

CP11/15**

Financial Services Authority

Client assets sourcebook:

- (1) Custody liens
- (2) Title transfer collateral arrangements

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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 29 August 2011 or 28 October 2011 as set out within.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_15_response.shtml.

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A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Acronyms used in this paper

CASS	Client assets sourcebook
CASS 6	Custody rules
CASS 7	Client money rules
CP	Consultation paper
CBA	Cost benefit analysis
CFD	Contract for difference
LBIE	Lehman Brothers International (Europe)
PS	Policy statement
TTCA	Title transfer collateral arrangements

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Overview

Introduction

- 1.1 The purpose of this Consultation Paper (CP) is to seek views on our proposals to amend the Client Assets Sourcebook (CASS).

Custody liens

- 1.2 Following the financial crisis and, in particular, the collapse of Lehman Brothers International (Europe) (LBIE) we have enhanced our client assets regime through proposals consulted upon in CP10/9¹ and made rules published in PS10/16.² One of the proposals included in CP10/9 involved prohibiting firms from granting inappropriate general liens over their clients' assets and client money derived from those assets.
- 1.3 The rules that were made following that consultation took into account the responses that we had received. However, two technical issues with those rules have subsequently been raised and we are consulting on rule amendments to address these issues. The proposed amendments are shown in Appendix 2 and are subject to a three month consultation period.
- 1.4 At the same time, we are also consulting on extending the current transitional provision which applies to agreements executed prior to the coming into force of these rules (1 March 2011) and which is due to expire on 1 October this year. We are also proposing to provide interim relief by switching off the rules for all other agreements currently subject to these rules. We propose that these arrangements will apply until 31 March 2012 to provide sufficient time for the consultation process, to address the two technical issues noted above, and to provide sufficient notice to firms of any amendments that are made.

1 *Consultation Paper 10/9: Enhancing the Client Assets Sourcebook* (March 2010), available at: www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_09.shtml

2 *Policy Statement 10/16: Client Assets Sourcebook (Enhancements) Instrument 2010* (October 2010), available at: www.fsa.gov.uk/pages/Library/Policy/Policy/2010/10_16.shtml

These proposals are shown in Appendix 1 and are subject to a one month consultation period.

Title transfer collateral arrangements

- 1.5 In CP10/15 chapter 8³, we consulted upon prohibiting the use of title transfer collateral arrangements (TTCA) with retail clients in all circumstances. TTCA are arrangements by which a client transfers to a firm full ownership of monies or assets for the purpose of securing or covering existing or future obligations. These arrangements have the effect of removing a client's monies or assets from the protections offered by CASS.
- 1.6 Following consultation, the FSA Board implemented rules in Handbook Notice 104 which prohibited the use of TTCA with retail clients in relation to only certain products (namely, spread betting and other contracts for differences (excluding rolling spot forex)). We are now consulting on extending the prohibition to include rolling spot forex contracts offered to retail clients.

Structure of this paper and next steps

- 1.7 There are a number of proposals in this paper. Chapter 2 (Custody liens) contains proposals on three different matters relating to the liens rules in CASS:
- The first relates to providing interim relief from the effect of the existing rules for a period of six months from 1 October 2011 expiring on 31 March 2012. The consultation period is **one month**. Subject to the consultation responses, we then plan to publish a Handbook Notice with made rules coming into force on 1 October 2011.
 - The second matter relates to changes in the rules to provide for the taking of certain liens or rights over omnibus client accounts.
 - The third relates to changes in the rules in relation to liens or rights over assets held in overseas jurisdictions.

The consultation period for proposals (b) and (c) above is **three months**, following which we intend to publish a Policy Statement in the first quarter of 2012, with rules coming into force in April 2012.

- 1.8 Chapter 3 (Title Transfer Collateral Arrangements) outlines our proposal to prohibit the use of TTCA in relation to rolling spot forex contracts offered to retail clients. The consultation for this proposal is **one month**. Subject to the consultation responses, we then intend to

³ *Consultation Paper 10/15: Quarterly consultation* (No. 25) (July 2010), available at: www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_15.shtml

bring these rules into force on 1 October 2011 and publish our feedback statement in a Handbook Notice.

	Proposal	Consultation close	Proposed commencement of new rules
Chapter 2	Interim relief for the application of the existing CASS lien rules	29 August 2011	1 October 2011
	Allowing certain custody liens over omnibus client accounts	28 October 2011	1 April 2012
	Clarifying the use of custody liens in overseas jurisdictions	28 October 2011	1 April 2012
Chapter 3	Prohibition on the use of TTCA in relation to rolling spot forex contracts	29 August 2011	1 October 2011

Who should read this CP?

1.9 This paper will be of interest to:

- all CASS firms;
- trade associations; and
- consumers.

1.10 The proposals in this paper do not apply to Insurance Intermediaries who only hold client money in accordance with CASS 5.

CONSUMERS

Our proposals relating to custody liens are designed to maintain a high level of consumer protection at an appropriate level of costs for consumers and firms.

Our proposals for rolling spot forex contracts are designed to enhance consumer protection. This should ensure that when retail clients provide client money or assets to firms in relation to rolling spot forex contracts, they receive the full protection available to them under CASS.

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Custody liens

- 2.1** Following the financial crisis and the collapse of LBIE, the FSA enhanced its client assets regime through proposals consulted upon in CP10/9⁴ and implemented following PS10/16.⁵ One of the proposals included prohibiting firms from granting inappropriate general liens over their clients' assets and client money derived from those assets. This was our response to an observation that some firms in the UK had allowed custodians and sub-custodians to include inappropriate general liens in their custodial agreements which could significantly delay or preclude the return of client assets and client money in the event of a firm failure. We also observed that many clients were not aware of, or had an insufficient understanding of, the risk associated with these types of lien.
- 2.2** The proposal to prohibit inappropriate general liens was supported by most respondents, but there was a strong view, particularly amongst custodians and prime brokers, that the rules should provide for three legitimate exceptions of a lien or right granted over a client's assets or client money derived from those assets:
- in respect of properly incurred charges and liabilities relating to that client's assets or money;
 - if required by a securities depository, securities settlement system or central counterparty to facilitate the settlement of that client's trades; and
 - if required as a condition for accessing an overseas jurisdiction.
- 2.3** The final rules were introduced to apply to new agreements from 1 March 2011 and will come into force for other agreements on 1 October 2011.
- 2.4** Following the publication and coming into force of the final rules, a number of firms and various trade associations representing custodians and brokers approached us. They found that although they agree with the policy behind the rules, the form in which the rules were made would require them to change their current business models in which assets are generally held

⁴ *Consultation Paper 10/9: Enhancing the Client Assets Sourcebook* (March 2010), available at: www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_09.shtml

⁵ *Policy Statement 10/16: Client Assets Sourcebook (Enhancements) Instrument 2010* (October 2010), available at: www.fsa.gov.uk/pages/Library/Policy/Policy/2010/10_16.shtml

in omnibus accounts and liens are taken over the assets in those accounts. We have also been told of some issues with the rule relating to liens over assets in overseas jurisdictions.

- 2.5 This chapter discusses proposed changes to rules covering general liens, specifically the requirements for using the exceptions found in CASS 6.3.6R. The proposed changes will apply to all firms offering custodial services to which our custody rules apply. The text of these proposed amendments is contained in the draft **Client Assets Sourcebook (Collateral Transfer and Liens Amendment) Instrument 2011** reproduced in Appendix 1 to this Consultation Paper and the draft **Client Assets Sourcebook (Liens Amendment) Instrument 2011** reproduced in Appendix 2 to this Consultation Paper.
- 2.6 We consider the use of inappropriate general liens to be a threat to our consumer protection objective, considering the complexity of the agreements and the risk to client assets. We are of the view that our regulatory response to the market failure identified in CP10/9 has had unforeseen consequences. The proposals in this paper are aimed at addressing these consequences.

Consultation period

- 2.7 This chapter contains proposals on three different matters. As the table following paragraph 1.8 shows, the first relates to interim relief for a period of six months from 1 October 2011 expiring on 31 March 2012. The consultation period for this proposal is *one month*. We would typically give respondents two months to reply to a consultation on a matter of this type, but have decided in this instance that a shorter consultation period is justified. This is because we wish to put in place these interim measures before 1 October 2011, which is when the current transitional provisions expire.
- 2.8 *Any comments on this proposal should reach us by 29 August 2011.* Subject to the consultation responses, we then plan to publish a Handbook Notice with made rules coming into force on 1 October 2011.
- 2.9 Again, as the table following paragraph 1.8 shows, the second matter relates to changes in the rules relating to custody liens to enable the taking of certain liens over omnibus client accounts. The third relates to liens over assets held in overseas jurisdictions. The consultation for our proposals on these topics is a period of *three months*.

- 2.10 *Any comments on these proposals should reach us by 28 October 2011.* Subject to the consultation responses, we intend to publish a Policy Statement in the first quarter of 2012 with made rules coming into force in April 2012.

Interim relief

- 2.11 We are proposing to re-introduce guidance at CASS 6.3.3G(4) requiring firms to consider any liens when entering into custody agreements while we, in effect, temporarily switch off the rules relating to the prohibition on inappropriate general liens. We consider that the guidance remains relevant alongside the proposals set out below so we are proposing that this guidance is in force for the period while we consult on the proposals below and then remains in force alongside the proposed rules.
- 2.12 To do this we propose to extend the current transitional provisions for six months from 1 October 2011 and to switch off the prohibition on liens for all agreements currently subject to these rules for the same period. We are now consulting on having these measures in place for a period of six months from 1 October 2011 to expire on 31 March 2012, following which we propose that the new rules come into force on 1 April 2012.

Q1: Do you agree with our proposal to switch off CASS 6.3.5R for all agreements subject to this rule for six months from 1 October 2011 expiring on 31 March 2012?

Omnibus accounts

- 2.13 The main issue brought to our attention regarding the prohibition of liens in CASS 6.3.5R concerns its application to omnibus accounts. As currently set out in CASS 6.3.6R, the rules permit liens to be granted by a firm to a custodian only over a specific client's assets and associated client money in respect of custody fees and liabilities relating to services for that client. In practice, clients' assets are often placed by a firm in omnibus accounts with custodians. These accounts are opened as client accounts in the name of the firm, usually a broker, asset manager or other intermediary, rather than in individual accounts for each underlying client of the firm. Custodians have told us that, although identifiable in the firm's books and records, it is not easy or in some cases possible for the custodian to identify which specific assets belong to each individual underlying client of the firm. Even where this is possible, the cost of doing so is significant under their current business models. So if the custodian wishes to take a lien over the assets it holds, to comply with the current rules, the firm would either have to open individual client accounts at the custodian for each underlying investor or require the custodian to change its business model so that it was able to reference each asset held on behalf of the firm for each of that firm's clients. We

understand that these costs are likely to be passed on to the firm's clients. We also understand some custodians are refusing to do business without the ability to obtain liens over their omnibus accounts.

2.14 We propose amending CASS 6.3.6R to permit liens over omnibus client accounts covering properly incurred charges and liabilities arising from the provision of custody services in respect of the assets held within a given omnibus client account.

Q2: Do you agree with our proposal to permit a lien or right over an omnibus client account where it is confined to properly incurred charges and liabilities arising from the provision of custody services in respect of the assets held within that account?

2.15 The problem is similar with omnibus accounts held at securities depositories, in securities settlement systems and at central counterparties as CASS 6.3.6R(2) requires the purpose of the lien or right to be for facilitating the settlement of a particular client's trades. We are proposing to amend CASS 6.3.6R(2) to permit liens over an omnibus account held at these institutions for the purpose of facilitating the settlement of trades in respect of the assets held in that account.

Q3: Do you agree with our proposal to permit liens over omnibus accounts held at securities depositories, in securities settlement systems and at central counterparties for the purpose of facilitating the settlement of trades in respect of the assets held in those accounts?

Overseas jurisdictions

2.16 CASS 6.3.6R(3) permits liens over clients' assets and associated client money in jurisdictions outside the UK, provided that: (a) the lien is required as a result of local law or as a necessary precondition for participation in that market; and (b) the firm has taken reasonable steps to determine that the lien is in the client's best interests.

2.17 We have been told of two issues with the practical application of this rule:

- 'necessary precondition' may be too strict a requirement as firms have had different degrees of success in negotiating to remove liens from agreements with custodians in overseas jurisdictions – where just one firm is able to remove a lien (due to market strength or otherwise), it casts doubt on whether other firms are in compliance with this requirement; and

- taking ‘reasonable steps’ does not seem appropriate in circumstances in which certain clients have requested or where the firm is required to hold assets in that jurisdiction.

2.18 In light of this feedback, we propose amending the existing ‘necessary precondition’ requirement in CASS 6.3.6R(3) to allow firms to grant liens over clients’ assets when this action is necessary for *that firm* to gain access to a local market.

2.19 We are making this proposal to incorporate a degree of flexibility in the application of this rule, and to reflect the fact that firms may have unequal bargaining power when negotiating terms with custodians or sub-custodians. We recognise that what might be a necessary action for one firm in an overseas jurisdiction may not always be necessary for another firm operating in the same jurisdiction.

Q4: Do you agree with our proposed amendments to CASS 6.3.6R(3)(a) so that general liens may be granted over clients assets in overseas jurisdictions if such a lien is necessary for an individual firm to gain access to a local market?

2.20 CASS 6.3.6R(3) also requires a firm to take reasonable steps to establish that the placing of money or assets is in the best interests of the firm’s client.⁶ Firms have commented that this test is not relevant in the context of professional clients who instruct the custodian to hold their assets in a foreign jurisdiction and where custodians are not typically expected to provide ‘advice’ on which jurisdictions are more favourable than others. In recognition of this, we propose that a firm may comply with this rule if it either takes reasonable steps to establish that the grant of the lien is in the best interests of the client, or it has received a specific instruction from a professional client to hold assets or money there irrespective of such a lien or right. This option would only be relevant if the firm has complied with the first limb of CASS 6.3.6R(3) and is satisfied that the lien is necessary for the firm to hold assets in the overseas jurisdiction.

Q5: Do you agree with our proposal to change CASS 6.3.6R(3)(b) so that general liens may be granted over clients assets in overseas jurisdictions (without the firm taking reasonable steps to establish that the grant of the lien is in the best interests of the client) if a professional client has instructed that the asset be held in that jurisdiction?

⁶ For firms subject to the ‘client’s best interests rule’ in COBS 2.1.1R, this requirement is part of that more general obligation which continues to apply to those firms’ business. For other firms, this requirement is a separate obligation.

- Q6:** Do you think that our proposal to change CASS 6.3.6R(3)(b) should be specifically limited to situations where the professional client is not provided with advice as to where the assets should be held?

3

Title transfer collateral arrangements (TTCA)

- 3.1** In July 2010, we published in a Consultation Paper (CP10/15, chapter 8)⁷ proposals to limit the application of our TTCA provisions in CASS, chapter 6 (custody rules) and chapter 7 (client money rules), so that they can only be used in relation to non-retail clients. Following consultation, the FSA Board made rules⁸ which affected spread betting and contract for difference (CFD) business specifically identified in our pre-consultation work as areas with market failures.
- 3.2** This chapter introduces further proposed changes to our provisions for TTCA and associated guidance in CASS. The proposed changes will apply to all firms offering rolling spot forex contracts to retail clients to which our custody rules or client money rules apply. The text of these proposed amendments is contained in the draft **Client Assets Sourcebook (Collateral Transfer and Liens Amendment) Instrument 2011** reproduced in Appendix 1 to this CP.

Consultation period

- 3.3** We are consulting on this proposal for *one month*. We would typically give respondents two months to reply to a consultation on a matter of this type, but have decided in this instance that a shorter consultation period is justified. The proposed changes articulated in this chapter were largely covered in our original consultation on this topic. Furthermore, the identified risks to consumers remain as originally published. We are also aware that the industry has generally been expecting us to extend our rules in this area to rolling spot forex contracts.

⁷ *Consultation Paper 10/15: Quarterly consultation (No. 25)* (July 2010), available at: www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_15.shtml

⁸ *Handbook Notice 104* (November 2010), available at: www.fsa.gov.uk/pubs/handbook/hb_notice104.pdf

- 3.4 *Any comments should reach us by 29 August 2011.* Thereafter, we plan to issue a Handbook Notice with made rules coming into force 1 October 2011, including transitional provisions effective until 31 October 2011.

Background

- 3.5 TTCA are arrangements by which a client transfers to a firm full ownership of monies or assets for the purpose of securing or covering existing or future obligations. This means that, in the event of a firm failure, a client would risk ranking as an unsecured general creditor in relation to his or her monies and assets which have been transferred to the firm under TTCA. This contrasts with the position of a client whose money and/or assets are protected under CASS 6 and/or 7. Such a client would, in the case of a firm failure, have a proprietary claim for the return of money and assets not already appropriated to satisfy the client's obligations to the firm.
- 3.6 We undertook focused supervision visits in 2009 and discovered that firms in the CFD industry (including spread betting) were using TTCA to remove retail clients' money from our client money protections. Both spread betting and rolling spot forex contracts are typically offered as a specific type of CFD.
- 3.7 We consider the use of TTCA provisions to remove retail clients' assets and money from the protections in CASS to be a potential risk to the FSA's consumer protection and market confidence objectives. While professional clients are, under normal circumstances, capable of appreciating and calculating counterparty risk, this is often not the case for retail clients. Excluding retail clients' assets from client assets protection effectively assumes retail clients should be able to assess those risks. However, retail clients are generally less able to appreciate or scrutinise the resulting credit risk. For retail clients, the expectation is that firms hold money balances as client money and assets under the protections of CASS and only appropriate those monies and assets as and when amounts become due and payable to the firm. This avoids the client bearing the credit risk of the firm's default.
- 3.8 In CP10/15, chapter 8,⁹ we set out our concerns regarding the use of TTCA with retail clients and consulted on the basis that the risk generated when firms use TTCA to exclude retail clients from the protection of the CASS regime outweighed any potential benefit. We proposed rules and guidance to limit application of our provisions on TTCA and other associated provisions contained within the custody rules (CASS 6) and the client money rules (CASS 7), so that they can only be applied to non-retail clients.
- 3.9 It has been difficult to identify precisely all firms which use TTCA with retail clients, as no comprehensive source of this data is available. In our original consultation it became apparent that we had not identified all firms that use TTCA with retail clients, in particular some offering rolling spot forex contracts (as a specific type of CFD). This was because we

⁹ Readers are encouraged to review the relevant sections of CP10/15 and Handbook Notice 104. Our analysis of this topic as it relates to rolling spot forex contracts remains largely unchanged.

initially focused on products where we already were aware of abuse – namely spread betting and related CFD product providers.

- 3.10** The draft Handbook text included in this original consultation was expressed to apply to firms providing all types of products to retail clients. However, we published Handbook Notice 104 which limited the application of TTCA so that firms offering spread betting and other general CFD products (excluding rolling spot forex) could only use TTCA in relation to non-retail clients. At the time we committed to further reviewing the necessity of extending these restrictions to other products and services.

Additional work

- 3.11** Since the publication of CP10/15, we have closely reviewed the market for rolling spot forex contracts. These contracts are usually offered as a specific type of CFD. We have observed a large overlap in the markets for rolling spot forex contracts, spread betting and more general CFDs and in most cases, these products are offered by the same providers. Although we captured some firms that offer rolling spot forex contracts in our initial cost benefit and market failure analysis (because they also provided spread bets and other CFDs), the consultation revealed that our original analysis had not captured an adequate representation of the retail market for rolling spot forex contracts.
- 3.12** Although it is possible to offer a rolling spot forex contract as a futures contract, we are not aware of any such products being provided to retail clients.¹⁰ In general, our observations in this paper are limited to firms that offer a rolling spot forex contract as a CFD. Nonetheless, we recognise that firms could potentially restructure their rolling spot forex contracts as future contracts.
- 3.13** As we have previously reiterated¹¹, we have always taken the view that the use of TTCA is not an approach likely to be appropriate in the case of retail clients. We still hold this view. As a result, our proposed rule amendments do not distinguish between those rolling spot forex contracts offered as a CFD or a futures contract.
- 3.14** Additionally, our provisions for TTCA appear both within the custody (CASS 6) and client money (CASS 7) rules. In general, our observations relate only to the use made of TTCA to remove retail clients from the protections of our client money rules. However, the changes we intend to make in this area will continue to apply to both the client money and custody rules for the purpose of ensuring consistent protection of both retail clients' money and assets.

¹⁰ For reference, the FSA Handbook defines a 'rolling spot forex contract' as either of the following:

- (a) a future, other than a future traded or expressed to be as traded on a recognised investment exchange, where the property which is to be sold under the contract is foreign exchange or sterling; or
- (b) a contract for differences where the profit is to be secured or loss avoided by reference to fluctuations in foreign exchange; and in either case where the contract is entered into for the purpose of speculation.

¹¹ CP 10/15, page 53; see also *Policy Statement 07/2: Implementing the Markets in Financial Instruments Directive (MiFID)* (January 2007), page 26, available at: www.fsa.gov.uk/Pages/Library/Policy/Policy/2007/07_02.shtml

- 3.15** We remain committed to considering other contexts in which investment firms may use, or attempt to use, TTCA with retail clients for the purpose of removing their client money or assets from the protections afforded in CASS. Although our current proposals extend to rolling spot forex contracts, firms can expect this topic to form part of our future efforts in reviewing our client money and custody rules.

Proposed amendments

- 3.16** Given the background set out above, we propose prohibiting the use of the provisions for TTCA contained within our custody and client money rules in relation to rolling spot forex contracts entered into with retail clients.
- 3.17** The policy objective behind this proposal is to strengthen the protections available to retail clients under CASS when they place money or assets with investment businesses.

Q7: Do you agree with our proposal to prohibit the use of TTCA with rolling spot forex contracts offered to retail clients in the form both of futures and CFDs?

Annex 1:

Cost benefit analysis

1. Before proposing new rules, we are obliged under section 155 of FSMA to publish a cost benefit analysis (CBA), unless we consider the proposed rules will give rise to no costs or to an increase in costs of minimal significance.
2. This CBA is divided into two parts. The first part covers our proposed amendments to the custody rules as they relate to custody liens. The second part relates to our proposed amendments to the provisions on TTCA in both our custody rules and our client money rules.

Part 1 – custody liens

3. The first part of this CBA is an estimate of the costs and analysis of the benefits that would arise as a result of our proposed amendments to our custody rules as they relate to the use of custody liens. This is a statement of the differences between the position that will arise as a result of our proposals and a baseline of what would happen if no further changes were made to our rules on custody liens in CASS 6.3.5R and 6.3.6R.

Scope

4. Our analysis in this section is based upon regulatory data and the responses we received to a limited survey we conducted with two trade associations. In the survey, members of these trade associations were asked how these proposals would impact their business and the associated costs. As of the publication date of this paper, only one trade association responded with a consolidated response to our survey together with an individual response from one firm. These proposals potentially affect approximately 1,300 UK authorised firms with permission to engage in the regulated activity of safeguarding and administering investments.¹
5. The rules we introduced in PS10/16 sought to mitigate the market failure originally identified in CP10/9 in a proportionate manner. However, our rules as currently implemented have had unintended consequences. The amendments we now propose to

¹ These 1,300 firms were originally identified in *Consultation Paper 10/9: Enhancing the Client Assets Sourcebook* (March 2010) (CP10/9), available at: www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_09.shtml

these rules are aimed at addressing these unintended consequences to ensure we achieve our original policy intention. Firms will remain able to choose to comply with the rules as originally implemented in PS10/16 if they so wish as the proposed rules will continue to include all the exceptions to the prohibition on general liens as published in PS10/16.

Interim relief

6. We are proposing to extend the current transitional provisions for our rules on custodian liens in CASS 6 for an additional six months from 1 October 2011 and to switch off the prohibition on liens for new business for this same period.

Costs

7. We expect this proposal to carry no additional costs to firms. Firms which are already in compliance (or set to be in October) with the rules published in PS10/16 may choose to continue to implement these rules changes as originally planned. This proposal gives firms additional time to meet our requirements.
8. There will be a potential detriment to consumers as our prohibitions on general liens will not take full effect for a longer period of time. However, we understand that many firms have not started to 're-paper' their custodian agreements and will as a result be unable to comply with our rules as they currently stand on 1 October 2011. Therefore, we consider any potential additional detriment (as a direct result of this additional time) to consumers to be limited.

Benefits

9. The proposal will provide legal certainty to firms regarding the FSA requirements concerning liens, allowing firms to continue using arrangements whereby they have certain liens over omnibus client accounts.

Omnibus accounts

10. We are proposing to amend CASS 6.3.6R to permit liens over omnibus client accounts covering properly incurred charges and liabilities arising from the provision of custody services in respect of the assets held within those accounts.

Costs

11. When a lien is exercised over assets in an omnibus account there is some cross-subsidisation between clients as they share in the loss equally rather than in proportion to the liabilities relating to their assets. For this reason, there is likely to be a marginal increase in risk to some clients due to the potential for cross-subsidy between clients whose assets are held in this way.

12. There will be no additional costs associated with reviewing existing custody agreements as compared to our original consultation in CP10/9, because our current requirements in CASS 6.3.5R and CASS 6.3.6R already require firms to review and if relevant ‘re-paper’ their custody agreements.²
13. Some firms may decide to ‘re-paper’ existing agreements, if the firm has already ‘re-papered’ to comply with CASS 6.3.5R and now chooses to take advantage of the opportunity these proposals present. If the firm ‘re-papers’ this will generate an additional cost. However, we should point out that a firm which is already in compliance with our rules as currently implemented will not need to ‘re-paper’ in order to meet compliance with the requirements in these proposals.

Benefits

14. This policy ensures that firms offering custody services and custodians can continue operating omnibus accounts under their current business models which deliver cost savings to intermediaries and investors. It also continues to address the underlying policy behind the introduction of CASS 6.3.5R and CASS 6.3.6R, namely the prevention of inappropriate general liens in custody agreements.
15. Under this proposal, clients will also remain able to access certain markets without having to incur the additional costs associated with the maintenance of individual segregated accounts. We understand from the additional evidence gathered that almost all UK firms hold safe custody assets in omnibus accounts.³ For this reason, requiring firms to incur the expense of setting up a large number of individual accounts at custodians for the benefit of an underlying client may in effect make it uneconomical for this same client to make certain investments. We were not aware of the extent of the potential cost to firms and clients when we published our made rules in PS10/16. Prior to this we had conducted various pre-consultation exercises and surveys, conducted conversations with trade associations and considered the consultation responses, none of which suggested that this would be an issue.

Overseas jurisdictions

16. We are proposing to make technical amendments to CASS 6.3.6R(3) so that this rule more appropriately reflects legitimate circumstances in which firms may allow general liens over clients’ assets and associated client money held in an overseas jurisdiction. This includes allowing firms to grant liens when this is necessary for the individual firm to gain access to a given market. We are also proposing to amend the rules to provide firms the option to allow a lien over a professional client’s assets and associated client money if the firm, having met

² In CP10/9, we estimated a median cost of £17,500 per firm would be involved in reviewing agreements.

³ One trade association provided an estimate that between 80% and 100% of safe custody assets in the UK are held in omnibus client accounts.

17. the applicable law or market access requirement, has also received specific instructions from a professional client to hold its assets in a given jurisdiction irrespective of such a lien or right.

Costs

18. As with our proposed amendments to CASS 6 to allow liens over omnibus accounts, this proposal may also cause firms to review their existing custody agreements and/or to 're-paper' their existing agreements.⁴
19. Should a wide-ranging general lien be exercised over assets held in an overseas jurisdiction there is potential for significant losses to be incurred by the client. We recognise that our rules as currently implemented could effectively limit the ability of firms to grant general liens; however, we think this could often be done at the expense of the ability of clients to do business in certain jurisdictions with their current providers. We consider this potential cost to clients to be outweighed by the ability of those same clients to do business in emerging markets which may require such a lien.
20. This risk to clients is further mitigated by our existing rules on clients' best interests, or because if the relevant client is appropriately classified as a professional client, they may have instructed their assets to be held in a given jurisdiction notwithstanding the existence of the lien. We expect this category of clients to be able to assess the risk associated with these jurisdictions and to mitigate appropriately.

Benefits

21. The policy ensures that firms can continue to offer custody services in overseas jurisdictions where the grant of a lien over clients' assets is as a result of local applicable law or necessary for them to gain access to that jurisdiction. This enables clients to continue using existing arrangements and to avoid incurring the expense of switching providers.

Q8: What are your views on the benefits and costs of our proposed policy measures relating to custody liens?

⁴ See the costs we have identified in the previous section on our proposals which relate to omnibus accounts.

Part 2 – Title transfer collateral arrangements (TTCA)

22. The remainder of this CBA is an estimate of the cost and an analysis of the benefits that will arise from extending our prohibition on the use of TTCA with retail clients to rolling spot forex contracts. This is a statement of the differences between the position that will arise as a result of our proposals and a baseline of what would happen without any requirements related to TTCA for rolling spot forex contracts.

Scope

23. Our analysis is in large part based on the cost benefit analysis we published with our original proposals in CP10/15.⁵ We have used the survey data collected in advance of this original consultation and supplemented it with further survey data collected later on. We have now approached the 12 FSA-authorized firms we are currently aware provide rolling spot forex services to retail clients and hold client money.
24. The survey respondents were asked to provide the client money balances, costs and a description of the impact if they were required to segregate all retail client monies they hold currently benefitting from the TTCA provisions. We received a total of 11 completed survey responses from firms that provide rolling spot forex contracts to retail clients. We consider these responses sufficient to provide an adequate representation of the retail market for rolling spot forex contracts.
25. Most of the costs and benefits of this proposal were already included in the CBA we published in CP10/15 on our proposals related to TTCA, even though rolling spot forex contracts were not ultimately included in the scope of the final handbook rules. Following the original consultation, our work uncovered only one additional firm offering rolling spot forex contracts that did not segregate client money, bringing the total number of firms identified utilising TTCA in relation to rolling spot forex contracts entered into with retail clients to two. Between these two firms, approximately £9.4m⁶ in retail client money is held unsegregated (compared with a total of approximately £528.5m in retail client money held segregated by firms that offer rolling spot forex contracts).

Costs

26. Nine out of 11 respondents reported that they do not use TTCA to avoid segregating retail clients' money. These firms indicated in their survey responses that they would incur no costs associated with extending this prohibition to rolling spot forex contracts entered into with retail clients.

5 *Consultation Paper 10/15: Quarterly consultation (No. 25)* (July 2010), available at: www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_15.shtml

6 This balance excludes any un-segregated balances held for clients that firms have informed us will be re-classified as elective professional clients in accordance with COBS.

27. The two remaining firms in this sample reported using TTCA to avoid segregating retail clients' money. These firms are likely to incur both one-off and ongoing costs as a result of this rule change.
28. The one-off costs for these two firms will come from having to arrange refinancing in order to segregate retail client money that is not currently segregated⁷ together with a small proportion of costs for system upgrades and the 're-papering' of client agreements.⁸ We estimate these costs to represent a total of £0.26m.
29. The ongoing costs relate to the increased cost of capital as retail client money can no longer be used for business financing. We estimate them to represent a total of about £1.44m annually.⁹ We understand that this may in turn affect the pricing offered to consumers. However, we view these effects as benefits relating to pricing policies and business models which could otherwise cause detriment to consumers and financial markets. We also note that as most firms offering rolling spot forex contracts to retail clients are currently segregating all retail client money, this demonstrates that it should be possible for a firm to operate under a business model which segregates retail client money.

Benefits

30. In implementing this proposal for rolling spot forex contracts, previously unsegregated balances in respect of these contracts would be required to be segregated and protected by the CASS regime. This means that retail clients will not bear the full credit risk of the firm's default.
31. Additionally, having now consulted and made rules in this area expressly not applicable to rolling spot forex contracts, we understand some firms who do not currently utilise TTCA with rolling spot forex contracts offered to retail clients may start doing so. Prohibiting the use of TTCA with rolling spot forex contracts offered to retail clients may also prevent potential consumer detriment if – in the absence of rules in this area – the number of firms offering TTCA to retail clients were to grow.¹⁰

Q9: What are your views on the benefits and costs of our proposed policy measures relating to title transfer collateral arrangements and rolling spot forex contracts?

7 We understand that for some firms, the total un-segregated amounts represent the funds used to hedge against their clients' positions, and therefore for them to continue to hedge against their clients' positions they will need to raise an equivalent amount for the un-segregated retail client balances. Where applicable, the one-off costs set out in this section represent an approximation of the costs of raising the additional working capital required and the changes to the systems and client agreements. The ongoing cost largely represents an approximation of the servicing of the refinancing (e.g. loan interest payments) of an equivalent amount to the un-segregated retail client balances.

8 The total one-off cost is based on the average cost of £0.13m per firm multiplied by the 2 respondents who are not segregating all of the retail client money they hold.

9 The total on-going cost is based on the average of £0.72m per firm multiplied by the 2 respondents who are not segregating all retail client money they hold.

10 Thematic work undertaken by the FSA, the responses we received to CP10/15 and informal conversations with industry participants suggest that some firms may choose to utilise TTCA to exclude their retail clients from CASS protections on similar terms if they are aware that some of their competitors do so.

Annex 2:

Compatibility statement

1. Our statutory objectives are set out in section 2(2) of FSMA. Our proposed amendments relate mainly to our consumer protection and, to some extent, to the FSA's market confidence statutory objectives. Given our understanding of the way the market operates, we consider that our proposals are the most appropriate way to achieve our objectives.
2. By introducing rules prohibiting inappropriate general liens whilst allowing custodians to continue to operate under their current business models, our proposals are aimed at providing clients certainty that their assets are held subject only to appropriate liens and that those assets are not at risk of being used to settle an unrelated liability. Our proposals should lead to firms reviewing their custody agreements and as appropriate entering into new agreements which will ensure that consumers are protected. We also expect our proposals to have a positive impact on market confidence by ensuring that market participants understand their position in the event of insolvency of an investment firm.
3. We also expect our proposed amendments to the provisions on TTCA in CASS 6 and 7 to provide enhanced consumer protection and to have a positive impact on market confidence. Our proposals should provide retail clients the appropriate level of protection for their client money and assets and, in turn, send a message to retail clients that the UK market applies a high level of consumer protection to investment business carried on here. They should ensure that all retail clients that provide client money to regulated firms in relation to rolling spot forex contracts are provided with protection under CASS.
4. Section 2(3) of FSMA requires that, in carrying out our general functions, we must have regard to a number of specific matters and in particular to the principles of good regulation.
5. We have had regard to the principle of proportionality in good regulation. Given our understanding of the way firms operate, we consider that the benefits to consumers and the market generally, as discussed above in this paper, outweigh the burdens or restrictions within our proposed rules.
6. We also have had regard to the requirement to minimise the adverse effects on competition that may arise from our activities and the desirability of facilitating competition between the firms we regulate. Our proposals relating to custodial liens clarify that we do not

expect custodians to operate differently from established international models of business. Relative to our proposals for rolling spot forex contracts, we believe, as previously explained, that it should be possible for a firm to operate under a business model which segregates retail client money as most firms offering rolling spot forex contracts to retail clients are currently segregating all retail client money.

Annex 3:

List of questions

- Q1:** Do you agree with our proposal to switch off CASS 6.3.5R for all agreements subject to this rule for six months from 1 October 2011 expiring on 31 March 2012?
- Q2:** Do you agree with our proposal to permit a lien or right over an omnibus client account where it is confined to properly incurred charges and liabilities arising from the provision of custody services in respect of the assets held within that account?
- Q3:** Do you agree with our proposal to permit liens over omnibus accounts held at securities depositories, in securities settlement systems and at central counterparties for the purpose of facilitating the settlement of trades in respect of the assets held in those accounts?
- Q4:** Do you agree with our proposed amendments to CASS 6.3.6R(3)(a) so that general liens may be granted over clients assets in overseas jurisdictions if such a lien is necessary for an individual firm to gain access to the local market?

- Q5:** Do you agree with our proposal to change CASS 6.3.6R(3)(b) so that general liens may be granted over clients assets in overseas jurisdictions (without the firm taking reasonable steps to establish that the grant of the lien is in the best interests of the client) if a professional client has instructed that the asset be held in that jurisdiction?
- Q6:** Do you think that our proposal to change CASS 6.3.6R(3)(b) should be specifically limited to situations where the professional client is not provided with advice as to where the assets should be held?
- Q7:** Do you agree with our proposal to prohibit the use of TTCA with rolling spot forex contracts offered to retail clients in the form both of futures and CFDs?
- Q8:** What are your views on the benefits and costs of our proposed policy measures relating to custody liens?
- Q9:** What are your views on the benefits and costs of our proposed policy measures relating to title transfer collateral arrangements and rolling spot forex contracts?

Appendix 1:

Client Assets Sourcebook (collateral transfer and liens amendment) draft instrument 2011

**CLIENT ASSETS SOURCEBOOK (COLLATERAL TRANSFER AND LIENS
AMENDMENT) INSTRUMENT 2011**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 138 (General rule-making power);
 - (2) section 139 (Miscellaneous ancillary matters);
 - (3) section 156 (General supplementary powers); and
 - (4) section 157(1) (Guidance).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 1 October 2011.

Amendments to the Handbook

- D. The Client Assets sourcebook (CASS) is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Client Assets Sourcebook (Collateral Transfer and Liens Amendment) Instrument 2011.

By order of the Board
[date]

Annex

Amendments to the Client Assets sourcebook (CASS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

6 Custody rules

6.1 Application

...

Title transfer collateral arrangements

- 6.1.6 R (1) The *custody rules* do not apply where a *client* transfers full ownership of a *safe custody asset* to a *firm* for the purpose of securing or otherwise covering present or future, actual, contingent or prospective obligations.
- [Note: recital 27 to *MiFID*]
- (2) Excepted from (1) is a transfer of the full ownership of a *safe custody asset*:
- (a) belonging to a *retail client*;
 - (b) whose purpose is to secure or otherwise cover that *client's* present or future, actual, contingent or prospective obligations under a *contract for differences* ~~(other than or a rolling spot forex contract)~~ that is a future, and in either case where that contract is entered into with a firm acting as market maker; and
 - (c) which is made to that *firm* or to any other *person arranging* on its behalf.
- 6.1.6A R (1) Subject to (2), where a *firm* makes arrangements for the purpose of securing or otherwise covering present or future, actual, contingent or prospective obligations of a *retail client* those arrangements must not provide for the taking of a transfer of full ownership of any of that *client's safe custody assets*.
- (2) The application of (1) is confined to the taking of a transfer of full ownership:
- (a) whose purpose is to secure or otherwise cover that *retail client's* obligations under a *contract for differences* ~~(other than or a rolling spot forex contract)~~ that is a future, and in either case where that contract is entered into with a firm acting as market maker; and

- (b) which is made to that *firm* or to any other *person* arranging on its behalf.

...

6.3 Depositing assets and arranging for assets to be deposited with third parties

...

- 6.3.3 G A *firm* should consider carefully the terms of its agreements with third parties with which it will deposit *safe custody assets* belonging to a *client*. The following terms are examples of the issues *firms* should address in this agreement:

...

- (4) ~~the restrictions over the third party's right to claim a lien, right of retention or sale over any *safe custody asset* which the *firm* holds for its *client*, or a right of set-off over any *client money* derived from that *safe custody asset*.~~

...

...

7 Client money rules

...

7.2 Definition of client money

...

Title transfer collateral arrangements

- 7.2.3 R (1) Where a *client* transfers full ownership of *money* to a *firm* for the purpose of securing or otherwise covering present or future, actual or contingent or prospective obligations, such *money* should no longer be regarded as *client money*.

[Note: recital 27 to *MiFID*]

- (2) Excepted from (1) is a transfer of the full ownership of *money*:
- (a) belonging to a *retail client*;
- (b) whose purpose is to secure or otherwise cover that *client's* present or future, actual, contingent or prospective obligations under a *contract for differences* ~~(other than or a *rolling spot forex contract*)~~ that is a *future*, and in either case where that contract is entered into with a *firm* acting as *market maker*; and

(c) which is made to that *firm* or to any other *person* arranging on its behalf.

7.2.3A R (1) Subject to (2), where a *firm* makes arrangements for the purpose of securing or otherwise covering present or future, actual, contingent or prospective obligations of a *retail client* those arrangements must not provide for the taking of a transfer of full ownership of any of that *client's money*.

(2) The application of (1) is confined to the taking of a transfer of full ownership:

(a) whose purpose is to secure or otherwise cover that *retail client's* obligations under a *contract for differences* ~~(other than or a rolling spot forex contract)~~ that is a future, and in either case where that contract is entered into with a firm acting as market maker; and

(b) which is made to that *firm* or to any other *person* arranging on its behalf.

...

TP 1 Transitional Provisions

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
...					
8A	CASS 6.3.5R	R	The <i>rule</i> listed in column (2) <u>does not apply.</u>	1 October 2011 until 1 October 2011 31 March 2012	1 October 2011
9	CASS 6.1.6R (2) and CASS 6.1.6AR	R	The <i>rules</i> to which column (2) refers do not apply in relation to an agreement that would otherwise be prohibited by CASS 6.1.6AR <u>as a result of its application to a rolling spot forex contract.</u>	1 December 2010 to 31 December 2010 1 October 2011 until 31 October 2011	1 December 2010 1 October 2011
		G	Notwithstanding the operation of CASS TP 1.1(9)R, a <i>firm</i> should as soon as reasonably practicable modify its		

			contractual agreement with that <i>retail client</i> so as to remove its ability to utilise that title transfer collateral arrangement.		
10	CASS 7.2.3R (2) and CASS 7.2.3AR	R	The <i>rules</i> to which column (2) refers do not apply in relation to an agreement that would otherwise be prohibited by CASS 7.2.3AR as a result of its <u>application to a <i>rolling spot forex contract</i></u> .	1 December 2010 to 31 December 2010 <u>1 October 2011 until 31 October 2011</u>	1 December 2010 <u>1 October 2011</u>
		G	Notwithstanding the operation of CASS TP 1.1(10)R, a <i>firm</i> should as soon as reasonably practicable modify its contractual agreement with that <i>retail client</i> so as to remove its ability to utilise that title transfer collateral arrangement.		

Appendix 2:

Client Assets Sourcebook (liens amendment) draft instrument 2011

CLIENT ASSETS SOURCEBOOK (LIENS AMENDMENT) INSTRUMENT 2011

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 138 (General rule-making power);
 - (2) section 139 (Miscellaneous ancillary matters);
 - (3) section 156 (General supplementary powers); and
 - (4) section 157(1) (Guidance).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 1 April 2012.

Amendments to the Handbook

- D. The Client Assets sourcebook (CASS) is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Client Assets Sourcebook (Liens Amendment) Instrument 2011.

By order of the Board
[*date*]

Annex

Amendments to the Client Assets sourcebook (CASS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

6 Custody rules

...

- 6.3.5 R Subject to CASS 6.3.6R, in relation to a third party with which a *firm* deposits *safe custody assets* belonging to a *client*, a *firm* must ensure that the agreement with that third party relating to the custody of those assets does not include the grant to that ~~third~~ party, or to any other *person*, of a lien or a right of retention or sale over the *safe custody assets*, or a right of set-off over any *client money* derived from those *safe custody assets*.
- 6.3.6 R Subject to CASS 6.3.8R, a *firm* may conclude an agreement with a third party relating to the custody of *safe custody assets* which ~~does confer~~ confers on that ~~third~~ party, or on another *person* instructed by that party to provide custody services for those assets, a lien, right of retention or sale, or right of set-off in favour of that ~~third~~ party or that other *person* ~~if and only if~~ that lien or right:
- (1) is confined to ~~an individual client's safe custody assets or client money~~ those safe custody assets held in an account with that third party or that other person and extends only to ~~that third party's (or a sub-custodian's, where a sub-custodian is appointed by that third party)~~ properly incurred charges and liabilities arising from the provision of custody services ~~to that client~~ in respect of safe custody assets held in that account; or
 - (2) arises under the operating terms of a securities depository, securities settlement system or central counterparty in whose books or accounts ~~a client's client money or~~ those safe custody assets ~~is or~~ are recorded or held, and provided that it does so for the purpose only of facilitating the settlement of ~~that client's~~ trades involving those assets; or
 - (3) arises in relation to ~~a client's~~ those safe custody assets or client money held in a jurisdiction outside the *United Kingdom*, provided that:
 - (a) it does so as a result of local applicable law or ~~as a necessary precondition for participation in a local market~~ is necessary for that firm to gain access to a local market; and
 - (b) in respect of each of the clients to which those assets belong, either:

- (i) the *firm* has taken reasonable steps to determine that holding those assets ~~or that money~~ subject to ~~such a~~ that lien or right is in the best interests of ~~that client~~ those clients; or
- (ii) where a *client* is a *professional client*, the *firm* is instructed by that *client* to hold those assets in that jurisdiction notwithstanding the existence of that lien or right.

6.3.7 R For the purpose of CASS 6.3.6R, references to a *safe custody asset* include any *client money* derived from that *safe custody asset*.

6.3.8 R CASS 6.3.6R does not permit a *firm* to agree to a right of set-off of the kind prohibited by either CASS 7.8.1R or CASS 7.8.2R in relation to *client money*.

...

TP 1 Transitional Provisions

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
...					
<u>8B</u>	<u>CASS 6.3.5R</u>	R	<u>The <i>rule</i> listed in column (2) does not apply in relation to agreements executed before 1 April 2012.</u>	<u>1 April 2012 until 30 April 2012</u>	<u>1 April 2012</u>

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