Linklaters

June 2014

FCA changes client money and custody asset rules

This note provides a summary of the extensive changes to the client money and custody rules for investment firms

Overview

The Financial Conduct Authority ("**FCA**") released on 10 June 2014 a new policy statement PS14/9: Review of the client assets regime for investment business (the "**Policy Statement**"), which makes changes to the rules in the Client Assets sourcebook ("**CASS**") which will come into effect in three stages over the next 18 months. The Policy Statement not only sets out the final rules and guidance, it also summarises and provides the FCA's feedback to the responses the received to its consultation paper launched in July 2013 (CP 13/5).

The Policy Statement affects all firms that are subject to CASS because they conduct investment business and hold client money, custody assets, collateral and/or mandates in relation to that investment business (or rely on an exemption contained within CASS). This includes loan-based crowdfunding firms who recently became subject to the client money rules in CASS 7 through the changes published in PS14/4.

The extensive and detailed changes include a rewrite of the client money rules for investment firms and substantial amendments to the custody rules in CASS. The changes are intended to improve firms' systems and controls around segregation, record keeping and reconciliations and set out how investment firms must address client assets risks within their business.

The FCA is not currently proceeding with most of the proposals it consulted on around the client money distribution rules, which were intended to speed up the distribution of client money on a firm's insolvency. This follows concerns raised in the feedback on the speed of the proposals and the need for the FCA to take account of any recommendations from the final report of the independent review of the Investment Bank Special Administration Regulations 2011 ("**SAR**"). The FCA intends to publish a further consultation on the client money distribution rules later this year.

The new rules will come in to effect in three stages: 1 July 2014 (rule changes that are optional or impose minimal regulatory burden on firms); 1 December

Contents

2014 (changes which may require firms to revise existing client-facing documentation); and 1 June 2015 (all remaining rules and guidance).

Context

The FCA Principle for Business 10 states that "*a firm must arrange adequate protection for clients' assets when it is responsible for them*". In this context, client assets include both client money and other custody assets, including safe custody investments. In July 2013 the FCA launched a consultation paper to review the client asset regime for investment business (CP 13/5). The FCA sought to address some of the lessons learned from a number of high profile insolvencies (including the Lehman Brothers International (Europe) administration and the MF Global UK Ltd special administration) and from a series of enforcement actions against firms for failures in the custody and safeguarding of assets. The aim of the client assets review was to achieve better results for clients whose assets are placed with a firm when it enters insolvency, by: (i) improving the speed of return of client assets; (ii) achieving a greater return of client assets to clients; and (iii) reducing the market impact of a firm's insolvency. The consultation closed on 11 October 2013. The Policy Statement summarises responses and provides feedback.

Application of CASS (CASS 1)

The changes clarify the application of CASS to particular firms, including guidance to firms' affiliates in the context of MiFID and non-MiFID business and rules on when CASS is applicable to trustee firms. The FCA has also amended the rules to clarify that the client bank accounts and the client transaction accounts that a firm holds in respect of different chapters of CASS or in its different capacities (as a trustee and otherwise) must be separately designated. These changes are effective from 1 July 2014.

Collateral rules (CASS 3)

The FCA has added guidance reminding firms that the client's best interests rule applies to collateral arrangements. These changes are effective from 1 July 2014.

Custody rules (CASS 6)

The new rules reflect substantial changes to the custody rules in CASS 6. The changes to key topics are summarised below.

Application of the custody rules: Clarification of which rules apply to depositaries of Alternative Investment Funds ("**AIF**") and when a firm is arranging safeguarding and administration of assets. These rules received no comments and are effective from 1 July 2014.

Physical share certificates: The FCA has confirmed that firms who are safekeeping physical share certificates fall within the scope of the

"safeguarding" part of the activity of safeguarding and administering investments under Article 40 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. As a result, where a firm is also administering an asset for which it is holding a physical share certificate, it will require the appropriate permissions and must comply with the custody rules in respect of those assets.

Registration of firm and custody assets: A firm's ability to register title to its own assets in the same nominee name as any custody assets held for clients will be restricted to circumstances in which this is necessary to facilitate a client transaction (e.g. in handling dealing errors, allocating bulk deals and/or processing transactions in fractional shares) or as a result of the law or market practice of an overseas jurisdiction. The rules were redrafted based on feedback and will not apply until 1 June 2015. The FCA has encouraged firms to discuss with their normal supervisory contact if the reregistration of any of their own assets will cause undue hardship.

Depositing custody assets when using third parties: The FCA has introduced a number of clarifications, reordering the rules to improve readability and amending the matters a firm should consider when selecting, appointing and periodically reviewing any third party custodian with whom it deposits assets. In addition to keeping records of the grounds upon which it satisfies itself of the appropriateness of its selection and appointment of a third party to hold client assets, a firm should also record each periodic review of the selection.

Written custody agreements: Firms will be required to have in place a written agreement whenever they place custody assets, or arrange for custody assets to be placed, with a third party custodian, whether or not that person is an affiliate of the firm. These agreements must: (1) set out the binding terms of the arrangement; (2) be in force for the duration of the arrangement; and (3) clearly set out the custody services that the third party is contracted to provide. Firms will have until 1 June 2015 to bring their existing custody arrangements into compliance with the new requirements. New custody arrangements, or materially altered existing arrangements must, however, be documented in writing in accordance with these rules from 1 December 2014.

Right to use arrangements: Firms are reminded that they must consider their client's best interests when agreeing to a "right to use" arrangement with a retail client for that client's custody assets. A blanket arrangement that automatically requires all retail clients to agree to right to use arrangements through a firm's standard terms of business would not be acceptable.

Custody recordkeeping, record checks and reconciliations:

The rules are being updated to accommodate firms that use integrated systems to maintain their records for custody assets. Firms will be required to maintain two sets of internal records of accounts: a client-specific safe custody asset record that identifies the custody assets the firm holds for each

particular client, and an internal record that includes all the assets the firm holds for its clients. These records may be created simultaneously based on the same information, but must be maintained separately and must be separate from records the firm has obtained from third parties.

All firms can use the internal custody reconciliation method to carry out their internal custody record checks, which must be performed on at least a monthly basis. This method will require firms to determine whether sufficient information is being recorded to enable them to comply with their custody asset obligations.

Firms that hold physical assets will be required to undertake a physical asset reconciliation using either the "total count method" or the "rolling stock method". Specific auditor assurance will not be required.

External custody reconciliations must be carried out at least monthly by comparing internal records with third party records. Where a firm is physically holding custody assets, such as paper share certificates, the firm will not be required to undertake an external custody reconciliation, but should conduct "spot checks" from time to time on whether title to a sample of physical custody assets that it holds is registered in accordance with the rules.

Firms will be required to review at least annually the frequency of these record checks and reconciliations.

The FCA has also clarified how record keeping discrepancies and shortfalls in custody assets should be resolved. Firms will be required to investigate discrepancies, which won't be resolved until the firm is holding the correct amount of custody assets and this is accurately reflected in the records. The FCA provides further guidance on when and how firms should make good a shortfall and when the affected client should be notified.

Firms will also be subject to more detailed notification and recordkeeping requirements and must maintain internal procedures and policies for their custody reconciliations.

In order to give firms time to make the required changes to systems and processes, these new rules will come into force on 1 June 2015, though firms may choose to comply before this date.

Changes affecting both custody rules and client money rules (CASS 6 and 7)

TTCA written agreements: The FCA is requiring all firms to have a written agreement in place for all title transfer collateral arrangements ("**TTCA"**). TTCA with new clients must be documented in written agreements in accordance with the final rules from 1 December 2014, though firms will have until 1 June 2015 to repaper existing client agreements. Note that MiFID II will ban TTCA for retail clients from January 2017.

TTCA procedure for switching: The new rules prescribe the mechanism firms should follow if a client requests protections under CASS for assets and monies subject to TTCA. This includes ensuring that the client's request and the firm's response are both documented. Firms have until 1 June 2015 to ensure compliance.

Delivery versus payment exclusion: The final rules set out exactly when a firm is allowed to cease to treat money as client money or cease to apply the custody rules to a custody asset, as applicable, while carrying out a "delivery versus payment" ("**DvP**") transaction through a commercial settlement system and ensure clients agree to these arrangements. Although the DvP window may not be available for the same length of time in relation to each transaction, in all cases it will be no longer than 3 business days. These rules will come into force on 1 December 2014, though firms will have until 1 June 2015 to ensure existing clients have agreed to, and the firm has documented, the arrangements.

Unclaimed client money: The FCA has clarified the existing rules providing firms with an optional mechanism to deal with allocated but unclaimed client money by giving it to charity if certain conditions are met, such as reasonable steps having been taken to trace the client. The FCA has provided an evidential provision setting out the steps a firm should take before paying out money. Any costs incurred must be paid out of the firm's own funds. Firms will also be permitted to pay away de minimis amounts of client money (£25 for retail clients and £100 for professional clients) after following an abbreviated procedure. Firms may not pay out money until at least 6 years following the last movement on the client's account. The final rules require a firm to unconditionally undertake to make good any valid claim. These rules come into force on 1 December 2014.

Unclaimed custody assets: The FCA is providing firms with a new optional mechanism to deal with unclaimed custody assets under the rules in the same way as unclaimed client money, subject to the same conditions. Firms must wait at least 12 years since the last contact from the client before transferring custody assets to a charity. These rules come into force on 1 December 2014.

Client money rules (CASS 7)

Changes to the client money rules will affect all firms who hold client money under CASS 7 but will not apply to general insurance intermediaries that only hold client money in accordance with CASS 5 or debt management firms that only hold, or will only hold, client money in accordance with CASS 11.

Application of the client money rules: The FCA is introducing certain amendments to the relevant rules and further guidance to clarify when the client money rules are applicable to a firm's activities.

Banking exemption: The FCA is clarifying the application of the exemption from the client money rules that banks may use and introducing new requirements around the notifications that banks must make to their clients when operating under the exemption. Firms should assess their own activities to determine whether they fall outside the exemption.

Trustee firms: The FCA is disapplying the client money distribution rules to client money held by a trustee firm. Trustee firms may, however, elect to comply with certain client money rules. Where a firm holds both trustee firm client money and non-trustee firm client money, those different pots of client money must be segregated and will be subject to different rules.

DvP exclusion for collective investment schemes: Authorised fund managers will be permitted to disapply the client money rules for a one-day window while carrying out a DvP transaction for the purpose of settling a transaction in relation to units in a regulated collective investment scheme. Money held beyond the business day following receipt must be segregated and treated in accordance with the client money rules. Firms will be obliged to obtain clients' agreement to these arrangements. These rules will come into force on 1 June 2015 in order to give firms time to analyse their business models and update their systems.

Payment of interest on client money: The FCA is clarifying when firms are and are not required to pay clients the interest earned on client money. Firms may contractually agree how much interest they will pay to clients, and clients must be notified in writing if not all interest is going to be paid.

Money ceasing to be client money: The rule changes include certain clarifications and revisions to accommodate transfer of business, unclaimed client money and a firm's legal obligations to pay client money to a third party. Money will cease to be client money if it is paid into a bank account of the client without the need to obtain the client's consent for each payment. However, firms may not make payments into a bank account of a client that has been opened without the client's consent.

Transfer of business – handling client money: The FCA is setting out requirements relating to transfer clauses in client agreements that will allow the firm to transfer client money to a third party in the context of a business transfer. Alternatively, a firm may obtain client consent at the time of the transfer. Neither form of consent is required if the firm holds a de minimis amount of client money per client, but notification requirements apply. Money will cease to be client money held by the transferring firm once it has been transferred to a third party in accordance with the rules.

Client bank accounts – due diligence and diversification: The FCA is enhancing the due diligence requirements that firms must carry out on banks

with whom they deposit client money. Firms must periodically assess whether they are appropriately diversifying the third parties with which they place client money and, following each assessment, make appropriate adjustments to the third parties and/or the amounts placed at each. Firms must keep a record of each periodic assessment. Firms will continue to be subject to the 20% limit on intra-group deposits, though a qualifying money market fund will no longer be considered a relevant group entity.

Unbreakable term deposits: Firms will be prohibited from placing client money in a deposit with an unbreakable term of more than 30 days. Trustee firms are carved out of this prohibition in relation to trustee firm client money.

Immediate segregation: Except where firms are using the alternative approach to client money segregation, they will be generally required to receive all client money directly into a client bank account. Where money is due and payable from a firm to a client, that money should be paid to the client or segregated in a client account within one business day of becoming due and payable. In order to accommodate the requirements of the European Market Infrastructure Regulation ("**EMIR**"), the final rules will permit firms who act as a clearing member of central counterparties ("**CCPs**") in certain situations to receive client money into a house account before transferring it to a client bank account so long as they maintain prudent segregation in their client bank account to address intra-day risk.

Physical receipts: The FCA is clarifying how firms should treat client money receipts in the form of cash and cheques and how these should be reflected in the internal client money reconciliation. Physical payments of client money should be recorded immediately and deposited in a client bank account within one business day, or held in a secure location as necessary. The rules also clarify how firms should treat post-dated cheques.

Cleared funds: The FCA is reiterating the principle that one client's money should not be used to fund another client's transactions. The rules also include explicit guidance that a firm must have adequate organisational arrangements to minimise the risk that client money may be paid for the account of a client whose money has not yet been received by the firm.

Allocation of client money receipts: Firms will be required to allocate client money received within 10 business days of receipt, and record it as "unallocated client money" in the interim. If a firm is unable to identify money it receives as client money, it may treat this as "unidentified client money" while taking all necessary steps to determine who the money belongs to.

Money due to client from firm: This guidance has now been made into a rule. Firms should segregate monies that become due to clients in line with this provision.

Prudent segregation: The FCA is setting out procedures and recordkeeping requirements that firms must follow if they assess that it would be prudent to segregate additional money in a client bank account to address specific

identifiable risks. Firms must establish a written policy setting out why the firm considers the use of prudent segregation a reasonable way to address each risk and how the firm will calculate the segregated amount.

Alternative approach to client money segregation: A firm must establish and document its reasons for using the alternative approach for a particular business line. It must assess whether the use of the alternative approach is appropriate for each business line, and calculate and maintain a "mandatory prudent segregation amount" ("**MPSA**") which must be reviewed quarterly and may require a change to systems and controls. Firms must obtain an auditor's report before operating the alternative approach or if it changes the way it calculates and maintains the MPSA. Firms must also create and maintain an "alternative approach record". A firm must review at least annually its reasons for continuing to use the alternative approach for each business line. It then has six months to stop using the alternative approach if that's what it concludes is appropriate.

Firms using the alternative approach may make intra-day adjustments to client bank accounts in certain circumstances.

All of the new rules relating to the alternative approach will apply from 1 December 2014, though firms operating an alternative approach for a particular business line on 1 November 2014 may continue to do so under the existing rules until 1 June 2015. Firms will also be required to use prudent segregation to address the risks to client money that may arise due to a firm using the alternative approach.

Client money held at third parties: In certain circumstances, a firm may allow a third party to hold client money, but the firm will remain responsible to the client for that money and must include the amount in its internal client money reconciliations. Any client monies held at a third party should be held in a client transaction account.

Client money relating to custody assets held at a custodian: The rules have been revised to clarify that where a firm deposits custody assets with a third party, any money arising from those assets should be treated as client money unless otherwise agreed and should either be held in a client bank account or in a client transaction account, as appropriate.

Client money recordkeeping and reconciliations: Under the new rules, firms will be required to undertake an internal client money reconciliation on a daily basis. This may be performed using one of two standard methods or, in certain circumstances, a non-standard method.

The FCA is introducing a new section, CASS 7.16, with detailed rules and guidance around the standard methods of internal client money reconciliation. Investment firms will be prohibited from using the "net negative add-back method" in certain cases, and the FCA will continue to keep this method under review.

In order to use a non-standard method of reconciliation, a firm must consider whether the method achieves the same specified outcome as a standard method. The firm must also obtain an auditor's report, which must be prepared on a reasonable assurance engagement. The auditor must opine on whether the proposed method is suitably designed and would achieve the desired outcome. These steps must be repeated whenever material changes are made to the non-standard method.

Firms will also need to carry out an external client money reconciliation at least once a month. Most firms will be required to review the frequency of this external reconciliation at least annually. Firms that undertake daily transactions in client money should undertake external reconciliations on a daily basis.

The new rules also introduce more detailed notification and recordkeeping requirements. Firms will be required to maintain records in a way that will enable them to determine within two business days the total amount of client money they should be holding for each client.

The new requirements for firms operating a non-standard method of internal client money reconciliation will come into force on 1 December 2014, though firms operating a non-standard method will not have to comply until 1 June 2015 or, if earlier, the date they materially alter their method of reconciliation. Firms may choose to comply with the new requirements before they come into force.

Acknowledgement letters: The FCA has introduced a template that firms must use when completing and exchanging acknowledgment letters with the third parties with whom they deposit or place client money. In all circumstances, firms will be required to have an acknowledgment letter in place before they place client money in the relevant account. This applies to overseas counterparties as well as UK accounts.

The new rules also provide guidance around the formalities involved when drafting and executing these letters in different circumstances and mandate how often and in what circumstances firms should review and update the letters they have in place.

Firms will have until 1 June 2015 to repaper existing client bank accounts and client transaction accounts. However, firms will be required to have new template acknowledge letters in place for any accounts opened after 30 November 2014.

CFTC Part 30 Exemption Order: The FCA is providing revised guidance for FCA-regulated firms that trade on behalf of U.S. customers on non-U.S. futures and options exchanges under the Part 30 Exemption Order issued by the Commodity Futures Trading Commission ("**CFTC**").

Multiple client money pools (CASS 7 and 7A)

The FCA is introducing provisions allowing clearing member firms of EMIR-authorised or recognised CCPs to offer multiple client money sub-pools in relation to net margined omnibus client accounts at CCPs. The intention is to support the porting of omnibus client accounts under EMIR. Segregation and diversification requirements will apply to each pool that a firm operates. Firms must use a template disclosure document when establishing a sub-pool and should notify the FCA at least two months before receiving client money for a sub-pool. The FCA has also amended the client money distribution rules so that they apply to the general pool and each sub-pool separately.

These rules will come into effect on 1 July 2014.

Mandate rules (CASS 8)

The FCA is introducing revised rules to ensure firms keep appropriate records of non-written as well as written mandates and remove the requirement on firms to hold records of all mandates indefinitely. The form and content of records to be retained around mandates have also been clarified.

Client reporting and information (CASS 9)

Regular reporting to clients: The FCA is requiring firms to honour client requests for information on their holdings of client assets, but will permit firms to agree to charge clients the reasonable costs for doing so. Where a firm provides a report to a client on its holdings of client assets for that client, the firm should ensure that it is clear from the report when assets or monies are, or are not, protected under either or both the custody rules and client money rules. These new requirements will apply from 1 June 2015.

Information to clients on safeguarding client assets: The FCA is requiring all firms subject to the custody rules or client money rules to provide the same information required by COBS 6.1.7R to all clients, regardless of client type or asset classification. Information currently provided only to retail clients will therefore need to be given to professional clients as well. These rules will come into force on 1 December 2014 for new clients and on 1 June 2014 for existing clients.

Client assets disclosure document: The FCA has decided not to proceed with its proposal for a client assets disclosure document at this time.

Linklaters

Next steps

Firms will need to review custody agreements for updates and clarifications in the light of the changes to CASS. Firms will also need review and update as necessary their systems and controls around segregation, record keeping and reconciliations and how they address client assets risks within their business.

All investment firms to which the CASS sourcebook applies will need to comply with the new rules by the relevant dates set out in Table 1 in Chapter 2 of the Policy Statement.

Author: Katherine Dossa and Christopher Bernard

Contacts

For further information please contact:

Michael Kent
Partner, Financial Regulation Group
(+44) 20 7456 3772
michael.kent@linklaters.com

Peter Bevan
Partner, Financial Regulation Group
(+44) 20 7456 3776
peter.bevan@linklaters.com

Martyn Hopper
Partner, Financial Regulation Group
(+44) 20 7456 5126
martyn.hopper@linklaters.com

Nadia Swann
Partner, Financial Regulation Group
(+44) 20 7456 5232
nadia.swann@linklaters.com

Carl Fernandes
Partner, Financial Regulation Group
(+44) 20 7456 3002
carl.fernandes@linklaters.com

Sarah Parkhouse
Partner, Financial Regulation Group
(+44) 20 7456 2674
sarah.parkhouse@linklaters.com

Harry Eddis
Partner, Financial Regulation Group
(+44) 20 7456 3724
harry.eddis@linklaters.com

Nikunj Kiri
Partner, Financial Regulation Group
(+44) 20 7456 3256
nikunj.kiri@linklaters.com

One Silk Street
London EC2Y 8HQ
Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com