claim. In practice, this may have little more chance of success than an unsecured creditor claim, since the client would need to "trace" the money in question within a potentially complex and lengthy history of credits and debits. This ruling acknowledges that MiFID, from which CASS derives in large part, creates no new legal safety net for clients whose funds are misappropriated by firms and that legal remedies against firms must instead be found in general UK law.

Although this judgment is being appealed, it still casts huge doubt over CASS as a framework for client money protection. It also serves as a stark reminder that LBIE's systems and controls were inadequate, resulting in its failure to carry out proper reconciliation of its house accounts and to segregate its client money. That this was not picked up on by the FSA is a clear testament to insufficient supervision and enforcement on its own part. HM Treasury has already issued a lengthy consultation paper on the failure of investment firms, parts of which look to address some of the defects highlighted by the judgment.

FSA reaction

The City watchdog's reaction has been swift. Besides writing to the CEOs of the industry's top 1,000 firms, it has also committed considerable resources to assessing standards of compliance with CASS and is pursuing a much more intrusive approach to enforcement. In March last year it created a CASS Risk Team to visit investment firms and insurance brokers and the conclusions of its Client Money and Asset Report are largely based on this team's findings.

The visits revealed that compliance with CASS, as well as levels of awareness of compliance, is generally poor across the industry and in many cases the FSA took disciplinary action including forcing firms to hire outside consultants to examine their systems and controls, freezing a firm's assets and even imposing a ban on taking on new business.

The FSA is keen to emphasise that this is just the beginning – there will be more visits, with similar action taken where necessary. It has also warned that in the context of client money protection it believes the responsibility for compliance ultimately lies with senior management, even if failings are on the part of junior staff.

It is also keen to work with the accounting profession to improve standards in CASS audits and has set up a number of trials with firms to find a suitable client money reporting system with a view to rolling it out by 2011.

Firms take note

The FSA is focusing on weaknesses found by the CASS Risk Team, including poor management oversight and control; over-simplified due diligence into institutions holding client money and issues with the letters with those institutions acknowledging trust status; segregation and/or reconciliation failures and breaches of trust/contract; vulnerability during M&A/restructuring; inadequate monitoring of third-party administrators and over-reliance on client money audits.

Given its increased interest in this area, all firms subject to CASS are well advised to carry out thorough checks of their governance arrangements, reporting lines, policies and procedures, and systems and controls relating to client money and assets. More particularly, firms should ensure they have taken the following steps:

- Governance – put in place robust governance arrangements and detailed management information to help senior management evaluate, monitor and mitigate the firm’s CASS risks. Senior management must have a genuine understanding of why those policies are required and how the mechanics of their firm’s particular arrangements work.
- Verification – verify that each institution appointed to hold client money has provided a letter confirming the firm’s status as trustee in respect of each of its client money accounts. These letters must quote the name and number of each account and be signed by an identifiable representative of the institution in question. Each account must have a unique name and the letter must confirm that the bank may not exercise any lien or set-off against the firm in respect of balances in the client money account.
- Due diligence – thoroughly check out any bank or institution before transferring client money and consider whether it is in the interests of the client to appoint several institutions to hold client money to reduce risk. Details of this due diligence should be recorded.
- Segregation – where client money is mixed with house money, however temporarily, the portion of that money that represents client money must not be put at risk pending the next reconciliation and segregation process. Firms must ensure that there are adequate arrangements to safeguard clients’ ownership rights.
- Legacy balances – these must be dealt with promptly and the transfer of client money to the firm may only be made in very limited circumstances and must require the firm to fully discharge its obligations under any credit write-back.
- Reconciliations – record accuracy is key and firms need to consider how often reconciliations need to be done to maintain accurate records that correspond to client holdings and to distinguish client money and assets at any time and without delay.
- Third-party agreements – these should be reviewed and updated periodically and firms should visit third-party administrators to assess security and CASS compliance, and should meet them regularly to discuss performance, regulatory matters and assess business continuity matters including plans for disaster recovery back-up facilities. If there is any evidence of non-compliance, firms must have a right to, and must take appropriate remedial action.
- Terms of business – firms should review all agreements they enter into with clients to ensure they comply with CASS and other applicable FSA rules, particularly in respect of any “title transfer collateral arrangements” (see below), which the FSA has indicated are no longer suitable for use with retail clients.
- M&A – where a firm is looking to acquire another, it must carry out due diligence and assess and mitigate any risks to the appropriate segregation of funds. Such risks include the impact of non-compliant terms of business on trust arrangements and the implications of any transfer of funds between the client accounts and the firm’s accounts.
- Records – proper records explaining transactions and commitments of its client money must be kept by firms for three years and information on fiduciary obligations kept on an on-going basis.
- Auditors – firms must verify that the appointed auditor has the appropriate skills to conduct client money audits and firms must retain oversight over the audit process as auditing by a third party does not guarantee regulatory compliance. The firm remains responsible for any breaches.
- Training – staff must receive on-going training on the protection of client money and assets and at any given moment a firm must be satisfied that its systems and controls, policies and procedures and senior management could withstand the scrutiny of an on-site ARROW visit.

But it's not just down to the firms to maximise the protection of client money. In light of the lessons learned from the failure of LBIE, there are a number of steps clients should take to minimise the risks they may be exposed to. These include:

- Rights – clients should ensure they understand their contractual rights in relation to i) money they pay to the firm (or that the firm receives from third parties) and ii) money the firm owes them in the course of providing services.
- Protection – clients using firms offering investment services that are also a licensed bank may not enjoy any client protection whatsoever. Their money will be treated as a deposit, ie as a debt, and will fall outside CASS.
- Terms of business – do these provide for any “title transfer collateral arrangement”? These arrangements are common where services provided by firms include the execution of margined transactions. In these cases the firm will not be acting as a trustee in respect of the money it received as this is deemed as held by the firm as collateral. Full title of the money actually passes to the firm and the client becomes a creditor. In some instances, a firm may be satisfied with a “right to use” client money under charge, rather than a full title transfer so it is worth raising this possibility.
- Time scales – if the service a client is using could result in the firm owing the client money as a debt, such as profits from a contract for difference, it should be clear how quickly the firm will discharge this debt. The safest option is to require immediate payment, but sometimes money could be retained for future services. This should be segregated into a client money account as soon as possible.
- Due diligence – does the firm comply with its obligations under CASS and does it use the “normal” or “alternative approach”? While the normal approach to handling client money means firms are required to receive and pay client money directly from a client money bank account and regularly clear that account of any of its own money, firms operating in a multi-currency and multi-product environment may use the FSA’s alternative approach for client money segregation. This involves receiving and paying client money directly from the firm’s own house accounts and segregating an amount equal to the value of client money into a client account through a daily reconciliation process.
- Liquidity management process – firms operating the alternative approach are riskier in the sense that long-running undetected failures to reconcile and segregate may significantly harm the chances of a client successfully recovering its money. This may be particularly relevant where a firm operates a liquidity management process, which sweeps up banked cash into one centralised location on a short or medium-term basis until their original source is identified, or until required elsewhere.
- Client money buffer – this can mitigate the risk of failing to segregate the correct amount of client money for firms operating the alternative approach. It is a fixed amount segregated daily into the client account, calculated on an historical average of the amount required. Interestingly, LBIE maintained such a buffer with the blessing of the FSA and in theory this should have reduced the risk to clients. In the event, the size of the buffer did little to compensate the overall shortfall, but it is still worth inquiring about.
- Location – firms are allowed to hold client money in a number of different locations. Choosing a firm that uses a location outside of its group may reduce the risk of a huge funding shortfall in the case of insolvency.
- Check – the chances of recovering client money from the client money pool if a firm becomes insolvent will be affected by whether that client’s money has in fact been segregated by the firm and is therefore part of the pool at the time of administration. This means clients must check any statements from the firm and do their own reconciliations, confirming they match their understanding of what should be happening with their money.

The FSA has got the bit between its teeth. It has published its report, put CEOs on notice and will continue to liaise with and visit firms to assess levels of CASS compliance. The watchdog will this year consult on amendments to CASS 7 to take into account the eventual outcome of the LBIE case, and also the recent bold measures being consulted on by the Treasury, which are aimed at increasing the protection afforded to client money.

With so much going on, firms should work closely with the legal advisers and auditors to confirm that their systems and controls are compliant and being run in accordance of the rules in respect of all clients, which may include affiliate companies. For clients, the picture is equally clear – review existing arrangements as there is plenty that can be done to maximise protection for their money under the existing legal and regulatory framework.

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-authorized 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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