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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 147: Client monies

Response to the consultation of the Financial Conduct Authority entitled:
"Review of the client assets regime for investment business"
(Consultation Paper CP 13/5)

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 147 WORKING GROUP

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1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. The FMLC takes the opportunity to respond to certain aspects of the consultation paper 13/5, dated July 2013 released by the Financial Conduct Authority (the "**FCA**") titled "Review of the client assets regime for investment business" (the "**Consultation Paper**"). The FMLC has previously responded to the consultation paper 12/22 dated September 2012 released by the Financial Service Authority (the "**FSA**"), entitled "Client assets regime: EMIR, multiple pools and the wider review"[1] (the "**2012 Consultation Paper**").

1.3. The Consultation Paper proposes wide-ranging changes to the existing rules on the handling of client money and custody assets, and related arrangements. The FMLC considers it important to comment on the legal uncertainties arising from the proposals described in the Consultation Paper in light of their implications for the financial markets. This Paper sets out the Committee's responses and recommendations in respect of the proposals on (i) records based distribution, (ii) the overlap with central clearing structures and the European Markets Infrastructure Regulation ("**EMIR**")[2], (iii) client reporting and information, (iv) the banking exemption, (v) acknowledgment letters, (vi) multiple pools and the identification of beneficiaries, and also highlights the need to take into account the operational realities of the trading of securities in the financial markets while reviewing the client assets regime.

1 That paper, along with the FMLC's other publications concerning client monies, are available for download at http://www.fmlc.org/Pages/papers.aspx.

2 Regulation (EU) 648/2012 of the European Parliament and of the Council of 4 July 2012 on over the counter derivatives, central counterparties and trade repositories, [2012] OJ L201/1.

2. RECORDS BASED DISTRIBUTION

The FCA's proposal in paragraph 2 of the Consultation Paper seeks to introduce changes to the Client Assets sourcebook ("**CASS**") by amending the client money distribution rules in chapter 7A of the CASS ("**CASS 7A**"). These rules deal with the distribution of monies to clients following the insolvency of an investment firm. The proposal seeks to speed up distributions by requiring the insolvent investment firm (or, in practice the insolvency practitioner) to make an initial distribution of client money to those persons who, according to the firm's most recent reconciliation, appear to have an entitlement to client money held by the firm at the point of insolvency ("**records based distribution**"). The FMLC believes that a number of areas of ambiguity and issues of legal uncertainty may arise from this proposal.

2.1. The FCA's concern with speeding up the process of distributing client money held by a defaulting firm is entirely understandable. The experience of the Lehman Brothers International (Europe) ("**LBIE**") administration has not been a happy one in respect of the distribution of client monies. The complexities and delays faced by the administrators have given rise to a considerable volume of litigation and the range and number of legal uncertainties considered in the *LBIE client monies* cases perfectly illustrate the point that the current rules are not fit for purpose in terms of clarity, certainty and coherence. [3]. Amending the existing rules of CASS to help resolve these complexities and uncertainties would seem likely to help achieve the goal of increasing the speed of return of assets and the FMLC supports the FCA's objectives in this regard. Unfortunately, the proposal put forward in the Consultation Paper also raises fundamental questions about the fair treatment of customers who can be said to have had a legitimate expectation in respect of segregation and beneficial ownership which has not been recognised by the firm's records.

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[3] See the judgments of the High Court in *Lehman Brothers International (Europe) v CRC Credit Fund Limited and others* [2009] EWHC 3228 (Ch), the Court of Appeal in *CRC Credit Fund Limited v GLG Investments Sub-Fund* [2010] EWCA Civ 917, and the UK Supreme Court in *Re Lehman Brothers International (Europe) (In Administration) and Re the Insolvency Act* 1986 [2012] UKSC 6.

2.2. The Consultation Paper proposes that the records based distribution would be based upon the firm's internal records reconciled against the balances held in the firm's client money bank accounts and transaction accounts. This means:

a) only those clients that are shown in the firm's records as having an entitlement would be eligible to receive a distribution from the initial client money pool; and

b) the amount of such distribution would be based solely upon the firm's records and would not involve customers in a claims process.

2.3. Paragraph 2.25 of the Consultation Paper recognises that this method of distribution is likely to mean that some clients that would have been entitled to a distribution under the current regime will not be entitled to a distribution from the initial client money pool under the new regime. Examples given include: (a) claims in relation to the particular type of business that a firm failed to include in its client money reconciliation, and (b) the claims of an affiliate who the firm failed to treat as a client with client money protection. The FMLC's concern is that a proposal by the FCA to alter client entitlements in this way may exceed powers conferred on the FCA and so be open to challenge. Specifically, it is not clear that the power conferred on the FCA by section 137B of Financial Services and Markets Act 2000 (the "**FSMA**") to make rules that result in a client's money being held on trust, carries with it a power to make rules that may effectively extinguish a client's beneficial interest in the client money trust but similar doubts might be raised about the existing rules, as interpreted by the Supreme Court.

2.4. It seems unlikely that a court would be willing to see a client's proprietary entitlement to money or assets defeated as a result of inaccurate record-keeping; for example, in the case where the records are inaccurate as a result of fraud. This would also be uncertain if the failure on the firm's part resulted from negligence or breach of trust.[4]

[4] *Heis and others v Attestor Value Master Fund LP and another* [2013] EWHC 2556 (Ch) (16 August 2013) at 71.

2.5. Whilst it is not for the FMLC to consider issues of policy, the fact that the new rules may be perceived as unfair by certain customers is relevant to the extent that this may lead to increased litigation. Where significant amounts of client money are at stake, experience suggests that customers at risk of being treated unfairly will be quick to litigate. The exclusion from the initial distribution of customers who feel that they have been mistreated would be fertile ground for dispute and challenge.

2.6. The risk that a customer may perceive its treatment as unfair may arise from a number of factors central to which is the fact that a firm's records, taken as a snapshot at the point of failure, may be a very unreliable basis for determining the true client money entitlements of the firm's customers. This can be illustrated in the following relatively simple examples:

a) Customer A gives the firm client money, but through dishonesty/negligence the firm fails from the outset properly to record the customer's entitlement;

b) Customer B gives the firm client money and the firm initially records the customer as being entitled to client money and segregates the money in the client account; later and at the point of failure, due to its dishonesty/negligence, the firm's records show that it no longer holds client money for the customer;

c) Customer C places £100 of client money with the firm which, through dishonesty/negligence, wrongly records that it is only holding £10.

2.7. In the above examples, neither Customer A nor Customer B will be able to make a claim on the initial client money pool. Customer C will be able to do so but only for the amount of £10. Other clients of the firm that happen to be shown as having a full client money entitlement as the date of failure will be able to make a claim for 100% of their entitlement.

2.8. The FMLC acknowledges that the proposal for a two stage process is intended to mitigate the risk of unfairness: customers who are excluded from a distribution from the initial client money pool would nevertheless be able to claim in any residual pool of client money that is left over after a first distribution based upon the firm's records. It is not clear, however, that customers will feel that an entitlement to a share of a residual client money pool justly reflects their rights since:

a) there is no guarantee a residual pool of money will exist; and

b) in the examples above, clients A, B and C will have not only to compete with each other for what might be an inadequate pool of money but they may also compete with all other clients who were eligible to claim on the initial pool but only received part of their entitlement.

2.9. It is also acknowledged that the Consultation Paper includes a proposal pursuant to which an initial distribution can be set aside in certain circumstances, which is intended to mitigate perceived unfairness. Those circumstances are those in which:

a) the firm cannot perform a reconciliation at the point of failure because of a systems failure;

b) the amount the firm had actually segregated immediately prior to the failure was less than 90% of what the firm's records show as the total entitlement of clients; or

c) the firm "cannot reasonably determine initial pool entitlements".

2.10. It is noted, however, that the first two circumstances (system failure and segregation adrift by 10%) do not address the problems inherent in a system which determines entitlements on the basis of records that may well be inadequate. The third safeguard (whereby initial distributions can be set aside where records cannot reasonably be relied on) does address this issue but, in practice, will place a very large responsibility on the insolvency practitioner, who will have to make this judgement. It is unclear how far an insolvency practitioner will be able and willing to make an initial distribution based solely on a firm's records. In practice, he or she will be very reluctant to make decisions on whether to proceed with an initial distribution based simply on a reading of the firm's records and is likely to seek directions from the courts, however reliable those records may appear. In particular, an insolvency practitioner will have a large responsibility to decide whether a distribution should *not* be made where an insolvent firm "cannot reasonably determine initial pool entitlements". On appointment, he or she may be confronted with records showing levels of segregated client money that point to a satisfactory state of affairs. At the same time, the records may not provide any indication that some customers' entitlements have not been recorded properly, or at all.

2.11. There are significant challenges here, including with regard to the role of the trustee under English trust law. The defaulting firm, and its insolvency practitioner, will owe duties as trustee to all client money beneficiaries, and also to affiliates to the extent the defaulting firm acts as security trustee on behalf of such affiliates. The insolvency practitioner must also consider the interests of creditors. There is significant potential for conflicting interests—to the extent that the proposals increase the chance of conflicts of interest, or to the extent that fairness is compromised more generally, there is inevitably an increased risk of litigation.

2.12. The proposed rules create considerable uncertainty as to the rights created by the statutory trust. The proposed rules stipulate that all client money is, from the point of receipt, held on trust by the firm for relevant clients. However, the beneficiaries will depend upon the records at the date an administrator is appointed. Some customers might initially be beneficiaries of the statutory trust at the point of receipt and then, in practice, cease to be so at a later point in time. This could be a source of legal uncertainty as it could be said that there is insufficient certainty as to who at any time are the objects or beneficiaries of the statutory trust.

2.13. In addition, it is noted that client money (along with other client assets held by a firm as trustee) may serve as collateral for a client's obligations to a firm, by way of a security interest granted by the client over its interest in the relevant client money/assets. This is supported in law and under the existing FCA client asset rules. It is also an essential mechanism for properly collateralising client obligations, while maintaining a segregation of the collateral assets from the insolvency estate of the relevant firm, so that upon a firm's insolvency those assets would be ring-fenced from the firm's insolvency estate while still serving as collateral for any outstanding liabilities owed by the client to the firm. This collateral mechanism is used throughout the investment services industry, and consequently it may be unrealistic to envisage a process for distributing client money to clients in a matter of a couple of weeks based only on the firm's books and records at the time of the firm's insolvency.

2.14. Client assets will, in many cases, be subject to a security interest which secures the client's obligations not only to the defaulting firm, but also to its affiliates, as was the case with LBIE. In such cases, while the administrator must consider the interest of clients holding claims for client assets, it must also consider the interests of creditors, and the affiliates with secured claims over client assets. In addition to the reconciliation of the firm's books and records regarding any client money, the administrators must also reconcile the liabilities owed by clients to the firm, and consider the interests of affiliates and liabilities owed by clients to those affiliates which also are secured by the client money/assets. In many cases it will be the clients, as the non-defaulting parties, who are calculating the value of those liabilities and submitting close out valuation notices to the defaulted firm (pursuant to their rights under the relevant agreements)–the administrators must make their own calculations and reconcile these with the calculations and claims of clients. All of this takes time, owing to the complexity of the process and the many variables and interested parties. For these reasons the proposals to amend the client money distribution rules to allow for a more speedy method may lead to uncertainty. The litigation relating to LBIE shows that there is a separate issue about affiliates' funds. The CASS rules require these to be treated as client moneys. But if (as LBIE did) those rules are deliberately disregarded, presumably as a matter of group policy and for the group's benefit, it is questionable whether funds of affiliates should in those circumstances be treated on a par with funds of unsegregated, unaffiliated clients.

2.15. In addition, the FMLC understands that that it is not realistic to anticipate that a firm's books and records can be assessed by an administrator/liquidator, and the accuracy/inaccuracy of those records properly determined in a matter of a couple of weeks. Leaving aside the collateral issue mentioned above, there are many variables which will ultimately determine the amount of client money available for distribution. Further, in certain situations even if a firm's books and records are accurate, that does not itself mean that client money is available. For instance, upon the occurrence of "secondary pooling events" (i.e. when a third party holding client monies on behalf of a firm fails, and the firm does not top up the amount of the shortfall) a firm is required to share the shortfall rateably among all its clients, and calculate each of the clients' new entitlements afresh.[5] This would have an impact on the amount of client money available for distribution at a given point of time. Such events do not themselves affect the accuracy of books and records, but they will affect the amounts of client money available to meet the claims reflected in those books and records. Another situation in which the accuracy of a firm's records may be irrelevant is in the case of client money claims relating to omnibus client transaction accounts at a central counterparty (a "**CCP**"). If the transfer of client positions and assets (required by the porting provisions of EMIR) is unsuccessful, such accounts and the relevant transactions will be closed out and collateral held at the CCP as client money will be included in that valuation process. Once again, the firm's books and records may well be accurate, but the amount of client money ultimately returned to the defaulting firm will be affected by that close out process and any losses suffered by the CCP.

Potential client money shortfall

2.16. It is stated in paragraph 2.34 of the Consultation Paper that, if a firm fails, provisions of the Insolvency Act 1986 may prevent a "top up" to correct any shortfall in the client money pool on the grounds that it would prefer the clients over the general creditors of the firm.

2.17. In light of the purposive approach applied in the LBIE client money judgments[6] however, it is not clear that this is correct. The Supreme Court held that client

[5] See further paragraph 3.17 below in relation to secondary pooling events.

[6] See footnote 4 above.

money is subject to pooling on the point of receipt rather than segregation.[7] The effect of the Supreme Court's decision is that clients would have a proprietary claim to unsegregated funds, but only if such funds were traceable pursuant to existing rules in trust law. If the client's funds were not traceable they would have a personal claim for a shortfall in the client money trust insofar as the shortfall results from a breach of trust by the firm but such a claim would rank *pari passu* with other unsecured creditors.[8]

Transfer of client money pool

2.18. Paragraph 2.40 of the Consultation Paper proposes that the transfer of a client money pool to a purchaser be permitted where certain conditions are met. This may give rise to a risk that a CCP, acting pursuant to the porting provisions of EMIR, may transfer customer account assets to Entity A whilst an insolvency practitioner transfers a claim on the same assets or similar assets to Purchaser B.

2.19. This risk would be mitigated if the following safeguards are applied during periods in which a CCP is undertaking the porting of client positions:

a) A mandatory notification is made to the CCP, where there is a transfer of the client money pool of a firm which is a clearing member of that CCP to a purchaser.

b) The insolvency practitioner should be required only to engage in a transfer in a way which would not interfere with the porting of positions by a CCP.[9] Consistency of approach with CCPs should be preferred.

2.20. Further, it is also noted that the Money Laundering Regulations 2007 (the "**MLR**") introduce an obligation on all relevant persons to carry out customer due diligence when a new relationship is established. Under regulation 17 of the MLR it is permissible to rely on another institution to carry out customer due

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7 *Re Lehman Brothers International (Europe) (in administration)* [2012] UKSC 6 at 62-63.

8 *Heis and others v Attestor Value Master Fund LP and another* [2013] EWHC 2556 (Ch) (16 August 2013) at 71.

9 Note that where Part VII of the Companies Act 1989 applies, the insolvency practitioner may not prevent or interfere with any action taken to give effect to a "qualifying property transfer". The expression "qualifying property transfer" in section 159 (*proceedings of exchange or clearing house take precedence over insolvency procedures*) of the Companies Act 1989 covers a return of collateral under Article 48(7) of EMIR or a transfer by way of porting.

diligence provided that (a) the institution consents; and (b) the relying party remains liable for any failure to apply customer due diligence measures. Such consent from an institution may be provided by way of a stand-alone reliance certificate, or may be included in a CCP rulebook. The draft rules do not provide for definitive reliance on the records of the transferor (or where relevant, the CCP), as regards questions of property law. In contrast, new protections are available for clearing members under the Financial Services Act 2012 amendments to the FSMA. Section 137B(2) of the FSMA provides that

> "*an institution with which an account is kept in pursuance of rules relating to the handling of clients' money does not incur any liability as constructive trustee if the money is wrongfully paid from the account, unless the institution permits the payment (a) with knowledge that it is wrongful, or (b) having deliberately failed to make enquiries in circumstances in which a reasonable and honest person would have done so*".

Similar protections in relation to client money pool transfers would enhance consistency in financial markets and certainty for transferees. No provision is currently made in the Consultation Paper or the draft handbook text appended to the Consultation Paper (the "**Draft Handbook text**") for a firm receiving the business from another firm to rely on the anti-money laundering checks carried out by the firm from whom the business is transferred. The FMLC suggests that this could result in an unintended barrier to any potential transfer and suggests that clarification or specific legislative guidance be given by the FCA allowing such reliance.

Currency conversion and interest on client money

2.21. It is proposed in paragraph 2.54 of the Consultation Paper that interest earned on client money after a primary pooling event be used to replenish any shortfall in the client money pool. If, however, the clients of a particular firm are entitled to the interest accruing on the money to which they have beneficial title under their contractual arrangements with that firm, this is problematic. A potential conflict of interest is created, as this proposal could provide an incentive to delay distribution in order to replenish the client money pool.

2.22. Converting pooled client monies to the most prevalent currency in the pool, as proposed in paragraph 2.55 of the Consultation Paper, is inconsistent with the "hindsight" proposal of using actual close out prices to value claims. It would provide greater certainty if funds were returned in the currency of the contract.

3. CASS, CENTRAL CLEARING AND EMIR

3.1. The relationship between (i) the provisions of EMIR—as they pertain to the segregation of cleared client positions and supporting collateral—and (ii) the corresponding requirements of CASS 7 and CASS 7A may give rise to uncertainty.

3.2. At a high level, Article 39 of EMIR (once fully phased-in) will require clearing members of EU CCPs (and the CCPs themselves) to offer a choice between individual client segregation and omnibus segregation in respect of those clients' cleared positions and supporting collateral (i.e. under Article 39 and the related protections in the Article 48 of EMIR, referred to hereafter as "**EMIR Segregation**"). In turn, Article 48(7) is designed to create a level of legally-enforceable segregation over such amounts,[10] by virtue of EMIR being a directly effective regulation. In particular, Article 48(7) provides that clients' collateral distinguished in accordance with Article 39(2) and (3)[11] shall be used exclusively to cover the positions held for their account and that

> *"[a]ny balance owed by the CCP after the completion of the clearing member's default management process by the CCP shall be readily returned to those clients when they are known to the CCP or, if they are not, to the clearing member for the account of its clients."*

3.3. In effect, Article 48(7) is a pan-European statutory preference in favour of clearing clients in respect of positions and supporting collateral segregated on their behalf at the level of an EU CCP. It implies, amongst other things, that

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10 The fact that these protections should take precedence over any conflicting provision of any Member State law, including any contradictory provision of the insolvency laws of any Member State, is made explicit in Recital (64) of EMIR, which provides that "*[t]he requirements laid down in this Regulation on the segregation and portability of clients' positions and assets should… prevail over any conflicting laws, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them.*"

11 i.e. the provisions on omnibus and individual client segregation at the CCP level respectively.

clearing clients' risk in respect of funds segregated on their behalf at the level of the CCP (e.g. posted cash margin) should not be mutualised with funds that the clearing member may hold in the course of other business (e.g. segregated cash held on behalf of a client undertaking non-clearing business) in the event of the failure of that clearing member. It is noted that FSA's Policy Statement 12/23 (the "**FSA EMIR Policy Statement**") states that the segregation requirements under EMIR mean

> "*that at a minimum, the client's assets and positions must be recorded in separate accounts at the CCP from those of the firm…" and* that *"[w]e must not infer from the terminology of EMIR that an individual client account and an omnibus client account necessarily hold client money under CASS*."[12]

Examples of cases in which accounts at a CCP would not contain client money within the meaning of CASS include the following: (a) where a clearing member is an incoming EEA firm subject to Home State regulation of its operational arrangements under client money; (b) where the clearing member is a credit institution accepting client funds on deposit as bank rather than as client money; and (c) where the client agrees to transfer funds to the clearing member under a Title Transfer Collateral Arrangement (or "**TTCA**").

3.4. However in certain other situations, both EMIR Segregation and CASS could apply in parallel. For example where a UK-incorporated clearing broker clears positions on behalf of a segregated client and places any excess funds received from that client with a third party credit institution in compliance with CASS 7.4. Significant legal uncertainties would arise when seeking to apply the existing patchwork of rules to such a case. Further, at a practical level, the potential operational burdens of operating a hybrid CASS / EMIR segregation offering may be a legitimate concern for clearing member firms, taking into account their overarching requirements in relation to systems and controls under the Senior Management Arrangements, Systems and Controls sourcebook.

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12 Financial Services Authority, "Policy Statement PS12/23—Client assets regime: changes following EMIR", December 2012 available at <http://www.fca.org.uk/your-fca/documents/policy-statements/fsa-ps1223> accessed [.] November 2013 (FSA EMIR Policy Statement).

3.5. It is noted that the FCA has proposed amendments to CASS to ensure that, subject to certain conditions,

> "*client money held in a client transaction account at an authorised central counterparty or a clearing member which is, in either case, held as part of regulated clearing arrangement does not form part of the initial pool*"

in the event of a primary pooling event following the failure of their clearing member (draft CASS 7A.2.4R). Whilst the FMLC understands that the overall intent of draft CASS rules in the Draft Handbook text is to create a presumption in favour returning segregated funds to clients, rather than including them in a client money pool, it notes that there are a number of conditions included in these rules, particularly in relation to the positions of omnibus segregated clients, and that some of these conditions are relatively complex (see in particular draft CASS 7A.2.6A(3)R). It is possible that the complexity of these rules could increase the risk of litigation over their meaning in the event of a clearing member insolvency and the Committee would therefore encourage the FCA to consider paring back some of these rules to ensure consistency with EMIR.

3.6. Depending upon how explicitly client transaction accounts at, and supporting cash collateral held, by the CCP are carved out of client money pooling under CASS 7A, EMIR Segregation alone without CASS protection may be of interest to some clients on the basis that it should avoid mutualisation of risk with other clients in the event of, say, a primary pooling event occurring in relation to their clearing member. By way of practical example, CASS protection may offer relatively little benefit to clients who opt for individual segregation of their cleared positions under EMIR. Such clients would provide margin for their cleared positions on a gross basis and their excess collateral would be swept up to the CCP in compliance with Article 39(6) of EMIR. Absent errors on the part of the clearing member or the CCP, such individually segregated clients should not be subject to a shortfall risk in respect of collateral provided to the CCP, noting that:

a) individually segregated clients will be reliant on their clearing member complying with their EMIR obligation to fully benefit from the protections envisaged by Article 48(7); and

b) (assuming that such clients would provide their clearing member with margin on either a TTCA basis or, where the clearing member is also a credit institution, on deposit) such clients would be exposed to credit risk against the clearing member in the time between when funds are received by the clearing member and the time those funds are transferred up to the individual account at the level of the CCP.

This risk, however, may be preferred by some clearing clients to the risk of getting caught up in client money litigation in relation to the interpretation of CASS 7A in the event of the insolvency of their clearing member.

3.7. In this context, the potential uncertainty as to how rights in respect of segregated client cash will be treated in the event of a clearing member or CCP insolvency remains a real area of concern for clearing clients in the wake of the extensive litigation of client money issues following the failure of LBIE. With this in mind, unless more explicit carve-outs from client money pooling for clearing are introduced into CASS, some clients may feel more comfortable relying on Article 48(7) without an additional CASS layer of protection, in order to avoid the risk of being brought within the scope of further client money litigation. In the event that EMIR segregated transaction accounts and supporting cash collateral at the level of the CCP are more explicitly carved out of client money pooling under CASS, then this would arguably eliminate the need for a separate regime for client money sub-pools for net omnibus client accounts.

3.8. Where a clearing client opts for omnibus segregation under EMIR, it is still possible that any shortfall in margin at the level of the CCP could lead to competing claims for return of the relevant funds, for example in respect of positions at those CCPs (such as LCH.Clearnet Limited and ICE Clear Europe Limited) that debit variation margin for omnibus segregated clients on a net basis. In this regard, the text in the FSA EMIR Policy Statement is noted which states "*EMIR does not specify the way that a clearing member firm should treat balances* *returned by CCPs 'for the account of its clients*'".[13] This results in part from the absence of any power for the Commission and ESMA to develop Level 2 regulatory technical standards on the operation of either Article 39 or Article 48 of EMIR. There is therefore some residual level of uncertainty as to how a court or an insolvency practitioner would resolve such competing claims in the event of the failure of a clearing member. It may not be sensible, however, to seek to resolve any such uncertainties using the statutory trust, since the interpretation of Article 39 and 47 of EMIR should be one for the European courts. There is a material risk that any "gap-filling" in the form of guidance on how to handle shortfalls under EMIR using the statutory trust could be seen *ultra vires* the right of return in Article 48(7), creating a greater risk of client money litigation, particularly considering the cross-border nature of much clearing business. With this in mind, it is recommended that the FCA seek to address this issue at the European level, for example by advocating an amendment to EMIR to allow ESMA to develop further regulatory technical standards on EMIR Segregation.

3.9. As regards the comparative scope of EMIR Segregation and client money segregation under CASS, whilst Article 39 and 48 of EMIR apply to client positions and supporting collateral at the level of the CCP they do not (on their face at least) cover any residual funds held by a clearing member pursuant to TTCA arrangements that are not used as margin for clients' positions at the level of the CCP. EMIR Segregation alone (e.g. a gross or net omnibus segregation offering, under which the client provides margin to their clearing member on a TTCA basis) may still be attractive to some clients, however, for example because it may offer a lower cost segregation option compared to segregation under CASS, in part because CASS is operationally more burdensome for firms to administer in practice than a TTCA based model.

3.10. In light of the broader relationship between clearing firms and their clients, care should be taken to ensure that the draft provisions in CASS 7A regarding remittance of funds to clearing clients following a primary or secondary pooling event do not pre-judge any decisions that may be taken by a court or an

[13] FSA EMIR Policy Statement, p. 21 -22.

insolvency practitioner in relation to the interaction between Article 48(7) and any rights of recourse that clearing members may have against their clients for other obligations that the clients may owe to them. An example of this may be where the clearing member has funded or pre-funded margin placed with the CCP in respect of the client's positions. In this context, it is noted that there are a number of provisions in the draft rules (e.g. draft CASS 7A.2.6A(3)(b) and 7A.2.6B(1)(b)(ii)) which could require clearing members to remit funds to their clients, subject to limited conditions. However, these conditions do not (in the current draft at least) expressly include consideration of any rights of recourse, e.g. set-off, that a clearing member may have in respect of outstanding liabilities owed to it by its clearing client. Any decision on this issue may require the courts and/or an insolvency practitioner to consider (amongst other things) what is meant by the "balance" that must be returned to clients under Article 48(7) and whether the requirement "readily to return" such amounts is in any way qualified with reference to that clients' obligations (if any) to the clearing member, as well as an analysis of how Article 48(7) interacts with the Financial Collateral Directive. It is therefore recommended that any obligations to remit funds to clients following the failure of a clearing member under CASS 7A are appropriately qualified.

3.11. In this context, it is noted that the text in the FSA EMIR Policy Statement states that

> "*if a client ends up in a position of owing money to the failed or defaulted clearing member, our rules do not prevent an insolvency practitioner from pursuing any claim against that client.*"[14]

The FCA is urged to consider this statement afresh in the context of the new draft rules and consider whether any requirement to make such remittances should be subject to any obligations of the client to the clearing member that may take precedence over the right of return in Article 48(7).

[14] Financial Services Authority, "Policy Statement PS12/23—Client assets regime: changes following EMIR", December 2012 available at <http://www.fca.org.uk/your-fca/documents/policy-statements/fsa-ps1223> accessed [.] November 2013.

3.12. The FCA is also urged to consider how EMIR Segregation should be reflected in any reports to clearing clients or other reports or notification to the FCA. Prior to the introduction of EMIR, it was common in the market to refer to clients who transferred funds to their clearing member pursuant to TTCA as "unsegregated clients", on the basis of their lack of client money protection under CASS. Following the introduction of additional protections for clients under EMIR, it may be appropriate to use different terminology for this relationship, such as "EMIR Segregated" clients. The FCA is urged to consider how this relationship (and related positions and funds) should properly be described, to ensure that there is not a mismatch between clients' understanding of the status of such funds and the treatment of those funds under EMIR.

3.13. It is important from the perspective of both legal consistency and certainty that nothing in the client money pooling rules in CASS 7A interferes with the operation of Article 48(7). With this in mind, it is recommended that segregated client positions and supporting collateral at the level of the CCP are explicitly carved out of both client money pooling and the definition of client money when they are either ported in accordance with Article 48(5) or (6) or returned to the client in accordance with Article 48(7). This should, amongst other things, help in assisting in a cleaner analysis of clearing clients' rights in respect of funds segregated at the CCP in the event of the insolvency of a clearing member and accordingly reduce the risk of litigation over any inconsistency between EMIR and CASS.

3.14. In practical terms, if the carve-out from the client money pooling rules in CASS 7A is drafted in such a way as to not interfere with the operation of porting and/or return of client funds under Article 48, then the resolution of any potential disputes in relation to the treatment of funds held at the CCP should not interfere with the pooling and prompt return of client funds in respect of non-clearing related business, whether or not the speed proposals are implemented. For this reason, the FCA is urged to ensure that both client transaction accounts and margin accounts at the CCPs are explicitly carved out of client money pooling, building on the wording already in CASS 7.2.15B for the direct return of money held by the CCP.

3.15. This recommendation for the carve-outs from the client money pooling rules in CASS 7A also applies in the context of the proposal to amend CASS 7A to deal with the remitting of client monies to indirect clients upon the failure of the relevant client. In line with comments and reasoning in the preceding paragraphs, the FCA is urged to include more specific carve-outs from the client money pooling rules in CASS 7A where there is a hard obligation to transfer or remit client monies under Article 48 of EMIR, which will be directly applicable to clearing members established in the UK and (in accordance with recital (6) of EMIR) will take precedence over any conflicting provisions of the CASS.

3.16. The FMLC notes the proposals in the Consultation Paper to apply hindsight valuations to the valuation of clients' cleared open-margined positions to determine their entitlements to the relevant client money pool. In the context of CCPs, however, such valuations are arguably an issue that should be dealt with in CCPs' own rulebooks. The rulebooks of the relevant CCPs would no doubt be subject to the precise valuation requirements of their competent authority, which may be the FCA if the clearing member is established in the UK (e.g. LCH.Clearnet Ltd) but could be another regulatory authority in the EU (e.g. BaFin in the case of European Commodity Clearing ("**ECC**")) or outside the EU (e.g. in respect of a third country CCP that has sought recognition from ESMA under Article 25 of EMIR or is otherwise grandfathered under Article 89(3) of EMIR). Since UK clearing members may be members of a wide range of CCPs established in different jurisdictions, some of which may be regulated by the FCA but many of which may not be, the FMLC considers that the issue of the valuation of cleared positions should not be dealt with in CASS 7A. If this issue is addressed in CASS, there is a risk that these rules could conflict with CCPs' own rulebooks and/or local rules on valuations in the jurisdiction in which the CCP is established.

3.17. The FMLC notes the proposal to extend the secondary pooling event rules to exchanges and CCPs. The clarification included in the Consultation Paper is also noted, which states that if a CCP fails, any firms (e.g. a clearing broker) for which this constitutes a secondary pooling event should not be required notionally to pool money from individual client accounts (or omnibus client accounts that relate to a sub-pool that that firm operates) with other client money the firm holds. The FMLC suggests that similar principles should be applied to primary pooling events in respect of clearing member failures would also provide greater certainty to market participants. As noted above, the practical benefits that would be gained by setting up a specific system of client money sub-pools for net omnibus segregated positions and the likely take-up of such proposals in the market are debatable. Commercially, the perceived benefits to clearing clients of sharing in a client money sub-pool may be minimal, particularly if this still assumes a degree of litigation risk in respect of their segregated funds. The potential for having two different client money regimes that could apply to omnibus segregated funds at the level of the CCP—one based around sub-pools and one not—arguably adds an additional layer of complexity to the rules. At an operational level, the additional practical burdens that would be placed on clearing members wishing to operate such a sub-pool (e.g. in respect of the need for separate records and the proposed sub-pool disclosure document) may limit the degree to which the sub-pool option is taken up.

3.18. It is noted from pages 23 to 24 of the Consultation Paper that the intended aim of net omnibus sub-pools is to help facilitate the porting of cleared positions to a back-up or replacement clearing member, with the paper suggesting that

> "*[i]n the event of the firm's failure, the firm/IP would make the client money in that pool available to facilitate the porting of the omnibus client account, for example, by providing the money to the back-up clearing member so that the relevant clients are not required to double margin.*"

Whilst it may be desirable to help port omnibus segregated positions in the event of a failure of a clearing member, the FCA is urged to consider whether the creation of a separate client money pool in respect of those funds would help facilitate this aim.

3.19. The Consultation Paper also proposes that

> "*[i]f the omnibus client account failed to port, or the client money in the pool held at firm level was not used to facilitate porting, the client money in the pool would*

remain separate from any other client money held by the firm and would be distributed to the relevant clients rateably in accordance with their entitlements to that pool."

In practice, a decision on the part of the relevant CCP, the defaulting clearing member's insolvency practitioners and the proposed replacement clearing member on whether or not it is feasible to port the relevant positions (or else close them out in accordance with the CCP's default management process) is likely to be taken very quickly, which may reduce the argument for a separate client money sub-pool covering such funds. In the event of a clearing member failure, Article 48(7) would require the client funds remaining following the CCP's default management process to be returned to clients, either directly by the CCP or (in the event that the clients are not known to the CCP) to the clearing member for the account of the clients; this would, in effect, prohibit such funds being pooled with other client monies held by the clearing member, whether or not the clearing member has opted to establish a separate client money sub-pool. Any requirement for net omnibus segregated funds to be included in a broader client money pool is likely to be *ultra vires* the right of return in Article 48(7) of EMIR.

3.20. The advantage of applying the client money pooling rules in such circumstances would be to help resolve any disputes around how any shortfall in the relevant funds should be shared amongst the relevant net omnibus segregated clients. However, in line with comments in paragraph 1.12, it is properly for the Commission, ESMA and/or the European courts to develop jurisprudence on the handling of such shortfalls which would apply to all clearing arrangements within the scope of EMIR, whether or not also within the scope of CASS. One approach would be to introduce a power for the Commission to adopt regulatory technical standards on the operation of Article 48(7). Seeking to achieve the same aim under CASS can only ever be a partial solution and would not bring the same level of certainty to clearing arrangements that fall outside the scope of CASS (e.g. in respect of clearing services offered by an incoming EEA firm); such an approach would also introduce potential anomalies between the treatment of different segregation solutions in the event of a clearing member insolvency.

3.21. The Consultation Paper contains proposals at paragraphs 5.49—5.51, as to how a firm documents TTCA agreements with its clients. If a client requests money previously subject to TTCA agreements henceforth to be treated as client money, the proposal requires the firm to notify the client of when such client money protections would come into effect. If no such request is made, the proposed new rules would require that the money be protected as client money on the business day following agreement by the firm that the money would cease to be part of a TTCA (as described in paragraph 4.23 of the Consultation Paper).

3.22. The FMLC notes that contracts concerning collateral are heavily negotiated arrangements and each agreement is likely to be on bespoke terms. In light of this, there would be significant legal difficulties should TTCA collateral arrangements be terminated without the execution of documentation governing the new arrangements: for example, registration requirements may apply to new security interests created without there being sufficient opportunity to satisfy them.

3.23. Any agreement to change to client money protection should not prevent onward transfers of the client monies to a CCP or require a CCP to become under-margined or unable to apply collateral. It is suggested that it should be a matter for the clearing member to change the details of any accounts at a CCP as required. It would help in this regard if clarification were to be given by the FCA that until the relevant clearing member changes the details of any accounts, a CCP will not considered to be on notice of any change for collateral arrangements.

3.24. In the context of clearing services it is important to consider how any documentary requirements in respect of a termination of TTCA arrangements would interact with the anticipated move into individual segregation in accordance with Article 39(3) of EMIR, when this provision takes full effect and CCP approvals are phased in.

4. CLIENT REPORTING AND INFORMATION

4.1. The proposal to enhance the client reporting regime for investment firms is welcomed as beneficial to all stakeholders and the financial services industry. The FMLC notes the introduction of a requirement for all firms which are subject to the CASS custody rules or client money rules to provide their clients with a stand-alone "Client Assets Disclosure Document" summarising the key provisions of the agreements governing the relevant client assets and the protections available to the client under the existing CASS rules. It is important to ensure that, in respect of the provision of clearing services, the document does not cut across the requirements on public disclosure statements on the segregated positions and supporting collateral under Article 39(7) of EMIR, which would include (amongst other things) a description of the main legal implications of the respective levels of segregation offered information on the applicable insolvency law.

4.2. Ways to avoid such a conflict are: (a) to carve out the details of the protections afforded to segregated positions at the level of the CCP from the proposed Client Money Disclosure Document (perhaps allowing firms to state that details of the protection of client assets held at the CCP would be included in a separate Article 39(7) disclosure document); and/or (b) to allow firms to satisfy their CASS and EMIR disclosure obligations within the same physical document.[15]

5. CASS RULES AND BANK/CLIENT RELATIONSHIP: BANKING EXEMPTION

5.1. The Consultation Paper sets out certain proposed amendments to the client money rules ("**CASS 7**") dealing with the "banking exemption". The exemption allows deposit-taking firms to hold money on deposit which would otherwise be categorised as client monies. The relevant firms must apply for this exemption and also show the deposits on their balance sheet as a liability. Currently, deposit-taking firms hold money for clients as client monies (i.e. as trustee) unless they actively choose to apply the banking exemption and hold

[15] Specialist clearing firms, in particular, only provide segregation of client money and assets in the context of clearing services. For these firms, as the FMLC understands, an obligation to make multiple, separate disclosures to clients is likely to add a considerable burden of complexity.

such monies on deposit (i.e. as banker). Under the proposal put forward in the Consultation Paper, the default position will be reversed, i.e. firms which can use the banking exemption will hold all money relating to investment business on deposit. If a firm chooses not to hold the funds in this way, it must notify the client of this and then comply with the client money rules in respect of these funds.

5.2. The general confirmation provided under the draft CASS 7.1.8A R that: (i) credit institutions for the purposes of the Banking Consolidation Directive ("**BCD**")[16] and (ii) approved banks will hold monies in the context of designated investment business and MiFID investment business as banker, is welcomed. This approach should generally assist legal certainty in this area.

5.3. As regards credit institutions, draft Rule CASS 7.1.8A R, seems to require no more than the taking of deposits or other repayable funds for the banking exemption to apply. (In other words, a debtor-creditor relationship is taken to be created merely by the depositing of funds, although the draft guidance at CASS 7.1.8C G. is noted.) As regards other approved banks, it is noted that under the draft Rule CASS 7.1.8A R, they would be within the banking exemption provided the money is both held on its balance sheet and reflected in its books and records.

5.4. It is noted that the formulation in draft rule CASS 7.1.8A R regarding credit institutions offers greater clarity for the depositing client since the determination of the banker-client relationship (as opposed to a beneficiary-trustee relationship, where the insolvency risk would be primarily against another credit institution) is achieved by means visible to the client, i.e. the client is informed of the relationship it has with the firm and can ascertain the nature of its claim against the firm. Where the position of the firm *vis-à-vis* the banking exemption is determined according to the firm's balance sheets, more clarity is required since the client is not able to check its deposit against the balance sheet of the firm or its underlying books and records.

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16 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), [2006] OJ L177/1 (Banking Consolidation Directive).

5.5. Draft rule CASS 7.1.8B R provides that a firm meeting one of the two sets of requirements in draft rule CASS 7.1.8A R (i.e. being a credit institution or an approved bank, as discussed above) will not be subject to the client money rules, but that instead it will be subject to that firm complying with the requirements of certain other CASS rules (being CASS 7.1.8DR to CASS 7.8.10G). Whilst the intention is to create a default position whereby the client money rules would not apply to monies held by these firms (save to the extent they choose to do so in accordance with CASS 7.1.10A R), the position as drafted appears to be conditional on the fulfilment of various requirements by the firm. This creates uncertainty as to the actual position of the client should any of these requirements not be met fully and also to makes it difficult for the client to determine what the nature of its relationship with the firm is.

5.6. Clarification is sought in respect of the statement at paragraph 4.9 on page 29 of the Consultation Paper which states

> "*...we found firms were depositing this money in the firm's own name with third party banks. By doing this the firm is not holding the money as a deposit itself and the money is client money and the firm must comply with client money rules.*"

The FCA is making the point that monies must be recorded as a debt to the client in the firm's own books and records to reflect a debtor-creditor relationship between the firm and the client and that, if the firm instead becomes a creditor of another credit institution, then the firm holds its entitlement to be repaid as trustee pursuant to CASS 7.7. This comment could be read to mean that a firm cannot accept a deposit from a client and, in turn, deposit monies with another credit institution (as in a correspondent banking relationship). It may be worthwhile clarifying this statement. Clarification is also sought as to how this proposal would operate *vis a vis* cash margins deposited by clearing members with CCPs, which the CCPs often place with their bankers in their own name.

5.7. Clarification on a related point is also sought from the FCA with regard to the proposal in paragraph 4.103 of the Consultation Paper, which deals with the treatment of client money relating to custody assets held at custodians or subcustodians. The proposal states that where firms holding safe custody assets deposit these with third parties, any money deriving from those assets should be recognised by the third parties as client money. It is unclear how this proposal is expected to apply in circumstances where a firm avails itself of the arrangements in draft CASS 7.1.8A R (detailed in paragraph 5.1 to 5.5 above), and also how they interact with the existing provisions of CASS 7.7 whereby the third party holds monies on trust for firms.

6. ACKNOWLEDGMENT LETTERS

6.1. The Consultation Paper sets out certain proposals in respect of notifications and acknowledgment letters which are given and received when client monies are placed by a firm with another firm, bank or third party. Each firm is required to provide specific notification to the third parties with whom it is opening an account to place client funds and withdraw the client monies if acknowledgment is not received from the third party institution within twenty business days of the giving of such notification.

6.2. To standardise the process in respect of these notifications and acknowledgments, the FCA has proposed that a standard template letter be used and despatched in accordance with a set procedure (including the obtaining of a countersignature as acknowledgement of notification from the third party institution) which is set out in the Consultation Paper.

6.3. Current practice of many CCPs is to comply with CASS 7.8.2R (1) through written provisions in their rulebooks and circulars.[17] CCPs' systems are designed to facilitate segregation of client and house accounts. There is no obvious additional protection which would be afforded by the requirement for a firm to obtain the countersignature of the CCP to the acknowledgement letter instead of relying on CCP rules and circulars.

6.4. The Consultation Paper fails to make it clear that in situations where client money is placed with CCPs, the proposed standard form client transaction account acknowledgement letters are only to be used in respect of segregated

[17] For example, ICE Clear Europe Circular 08/032.

customer accounts. If an acknowledgement letter were submitted, however, in relation to proprietary accounts of a clearing member or accounts designated solely for assets held subject to a TTCA, this would be incompatible with Article 39 of EMIR. Such an arrangement would also be operationally unworkable, and could have a significant adverse impact on the CCPs' ability to net and apply collateral.

6.5. Clarity is also required on how the proposals will apply to CCPs outside the UK, which are not subject to the same regulatory regime but could receive these letters.

6.6. To overcome the operational hurdles to implementing the proposals in the context of CCPs, it is suggested that the CCPs' acknowledgement for these purposes be given in writing to clearing members in the form of rules or a circular. It is suggested that this, together with the relevant provisions of the clearing rules and clearing membership agreement should be sufficient for clearing members to rely upon, in line with current practice.

7. MULTIPLE POOLS: IDENTIFICATION OF BENEFICIARIES

7.1. In the 2012 Consultation Paper, the FCA has consulted on the mechanism for establishing discrete "pools" of client money, distinct from other pools of client money in the event of a firm's insolvency. The Consultation Paper's proposal on the establishment and operation of these pools of client money relies on clearing member records to designate separate client asset pools relating to the net omnibus client transaction accounts that such clearing members operate. It is noted that this approach is open to creating more uncertainty and litigation on insolvencies if, for example, clients of one pool claim that they should be the beneficiaries of a different pool. It is important, as suggested, that the beneficiaries of each pool are clearly defined in the FCA rules.

7.2. Upon the occurrence of a primary pooling event, i.e., at a time when a firm is in financial difficulty, it may not be straightforward to obtain information on the beneficiaries of particular sub-pools if this information is only held by the firm or records are ambiguous, or inconsistent with their accounts.

7.3. It is not clear from the wording of paragraph 3.21 or the relevant Draft Handbook text how clients could be prevented from seeking to trace their assets into other sub-pools to which they claim to have an entitlement, or that a Court would be unable to hold that a constructive trust was created of certain pool claimants in another pool. This is also an issue for recipient clearing members, who need protections from claims by the defaulter and its customers. This issue should be addressed because uncertainty as to the scope of different pools could result in protracted litigation and delay in returning client assets.

7.4. It is intended that client money in separate pools would be used to facilitate the porting of client positions in the event of firm failure, and it is therefore important that the relevant CCP has adequate notice so that it can put the necessary arrangements in place. Firms should therefore be required to notify relevant CCPs as well as the FCA of their intention to establish a client money sub-pool. Otherwise, CCPs will not have the information needed in order to transfer funds on porting or to determine whether there may be additional resources available to port.

7.5. CCPs may also be vulnerable to litigation on the grounds of tort, interference with contract or breach of trust unless they are provided with express protection from claims by clients of clearing members when they undertake porting of client positions and margin or return assets to customers in accordance with their rules, the relevant CASS provisions and Article 48 of EMIR. CCPs have some protections in the Companies Act 1989 for actions taken under "default rules" but these are ambiguous in their application to actions taken under CASS. CCPs should have protections over good faith payments made based on their books and records, and for porting of client positions and margin. Similar protections in relation to the proposed client money pool transfers would enhance certainty for transferees.

8. CLIENT ASSETS AND THE OPERATION OF FINANCIAL MARKETS

8.1. The operational realities of the financial markets should be taken into account when making rules for investment firms who conduct equity dealings for their clients, and consequently deal with their client's assets. In the context of trading equities in the UK marketplace, it is necessary to distinguish between order-driven and quote-driven markets. For the majority of equity dealings performed by private client investment managers, firms use the well-established quote-driven retail service provider model ("**RSP**"). This model has the following key elements:

a) The firms acting for clients do so in an agent capacity.

b) The firms providing prices etc. are market-makers and act in a principal capacity.

c) Deals, once matched between an agent firm and a principal market-maker, pass directly to the CREST settlement system.

d) The agency firms are members of CREST via their nominee companies NOT their firms thus retaining client segregation throughout the post-trading chain.

e) "Clearing" is not used in the RSP model.

8.2. The alternative, order-driven system works on quite a different basis in that:

a) Firms "attached" to the order-driven system act in a principal capacity.

b) Clearing has to be used between trading and settlement.

c) If netting is used as part of clearing, then the ability to identify assets specifically for individual clients becomes extremely complex.

8.3. Greater regulatory and legislative attention should perhaps be given to the management of client assets by firms operating the RSP systems. Given the structure of the systems, several complexities arise which can severely impact the ability to "pay-away" any monies quickly to clients when firms stop. Additional layers of complexity in relation to the distribution of client assets can arise when firms offer instruments such as derivatives and CFDs (and possibly overseas trades), which can result in extensive time delays when distributing client assets.

8.4. In light of these complexities, upon the insolvency of a firm trading securities within these systems there is a risk of non-delivery of client assets whether held as cash or held as securities in custody accounts. There is therefore a need to assess the practical workings of the markets since the current regulations do not seem fully to address or apply to the operational realities of the markets which operate in this way.

9. CONCLUSION

9.1. The FMLC acknowledges that the far-reaching changes proposed by the FCA are reflective of the need for change that has been highlighted in light of the significant difficulties faced on the insolvency of investment firms in recent times. However, the proposals—especially those in relation to the records based distribution, creation of multiple pools and other changes to the CASS rules—must be clarified in light of existing European legislation and other regulations to which they are intended to be complementary. In the absence of such clarity, the resultant legal uncertainties could affect post-insolvency distributions of client assets. Further, while certain of the proposals relating to disclosure and reporting are helpful they should be aligned with existing rules and obligations to avoid confusion and duplication for firms operating in the market. The FMLC invites a further clarification of these proposals from the FCA, with respect in particular to their interaction with European legislation such as EMIR and with the real-world operational constraints of the financial markets.

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