Policy Statement

10/16

Financial Services Authority

Client Assets Sourcebook (Enhancements) Instrument 2010

Feedback on CP10/9 and made rules

Financial Services Authority

October 2010

Contents

This Policy Statement reports on the main issues arising from Consultation Paper 10/9: *Enhancing the Client Assets Sourcebook* and publishes final rules.
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List of acronyms used in this paper

Client Asset Sector (CASS Sector)

Client Assets sourcebook (CASS)

CASS Operational Oversight Controlled Function (CF10a)

Client Money and Assets Return (CMAR)

Collective Investment Scheme (CIS)

Committee of European Securities Regulators (CESR)

Compliance Oversight Controlled Function (CF10)

Conduct of Business sourcebook (COBS)

Cost benefit analysis (CBA)

European Commission (EC)

European Economic Area (EEA)

Financial Services Compensation Scheme (FSCS)

Firm reference number (FRN)

Individual Liquidity Adequacy Standards (ILAS)

Insolvency Practitioner (IP)

International Organization of Securities Commissions (IOSCO)

International Swaps and Derivatives Association (ISDA)

Lehman Brothers International (Europe) (LBIE)

Markets in Financial Instruments Directive (MiFID)

Markets in Financial Instruments Implementing Directive (MiFID Implementing Directive)

Over the counter (OTC)

Prime brokerage agreement (PBA)

Significant Influence Function (SIF)

Special purpose vehicles (SPVs)

Qualifying Money Market Fund (QMMF)

Undertakings for Collective Instruments in Transferable Securities (UCITS)

Part I

1 Overview

1.1 In CP10/9 *Enhancing the Client Assets Sourcebook (CASS)* we proposed a number of policies to enhance the protections offered by CASS in response to issues highlighted by the global financial crisis and a number of insolvency appointments – most notably that relating to the insolvency of Lehman Brothers International (Europe) (LBIE). Although the UK client asset regime has performed relatively well in facilitating the early return of client assets and money (compared with some overseas jurisdictions), the failure of LBIE and the financial crisis in general highlighted a number of issues relating to existing market practices. By introducing the rules contained within this Policy Statement, we aim to enhance standards of client protection in the UK, as well as market confidence and financial stability.

1.2 During the consultation period we participated in the LBIE Client Money Appeal hearing, which gave judgment on a number of provisions in the Client Money Rules on 2 August 2010.[1] We gave the case careful consideration to ensure that the judgment of the LBIE Appeal hearing would not adversely affect the policies proposed.

1.3 We understand that certain parties in the case will be seeking leave from the Supreme Court to appeal a number of issues in the judgment of the Court of Appeal. Following the final determination of the LBIE litigation, however, we consider it likely that a comprehensive review of CASS will be necessary to ensure that it continues to provide the required degree of client protection and market certainty. A comprehensive review of the regime can only be undertaken following the final determination of LBIE, which may be subject to further appeal to the Supreme Court and potentially to the European Court of Justice.

1.4 The consultation closed on 30 June 2010 and we received 50 responses from trade associations, buy and sell-side firms, compliance consultancies, auditors, lawyers and individuals, in addition to the extensive pre-consultation exercise we undertook to review the market. We have also taken account of responses to the Treasury's consultation documents, which considered effective resolution arrangements for investment banks.[2] CP10/9 developed several of the specific client money and assets

1 [2010] EWCA Civ 917

2 *Developing effective resolution arrangements for investment banks* (May 2009) (www.hm-treasury.gov.uk/consult_investment_banks.htm) and *Establishing resolution arrangements for investment banks* (December 2009) (www.hm-treasury.gov.uk/consult_investment_banks2.htm).

proposals[3] that the Treasury asked the FSA to consider, addressing the following areas in particular:

- increased re-hypothecation disclosure and transparency in the prime brokerage community;
- enhanced client money and assets protection; and
- increased CASS operational oversight.

European Commission

1.5 We are liaising with the Treasury over notification of the European Commission (EC) – under Article 4 of the Markets in Financial Instruments Implementing Directive (MiFID Implementing Directive) – that our proposal to require prime brokers to report to clients on a daily basis is super-equivalent to the relevant provisions within that Directive. The EC was also notified, on a precautionary basis, about the other policy proposals in this paper which might be interpreted as super-equivalent. We regard each of the proposals notified as necessary in view of the risks and issues that have become evident as a result of the financial crisis. We will publish the notification in due course. We will also continue to participate and influence European policy making at the Level 3 Committees and subsequent European Supervisory Authorities.

Launch of the Client Asset Sector

1.6 We launched a specialist unit – the Client Asset Sector (CASS Sector) – on 3 June 2010, to increase our focus on the regulation of client assets in the United Kingdom. The sector has brought together staff responsible for policy, data collection, monitoring and analysis, who support the horizontal and thematic supervision of firms that hold and control client money. We expect the results of our data analysis and supervision projects to inform policy development.

Policy work undertaken in 2010

1.7 We have consulted in quarterly consultations to limit the use of Title Transfer Collateral Arrangements and adding guidance to the Money Due and Payable to the Firm provisions (CP10/15). We have also taken the opportunity to correct the typographical error contained within CASS 7.7.2 R in relation to the statutory trust (CP10/10), which had caused some firms to misunderstand the policy intent underlying the rules.

3 Specifically, we considered proposals 12 to 19 as numbered in Annex A of *Establishing resolution arrangements for investment banks* (December 2009).

1.8 During 2010 we have also reviewed the special purpose vehicles (SPVs) that were established by certain prime brokers to hold client assets in insolvency-remote vehicles. See Part III of this paper for our report of the SPVs.

1.9 We also published CP10/20 Improving the auditor's report on client assets on 27 September 2010, which proposes amendments to our Handbook to drive improvements in the quality and consistency of the auditor's report on client assets.

1.10 We have conveyed messages through 'Dear CEO' letters, which highlight the importance we attach to the adequate protection of client assets and our continued intention to pursue a credible deterrence agenda where we find failings in firms' systems and controls.

Future work

1.11 As we noted in CP10/9, we plan to consult on a number of areas to ensure that the CASS regime delivers the desired level of client protection, financial stability and market confidence. We will continue to work with Treasury to develop effective and proportionate resolution regimes for firms.

1.12 In particular, firms can expect future consultations to focus upon:

- improvements to the Part IV permission regime for firms that hold and control client money;
- the effectiveness of CASS Chapter 7.8 (notification and acknowledgement of trust);
- a review of CASS 5 Client money: insurance mediation activity; and
- a review of CASS 7 Client money rules (once the final judgment in the LBIE client money hearing has been given).

Key issues

1.13 While we received widespread support to enhance the protections offered by the CASS regime, we received mixed feedback on the proposals relating to:

- the prime brokerage disclosure annex;
- daily reporting to prime brokerage clients;
- restricting client money deposits intra-group; and
- prohibiting general custodian liens.

1.14 Although we plan to address a number of the detailed concerns raised by respondents, we will generally implement the proposals we consulted on.

1.15 We consulted on the basis that we would implement a number of the policy proposals as soon as the made rules came into force. We accept, however, that a rapid implementation period may be difficult for a number of firms. So, in the interests of proportionality and the principles of good regulation, we have decided

to phase in the proposals over the course of 2011 with transitional periods where necessary. For a summary of commencement dates please see Annex 2 and the made rules at Appendix 1.

Structure of the paper

1.16 Each chapter of this paper summarises the comments we received on questions asked during consultation. We provide our response and describe any significant changes that we have made to the Handbook text that we published as part of the Consultation Paper.

1.17 Some respondents made general comments that did not address the specific consultation questions posed. We have summarised these where appropriate in Chapter 2. Many respondents addressed several questions together, particularly answering questions on the cost benefit analysis when responding to other questions. We have addressed these responses, where applicable, in the most appropriate chapter rather than repeating the discussion several times.

1.18 We have addressed the issues as follows:

- Chapter 2 addresses the general feedback;
- Chapter 3 explains the changes we have made to enhance disclosure and transparency requirements for prime brokers;
- Chapter 4 provides details of the enhanced client money and asset protection that will result from the proposed new rules and guidance;
- Chapter 5 describes measures to increase our CASS operational oversight;
- Chapter 6 describes our post implementation review of the insolvency-remote special purpose vehicles that have been created by a number of institutions that hold client money and assets;
- Annex 1 provides a list of non-confidential respondents to CP10/9;
- Annex 2 summarises the commencement dates; and
- Appendix 1 contains the Handbook text.

Who should read this Policy Statement?

1.19 This Policy Statement will be of interest to regulated firms and groups who hold the relevant client money and assets permissions, their senior management and staff with client money and/or assets responsibility, their trade associations and those who intend to hold or control client money. This paper may also be of interest to consumers, who will benefit from enhanced protection as a result of the proposed rules changes.

Cost benefit analysis (CBA)

1.20 We have received some comments relevant to the CBA to which we have responded in the relevant sections below. The comments we have received have not required a change in our analysis.

1.21 Some respondents have noted that enhancing the protections offered by the CASS sourcebook may, in some cases, result in higher costs to firms which will ultimately be passed on to clients. We made this point in CP 10/09 and the analysis is therefore not altered.

Next steps

1.22 The made rules attached to this Policy Statement will come into force over the course of 2011. The commencement dates will require work from regulated firms and the FSA to ensure that the new system for categorising firms as small, medium or large for the purposes of the Client Money and Assets Return (CMAR) is in place by June 2011. To collect the relevant data from firms, we intend to contact all firms with the relevant permissions in January 2011, asking them to confirm their largest monthly client money balance and value of client assets held during the 2010 calendar year by the end of January 2011. Please see Chapter 5 for further information.

Consumers

We received comments from a small number of consumers and the Consumer Panel who were supportive of our objectives and policy proposals. While the policy proposals are integral to consumer protection, market confidence and financial stability and aim to strengthen the protection provided to the clients of regulated firms, the proposals are most relevant to regulated firms who hold and control client money and assets.

Part II

2 General feedback and specific responses from firms

General feedback

2.1 The feedback we received was generally supportive of the steps we were proposing to take to enhance the client protections offered by CASS, and in doing so strengthen market confidence and financial stability. Under Principle 10 a firm must arrange adequate protection for clients' assets when it is responsible for them. In relation to the insolvency of LBIE, one trade association noted that the market now anticipates that the CASS regime will offer a quicker and more certain return of client assets than the equivalent USA regime.

2.2 We also received a number of responses from firms, trade associations and industry experts about specific issues we did not consult on in CP10/9. We have summarised some of this feedback and provided our response below. We will respond to the other feedback we received directly with the respondents in due course.

Specific issues

The insolvency regime and criminal sanctions

2.3 One firm and some trade associations considered the proposals to be insufficient and thought we should pursue changes to insolvency law and consider criminal sanctions for breaches of the rules. The responses also stated that client assets as a class within an insolvency should be given automatic seniority and priority of distribution. Some respondents suggested that extensions to the Financial Services Compensation Scheme (FSCS) should be considered. These types of proposals, however, would require amendments to primary legislation and/or a fundamental review of the CASS regime. We are working with the Treasury on the broader investment bank resolution arrangement consultations and we will keep this area under review in light of any proposals the Treasury suggests for legislative change. We plan to review the CASS regime once we have the final determination from the LBIE Client Money litigation (see further below).

Financial Services Compensation Scheme (FSCS)

2.4 The policy proposals in CP10/9 would not fundamentally alter the diversification requirements relating to client money deposits. A small number of respondents questioned how the FSCS would address pooled claims against deposits held on a secondary pooling event. While we will not address the FSCS in this policy paper, we acknowledge that the CASS Sector has a role to educate the market and participants about how the CASS regimes and FSCS interact.

CASS Sector and enforcement

2.5 A number of responses welcomed our increased focus on the adequate protection of client assets and the credible deterrence agenda we have pursued for enforcement cases.

LBIE Client Money Appeal

2.6 During the consultation period, we participated in the LBIE Client Money Appeal hearing, which gave judgment on a number of provisions in the client money rules. We gave the case careful consideration to ensure that the judgment of the LBIE hearing did not adversely affect the policies proposed in CP10/9.

2.7 We received feedback from a representative group of lawyers asking us to delay the consultation until after the final determination of the LBIE proceedings. However, our view is that the proposals set out in CP10/9, which seek to enhance the standard of protection provided by the CASS regime, are sufficiently distinct from the issues that are currently the subject of the proceedings and do not depend on the final resolution of the relevant court cases. Following the final determination of the LBIE proceedings, however, it is likely that we will wish to conduct a further comprehensive review of CASS. This review will only be undertaken once the final judgment has been handed down.

2.8 One trade association felt that, while CASS is not flawed as a regime, it could be made clearer in parts – but there are constraints in doing this before the final determination of the litigation. One law firm supported the planned review of CASS, as described above.

UK competitiveness

2.9 A small number of respondents noted that, following the proposed changes, the UK may offer a higher standard of protection for clients than other jurisdictions, and that this could impair the competitiveness of the UK financial sector. We are firmly of the belief that the CASS regime has generally helped to make the UK a more attractive place to undertake investment business because clients have had a relatively high degree of confidence that their money and assets will be returned in an insolvency.

2.10 Following the insolvency of LBIE and the resultant market instability, it became clear that confidence in the UK CASS regime had been damaged. We consider that this loss in confidence may, to a certain extent, have been based on perceived weaknesses rather than fundamental flaws in the regime. We believe, however,

that the measures we intend to take to enhance the regime, together with the Government's wider review of resolution regimes for investment banks, will help to restore confidence in the UK financial system and maintain the competitiveness of London as a global financial centre.

2.11 The FSA Consumer Panel asked us to keep international developments under review, and we will continue to lead the debate about client asset regulation at the International Organization of Securities Commissions (IOSCO) and the Committee of European Securities Regulators (CESR).

Miscellaneous comments

2.12 A number of respondents noted that many clients have only a limited understanding of the CASS and insolvency regimes. In recent months, we have taken the opportunity to improve firms' and clients' understanding of the regime by speaking at public events, engaging relevant trade associations, and participating in industry workshops. Further external communication work is planned for the rest of 2010. In particular, we are planning to hold an industry seminar in Q4 2010 that will be of interest to firms and their senior executives responsible for client money and assets.

2.13 One respondent asked if firms that had the relevant Part IV permission to hold client money and assets would be captured within the scope of the rules if they did not actually hold client money and assets. The rules are drafted to capture any firm with the relevant permissions. Firms that hold the necessary permissions, but do not hold client money or assets in practice, may apply for a variation of Part IV permission to ensure that their permission scope accurately reflects the activities they are undertaking. We plan to consult further on possible improvements to the way in which firms' authority to hold client money and permission to hold client assets is recorded.

3 Increased re-hypothecation disclosure and transparency in the prime brokerage community

3.1 In Chapter 2 of CP10/9 we consulted on a series of proposed measures designed to increase transparency in the prime brokerage market – in particular, rules requiring prime brokers to include a disclosure annex in their client agreements and rules requiring prime brokers to report to clients on a daily basis.

Scope

3.2 The made rules attached to this Policy Statement only apply to UK-authorised prime brokers who hold client money and/or assets, and overseas branches of these UK firms. They also apply to UK branches of prime brokers incorporated in a non-European Economic Area (EEA) third country who are subject to CASS. While we could have extended the scope of these requirements to the UK branches of incoming EEA prime brokerage firms conducting Markets in Financial Instruments Directive (MiFID) business – we decided to restrict the scope to UK-authorised prime brokers only. These rules will now form part of CASS.

3.3 We will consider whether these requirements should be applied more broadly to other market participants who enter into rights of use arrangements – for example, private wealth management businesses. To avoid doubt, the made rules have been clarified to ensure they do not apply to pure wealth management business, as this is outside the definition of *prime brokerage services*.

Record-keeping requirements

3.4 The Treasury asked us to consider whether there was scope to strengthen the CASS record-keeping requirements. We did not consider that any additional record-keeping requirements were necessary and asked for comments from the industry on this point.

3.5 In the CP we asked:

> Q1: Do you agree that existing CASS record-keeping requirements are sufficient? If not, please outline where you consider these could be enhanced.

3.6 The feedback we received confirmed that participants considered existing record-keeping requirements to be sufficient.

3.7 A small number of respondents noted that record-keeping requirements are only sufficient if a firm is in compliance.

Our response

We agree with the feedback we received and will retain the current record-keeping requirements in CASS.

While compliance is a general issue, we have recently created a CASS Sector to improve compliance with CASS and pursue a credible deterrence agenda against individuals and firms who fail to discharge their responsibilities. As part of this agenda, we will review the quality of firms' record keeping and take appropriate action if we discover failings.

Glossary definitions of prime brokerage

3.8 When drafting the Consultation Paper we were aware of the difficulties surrounding the definition of a prime brokerage firm, the services it provides and the agreements it enters into with clients. Prime brokers are usually (but not exclusively) global investment banks providing a wide range of client services, and we sought feedback on whether the proposed glossary definitions were accurate and comprehensive.

3.9 The draft definitions were as follows:

prime brokerage agreement	an agreement between a *prime brokerage firm* and a *client for prime brokerage services*.
prime brokerage firm	a *firm* that provides *prime brokerage services* and which may do so acting as *principal*.
prime brokerage services	a package of services which comprise each of the following: (a) *custody* or *arranging safeguarding and administration of assets;* (b) clearing services; and (c) financing, the provision of which includes each of the following: (i) capital introduction; (ii) margin financing; (iii) *stock lending*; (iv) stock borrowing; (v) entering into repurchase or reverse repurchase transactions; and which, in addition, may comprise consolidated reporting, other operational support and related services.

3.10 In the CP we asked:

> Q2: Do you agree with our proposed glossary definitions regarding prime brokerage as stated above?

3.11 One respondent asked whether a company dealing on own account only would be captured (i.e. a MiFID firm dealing as principal that did not hold client money

or assets). If a firm was only acting on its own account/dealing as principal, it would not be captured. This is because the application of the policies discussed in this Policy Statement is dependent on the firm actually holding client money and/or client assets, neither of which it would have if it was acting only as principal. However, to avoid doubt, we have expanded the definition of *prime brokerage firm* to require the provision of prime brokerage services 'to a client'.

Our response

Respondents agreed with the definitions for *prime brokerage agreement* and *prime brokerage firm*, so we confirm our definitions of these – apart from the addition to the definition of *prime brokerage firm* of 'to a client' following *'prime brokerage services'*.

3.12 A minority of respondents accepted the proposed definition of *prime brokerage services* as drafted. Some feedback suggested that the definition we consulted on was broadly fit for purpose, but could be refined by making the list of activities non-exhaustive and by excluding specific businesses, such as central securities depositories, international securities depositories and wealth management.

3.13 We agree with these comments and have included, as part of the definition of *prime brokerage services*, the expectation that a prime broker will have a right to use or re-hypothecate safe custody assets under the *prime brokerage agreement*. We believe that this amendment to the drafting will correctly identify prime brokers but exclude custodians, wealth management and securities depositories.

3.14 Some firms stated that, while the definition for *prime brokerage services* captured the activities the largest prime brokers undertook, it included activities that the smaller firms in the market did not provide. One consultancy practice also suggested that we should include additional services, such as corporate actions and derivative transactions to the definition (again supporting a non-exhaustive list of activities with the definition).

3.15 We do not believe there was sufficient support for an expansion of the proposed definition for *prime brokerage services*. If we were to open the list of services included, so that instead of each of those services it included one or more of those services, it would not capture the inherent package of services involved with prime brokerage. However, we consider the list of financing services within (c) of the proposed definition to be more flexible and we have amended this to include 'one or more' of the listed financing services instead of each of them. This will help to ensure that even small prime brokerage firms fall within the definition.

3.16 A small number of respondents suggested that the definition should be based on activities defined within prime brokerage agreements. However, this would be difficult to enforce against and would be unworkable in practice.

3.17 Other respondents questioned the narrow scope of the definition, which we consider to be appropriate given the small number of prime brokers. We estimated a market of 35 firms – a number that one trade association thought was an over-estimate. Accordingly, we consider the final instrument as amended will capture UK authorised prime brokers.

Our response

We have amended the definition of *prime brokerage services* to include the fact that a *prime brokerage firm* will have a right to use safe custody assets under the *prime brokerage agreement*. We have also widened the definition to include a firm which, in addition to the other requirements, only carries out one or more of the listed methods of financing.

Increasing transparency through a disclosure annex

3.18 In CP10/9 we proposed to introduce a requirement for contractual re-hypothecation provisions to be summarised in a disclosure annex attached to each prime brokerage agreement (PBA). Although brief, the annex would highlight the relevant definitions, including client indebtedness and the contractual limit on re-hypothecation, and it would include a statement setting out the risk to the client's assets if the prime broker defaults. It would also cross-reference the detailed provisions in the PBA, which may help reduce the amount of time spent conducting the legal due diligence undertaken by an Insolvency Practitioner's (IP's) legal adviser following a prime broker's collapse.

3.19 In the CP we asked:

> Q3. Do you agree that we should introduce a requirement that the re-hypothecation clauses be summarised in a separate annex to the PBA and/or other relevant contractual documentation which contains such provisions?

3.20 Responses to this proposal were mixed, but generally the disclosure annex was supported by the buy-side and opposed by the sell-side.

3.21 This proposal provides a relatively high level of protection for professional clients in a sophisticated market where it might be assumed that they are capable of safeguarding their interests. We received feedback that this annex would offer greater protection than other agreements, such as the International Swaps and Derivatives Association (ISDA) agreements. While we are mindful of this point, and we understand that the relationship between prime brokers and their clients is usually considered to be wholesale in nature, we are also conscious that a large number of wholesale clients manage very large amounts of money and financial instruments on behalf of retail clients.

3.22 We are also aware, from experience of the financial crisis, that standards of due diligence and monitoring undertaken by institutional clients are highly variable. Efforts to improve market disciplines in this area without explicit regulatory intervention have enjoyed mixed success. In light of these considerations, we will implement the proposed rules largely on the basis set out in CP10/9.

3.23 Firms requested 12 months to re-paper their existing agreements, rather than the six-month period consulted on, and said that we should have regard to EU directive developments in implementing the disclosure annex. We understand, however, that

the largest prime brokers have no more than a couple of hundred clients and we believe that the 1 March 2011 commencement date should allow enough time to re-paper agreements.

3.24 A number of respondents criticised our statement that the annex would speed up an insolvency proceeding because they said that the annex might be expressed such that the underlying PBA (rather than the annex) would remain the determinative expression of the parties' legal obligations. No doubt bespoke legal analysis would still have to be undertaken on individual client agreements. In any event, this is only one aspect of the policy outcome, which is primarily designed to increase the quality of information provided to the clients of prime brokers. We therefore expect firms to incorporate appropriate disclaimers into the disclosure annex.

3.25 Some responses thought that an industry-led response to this issue would be appropriate – for example, a generic industry explanatory guide for clients. These respondents suggested that non-binding industry guidance should be produced to address re-hypothecation. Unfortunately, in pre-consultation exercises it became clear that there was insufficient industry support for market-led solutions in this area, so we do not consider this proposal to be viable. Additionally, the form of disclosure proposed by respondents who favoured a market-led initiative would not achieve the policy outcomes described in paragraph 3.18 above.

3.26 Firms suggested that the disclosure annex should be introduced for new clients only (to avoid the repapering exercise), but we consider the policy should operate fairly so that previous clients are not disadvantaged. An added benefit of this is that the repapering exercise will improve the poor documentation and compliance observed in many of the firms we visited.

3.27 One trade association noted that, while the PBA disclosure annex would be useful, the annex should be short, informative and understandable rather than repeating the PBA clauses. Respondents supported the non-binding nature of the annex. Some respondents noted that the disclosure requirements should be placed within the Conduct of Business(COBS) sourcebook – however, since this requirement will only apply to UK-authorised prime brokers, and to increase the consolidation of the location of requirements applicable to the holding of client money and/or assets, we will retain the requirements in CASS. As a consequence, and to ensure that the requirements cover all clients, we have also decided to move the 'daily reporting to clients' requirement to CASS.

3.28 One firm suggested that re-hypothecation be limited to client indebtedness. This is a policy option that we considered – however, our view was that it would be a disproportionate response, which fails to appreciate that re-hypothecation is an efficient financing mechanism when it is used appropriately, and that it would, if implemented, adversely affect the competitiveness of the UK market. For example, most funds are indebted to their prime broker. In return for reduced financing rates, the funds allow their prime broker to use an equivalent value of assets, plus a margin ('haircut'), which is usually determined by the liquidity and/or quality of those assets. Treasury Bills or gilts usually have a haircut of 10%, whereas emerging market

equity haircuts are usually closer to 40%. Restricting re-hypothecation to 100% of indebtedness could force a significant part of the prime brokerage market offshore.

3.29 One consultancy argued that we should require the PBA to be in writing. We consider that CASS 6.5.1R – 6.5.2R and CASS 7.3.1R – 7.3.2R would require any agreement that affects client money or assets to be in writing to comply with the CASS regime.

3.30 One firm suggested that the cost of the disclosure annex would be higher than we anticipated in CP10/9. The additional costs anticipated were two additional resources within a documentation unit at a cost of £40,000 per person, plus a cost of £20,000 to update the existing template and two weeks' of a senior lawyer's time. This estimate is not inconsistent with the CBA – where we estimated an average cost of £80,000 (median of £17,500) and therefore does not change the results of the overall analysis.

Our response

Responses to this proposal were broadly balanced, with a slight majority supporting the introduction of this requirement for prime brokers. We accept that in most cases the PBA will continue to be the authoritative account of the parties' legal obligations to one another. The purpose of the disclosure annex is to highlight relevant clauses to clients in a clear, accurate and succinct way. Clients are still likely to want to review the operational re-hypothecation clauses themselves and/or in conjunction with their legal advisers. We therefore envisage that a disclosure annex will incorporate appropriate language clarifying its legal status. The disclosure annex will assure us that clients are informed about the risks that are inherent in a complex part of the wholesale market, and it will help ensure that documentation is properly executed.

3.31 In CP10/9 we asked:

> Q4: Are there any other transparency and/or disclosure issues we should consider?

3.32 Most comments addressing this question were incorporated in response to Question 3. Two respondents suggested we also consider set-off provisions, but these would be subject to common law, contractual negotiation, and might also include third parties for valuation purposes. We do not rule out the possibility of introducing more prescription in this area, but it is outside the scope of this consultation and would require further detailed consideration. We also received further feedback stating that we should compel firms to disclose which assets have been re-hypothecated. This information will be mandated in the daily prime brokerage report (see below).

3.33 We also received feedback suggesting that some contracts are not complete or are confusing for clients. The PBA disclosure annex will require firms to consider their agreements and we remind firms of their obligations contained within CASS to have appropriate records and documentation under our existing rules.

Our response

We have considered the additional issues raised, but we are not taking any further action in this regard.

Reporting to prime brokerage clients

3.34 Following the failure of LBIE, many clients and counterparties did not have access to recent information about their accounts. So we consulted on the proposal that prime brokers should offer daily reporting to all clients.

3.35 The relevant European requirement in MiFID only requires reporting on an annual basis. However, following LBIE, client demand forced prime brokers to develop enhanced reporting platforms for clients and daily reporting represents current best practice in the market. Most prime brokers offer a client portal, through which funds can access their portfolios.

3.36 In CP10/9 we asked:

> Q5: Do you agree that we should introduce a requirement that prime brokers offer daily reporting to all clients?

3.37 We received support for the daily prime brokerage report, with many respondents stating that the report would provide useful information to market players and support the aims of market confidence and financial stability. The buy-side commented that this would be useful and would assist risk management practices, but were concerned with any fee rises. However, we believe that the costs associated with this proposal have already been incurred by the prime brokers as a one-off cost, which should not materially affect fees in the medium to longer term.

3.38 One trade association noted that the policy had already been taken up by the market and implementing it as a rule would not add value. However, we believe that the rule is required to level the playing field for the buy side, who face an inequality in bargaining power in their relationship with their prime broker. We received support to enshrine current market practice in the rulebook – for example, only the largest funds were able to negotiate daily reporting in the immediate aftermath of the LBIE failure. We also received feedback stating that the implementation period should be 12 months rather than six months. However, in considering the technical and procedural requirements necessary to implement this provision, we still consider the 1 March 2011 commencement date to be achievable.

3.39 One consultancy firm stated that clients should have the ability to opt-out of the daily reporting. We also recognise that MiFID generally permits more sophisticated clients to opt-out of receiving annual reports. However, given the high number of smaller buy-side clients, the result of an opt-out for the daily prime brokerage report would be that small clients would have to accept less frequent reporting as part of the prime broker's standard terms of business agreement. This would potentially allow their prime brokers to re-hypothecate their assets more aggressively than for clients who receive daily reporting. This would mean that only the largest funds can request daily reporting to manage their exposure to the prime broker. Clients would

not have to access the information, but we believe it is necessary to level the playing field by introducing standard reporting for all clients.

Our response

Given the support we received to introduce this requirement, we will proceed with our proposal.

3.40 We asked in CP10/9:

Q6: Do you agree that we should require that the daily report contain at the least, the cash value of the following:

- cash loans and accrued interest;
- securities to be redelivered by the client under open short positions;
- current settlement amount to be paid under any futures contracts;
- collateral held by the firm in respect of securities transactions, including if the firm has exercised a right of use in respect of safe custody assets;
- short sale cash proceeds held by the firm in respect of the short positions;
- cash margin held by the firm in respect of open futures contracts;
- mark-to-market close-out exposure of any over the counter (OTC) transaction secured by safe custody assets or client money;
- total secured obligations;
- all other safe custody investments held for that client;
- the location of all safe custody assets, including the sub-custodian where the assets are held; and
- a list of the institutions at which the firm holds or may hold client money including money held in client bank accounts and client transaction accounts.

Q7: Do you consider that the content of the report provides clients with enough information to manage their exposures?

Q8: Do you agree that this report should be made available to clients on a daily basis?

3.41 The policy objective of this proposal was to ensure that clients had sufficient up-to-date information to manage their exposure to their prime broker and for all clients to receive that information on a daily basis. The proposal should have a minimal impact on a number of firms who currently have a full suite of online reporting tools for clients, which are usually accessed through an online portal. The proposal was in part designed to ensure that all clients were able to receive this information, rather than just those with sufficient bargaining power.

3.42 Trade associations noted that some prime brokers still need to undertake some IT development in this area to offer a full suite of reporting to clients. One firm and a trade association noted that there are difficulties in reporting the value of certain positions and raised a concern that prime brokers would withdraw from the market if the business became unprofitable, which would reduce competition and raise costs. Given the highly competitive nature of the prime brokerage market, we consider this possibility very unlikely. One trade association suggested we take an outcomes-based approach to the rule to allow some flexibility in the items which must be reported on. We agree that a principles-based requirement would enhance this rule and have amended it to reflect this. However, notwithstanding that amendment, we believe it is important to retain the itemised list in order to highlight the minimum level of disclosure we expect.

3.43 Sell-side firms suggested that assets over which a right to use had been exercised should be excluded from the report. We disagree, as it is fundamentally important for clients to understand this use if they are to manage their credit risk exposure to the prime broker effectively. It was also a lack of information about which assets had been re-hypothecated that contributed to the financial instability and lack of market confidence following the LBIE insolvency. To avoid doubt, the report should enable a client to understand which assets have been subject to a right to use (have been re-hypothecated) and which they only have a contractual claim against (not just the cash value of those assets). We expect the identity of assets held to be disclosed rather than just the cash value of assets held.

3.44 One trade association's members could not agree whether short sale proceeds should be included in the prime brokerage daily report. Some prime brokers include this figure in daily reporting to clients. Other prime brokers, however, do not include it as it depends on how the prime broker calculates client indebtedness (we understand these prime brokers use a gross indebtedness view). To give clients full disclosure, we believe that prime brokers should be able to determine a client's net indebtedness – which is information that may assist in insolvency proceedings.

3.45 One consultancy firm suggested that we also include pending/failed transactions and any other obligations. We will include this requirement in future consultations.

3.46 Two trade associations considered that total secured obligations should only be reported to the extent that they refer to static security interest beneficiaries. One noted that the requirement should be drafted to limit the total secured obligations against the prime broking entity – which we agree with and have clarified in the Handbook text.

3.47 One firm noted that daily mark-to-market calculations only refer to the sufficiency of collateral, not to the close-out calculation, which is subject to additional and specific contractual terms under trading agreements. However, we consider this indicative calculation to be useful to clients and so retain it in the made rules.

3.48 Two trade associations commented that the location of all safe custody assets should simply be a list of custodians who could potentially be holding assets. This would, however, render the detailed custody information envisioned by this policy of very little protection to clients.

3.49 A consultancy firm suggested the list of data fields was overly long and that it could be shortened. The same consultancy firm suggested that we should also mandate daily reporting of pending and failed transactions, as well as any other obligations.

3.50 One firm noted that the data should be made available separately and not on an amalgamated basis. However, a different firm noted that the report should be on a consolidated basis to give clients a comprehensive and accessible view. We confirm that the report should be provided in an amalgamated form or reporting portal.

Our response

We received a mix of responses, with a slight majority of feedback supporting the proposal. We have addressed the specific drafting feedback in the final rules attached to this Policy Statement.

We confirm we will implement the prime brokerage report on a daily basis, based on the prime brokers books and records, to be made available by the end of the next working day by reference to the end of day position of the previous working day.

We will not introduce any further data field requirements.

4 Enhancing client money and asset protection

4.1 In Chapter 3 of CP10/9 we consulted on the basis that we would restrict the placement of client money deposits within a group and prohibit the use of general liens in custodian agreements.

Scope

4.2 Please note that the policies described in this chapter will apply to all UK-authorised investment firms that hold client money and/or client assets, as well as overseas branches of these UK firms. They will also apply to UK branches of firms authorised in a non-EEA third country who are subject to CASS.

Restricting the placement of client money deposits within a group

4.3 CASS has always contained rules and guidance constraining where client money can be deposited. As a result of the implementation of MiFID and successive reviews of the sourcebook influenced by the principles-based approach and the 'better regulation' agenda, prescriptive rules were replaced by higher-level requirements supported by guidance. CASS currently requires a firm to exercise all due skill, care and diligence in selecting, appointing and periodically reviewing the institution where the client money is deposited and arrangements for holding this money.

4.4 We consulted on a proposal to restrict intra-group client money deposits to 20% of the total. The policy rationale for this proposal was to prevent losses created by intra-group contagion. This potential for loss is illustrated in LBIE's placement of approximately 50% of its client money with a group bank – Lehman Brothers Bankhaus AG – which is currently subject to German insolvency proceedings.

4.5 In CP10/9 we asked:

> Q9: Do you agree that we should impose a 20% maximum limit on intra-group client money deposits in client bank accounts and that we should change existing guidance into a rule? Do you have views on alternative limits?

4.6 Responses from trade associations made it clear that there is no market consensus on this issue. There was a split response from the sell-side in relation to this proposal because some firms deposit no client money intra-group whereas some firms deposit large amounts intra-group. The sell-side firms who do not place client money intra-group did not respond to the consultation questions directly, but did state that the proposal would not affect them. The buy-side supported the proposal subject to individual client wishes.

4.7 One trade association suggested allowing clients to object to the use of group banks in a similar way to the rule that allows clients to object to client money being placed in a Qualifying Money Market Fund (QMMF). Given the unequal bargaining power and information asymmetries, however, we do not consider that this will achieve the policy objectives sought.

4.8 Firms suggested that there would be a number of consequences of the proposal:

- A reduction in the number of firms offering client money because of increased operational complexity – this argument does not appear to be particularly convincing given the competitive nature of the wholesale London banking market.
- Rise in concentration risk – two trade associations and a number of firms suggested that there would be a rise in the concentration of client money at fewer larger institutions. If any of these institutions were to fail, there could be systemic consequences. A small number of firms and two trade associations thought that an institution would be able to place 20% intra-group with 80% being deposited with a third-party institution. However, for client money deposits of any material size, this would not satisfy the diversification requirements already set out in CASS (discussed further below) – so in our view this is not a legitimate objection to the proposed policy. One firm suggested that we should be able to monitor individual banks' holdings of client money for macro-prudential purposes. We will gain access to this information through the CMAR (discussed below) and we will closely monitor the impact of this proposal on implementation and review as necessary.
- Impact on credit risk management – three trade associations and a number of firms stated that clients should be able to negotiate their own limits on intra-group deposits. We believe this could in principle be achieved through the use of individual waivers to the rule, subject to the relevant criteria being met – an option we highlighted in CP10/9. Feedback also failed to appreciate that firms would still need to disclose which banks could be used to deposit client money to clients. The baseline policy for client designated accounts will not change for banks outside the group. That is, clients can object to their money being placed at a particular institution or institutions, and clients can elect to hold their money at specific institution(s), if they consider this appropriate given their risk appetite. Designated accounts can carry additional costs, which further supports our policy to diversify intra-group holdings for omnibus accounts away from the group. Clients will no longer be able to request that 100% of their client money is held intra-group, even in a client designated account. This is because the recent crisis has demonstrated that asymmetric information

between firms and their clients means that clients do not have the ability to assess counter party credit risk to a sufficient extent. We understand that clients regularly request a list of institutions where client money may be deposited.

- Impact on non-core currencies and operational risk – one trade association and some firms noted that the limit may necessitate a move to local banks to hold non-core currencies, which would add to operational complexity and potentially increase credit risk, as banks with lower credit ratings would potentially be used. Other respondents, however, noted that they would receive additional client money deposits because of their high credit rating. These institutions were active globally and would have local bank subsidiaries that would be able to hold client money deposits as a third-party institution. In our view, some respondents appear to have under-estimated the number of quality institutions willing to accept deposits of client money.

- Lack of level playing field – one trade association and some firms thought that the proposal would create an unlevel playing field as the proposals would only apply to UK-authorised firms (i.e. not incoming EEA branches). This was taken into account as a potential issue in the CBA – however, we have not received any concrete evidence to suggest that there will be a material impact, or what that impact may be. One trade association suggested that we allow highly rated investments to be used to segregate client money (e.g. gilts etc). However, we are constrained by MiFID in this regard and we will continue to discuss this with the European Commission to seek to review this in any directive negotiations.

- Firms stated that they would implement a buffer to ensure they did not exceed the 20% limit, suggesting that a higher limit might be appropriate. We believe that firms may well wish to consider establishing a buffer to avoid a high number of technical breaches.

- Some respondents felt that the proposal did not take sufficient account of the fact that intra-group companies may gather more information as part of their due diligence on a group bank. While this may be true in some cases, we believe there is an inherent conflict of interest involved in depositing client money intra-group, which sometimes results in inadequate due diligence being performed and relationships not being maintained on an 'arms-length' basis.

4.10 One body of legal representatives suggested that the pre-MiFID rule requiring disclosure of intra-group client money holdings and allowing a client to object to the placement within a group bank, should be re-adopted. However, we are not confident that this would achieve the desired policy objective because it would still be open to larger institutions to require smaller clients to accept intra-group deposits as part of their general terms of business agreements. This is a market where a large proportion of clients tend not to have access to information that would allow them to make economic decisions in their best interests.

4.11 Some firms asked whether the limit would apply on a client-by-client or aggregate basis. We intend to apply the rule on an aggregate basis because the rule addresses the contagion issue witnessed in a primary pooling event, where the intermediary and group bank both become insolvent and any shortfall would be allocated on a

pro-rata basis to all clients. The 20% limit will be applied equally to designated client bank accounts and designated client fund accounts.

4.12 The buy-side, however, agreed with this proposal and one respondent considered that a total ban on depositing client money within a financial group would be more appropriate than a 20% limit. The buy-side also noted that the additional costs did not exceed the benefits of reduced credit risk. Some firms supported our suggestion that the waiver process could be used in exceptional circumstances to provide additional flexibility (e.g. where 100% of clients want to deposit client money intra-group).

4.13 Some firms and one trade association were concerned that we should limit the amount of money that could be placed with a third-party bank. This is important and we consider that the existing guidance on diversification requires firms to conduct regular due diligence reviews and ensure that excessive concentrations of client money are not placed with third-party banks. For example, we would expect all firms to utilise more than one credit institution or QMMF to hold client money. For large client money deposits, we consider the 20% maximum intra-group deposit to be indicative of our risk appetite in this area. Equally small client money deposits may be placed into fewer institutions – the obligations require firms to come to a judgement on what is appropriate in all of the circumstances.

4.14 Some firms asked us to clarify the rationale for selecting a 20% maximum. Although any quantitative ceiling will inevitably be subjective, the proposed limit reflects practice elsewhere in the regulatory framework. For example, the Undertakings for Collective Investments in Transferable Securities (UCITS) regime prohibits UCITS schemes from depositing more than 20% of their net asset value with a single credit institution.[4]

4.15 One firm was also concerned that the manager or custodian of a Collective Investment Scheme (CIS) should not be subject to the 20% intra-group limit. This, however, would be contrary to our objectives of applying a common platform for firms and we see no convincing rationale for this exclusion. The firm noted that many small CIS managers or custodians do not hold significant amounts of client money, but the converse of holding large amounts of money is equally applicable.

4.16 Some firms and one trade association also requested longer transitional periods. To assist firms in this regard we have extended the commencement date until 1 June 2011.

4.17 One trade association asked if the limit related to the firm's records or the bank records. The requirement is placed on the firm and we expect the firm to use its own records.

4.18 Two firms did not consider the hard 20% limit to be appropriate. A trade association and a small number of firms suggested that the risk of diversifying to lower-rated institutions was particularly problematic. This seems unconvincing given the large number of credit institutions operating in the UK. One firm suggested that a differentiated approach should be used where highly-rated group banks could hold, for example, 65% of the client money deposit on a sliding scale and lower-rated banks holding less. However, in light of experience with the global financial crisis, we do not

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consider it appropriate to make formal use of credit ratings in the CASS regime. We would expect that many firms will wish to take credit ratings into account as part of their due diligence when deciding where to place client money.

4.19 A small number of firms commented that we should only require diversification over and above a *de minimis* amount (one suggestion being £10m). Another respondent suggested that firms classified as a small CASS firm should be exempt from this requirement. We disagree with these comments as firms have to make a judgement on the appropriateness of their diversification arrangements and we will pursue our credible deterrence agenda against firms and individuals who fail to discharge their responsibilities in this area.

Our response

No new issues were raised in the consultation and a balance has to be struck between the benefits of diversification and the possibility of increased counterparty and operational risk. The balance of responses suggested that the former would outweigh the latter.

We believe that many respondents appear to have under-estimated the number of highly credit rated institutions that hold client money.

In light of these points, we intend to implement the 20% restriction intra-group on 1 June 2011, which should give firms sufficient time to establish robust diversification policies and procedures. If we find breaches of our diversification rules after 1 June 2011, we will pursue our credible deterrence agenda aggressively.

We confirm our policy proposal to implement a 20% limit of placing client money deposits within a group for both general client bank accounts, designated client bank accounts and designated client fund accounts based upon a firm's internal reconciliation. We have clarified the final text of the rules to ensure that this application is clear.

4.20 While we anticipated certain liquidity impacts, in CP10/9 we asked:

> Q10: Will a 20% limit impact on your firm's liquidity. If so, how?

4.21 Most firms reiterated their responses to the previous question.

4.22 Two trade associations and some firms argued that requiring firms to deposit client money outside the group to which the firm belongs would reduce the firm's liquidity, as the firm in question might not be able to negotiate equally attractive terms with third-party institutions. Some respondents questioned whether they would face increased costs associated with the requirement to place 80% of client money outside the group. They argued that replacement funding would attract higher liquidity requirements when sourced from third parties under our Individual Liquidity Adequacy Standards (ILAS) regime. In the ILAS stress scenario a firm must assume that others in the market will consider that the firm unlikely to be able to meet its liabilities as they fall due (BIPRU 12.5.8R(2)). Therefore under ILAS we would already be expecting firms to be holding significant liquidity resources against client money deposits and to include material outflows of such funds in their liquidity stress testing.

4.23 In addition, one trade association thought that banks applying the new liquidity rules would be reluctant to accept client money from firms, as they would have

to increase their liquidity buffer accordingly. As a result, client money could be diverted from higher to lower-rated institutions. Some respondents thought that banks accepting client money would be unable to use it effectively for funding purposes because our new liquidity rules require them to apply worst case scenario assumptions rather than historical behavioural traits to evaluate the likely stability of funds.

4.24 In general, we did not find these arguments persuasive. It seemed to us that the objections raised were more a consequence of the new liquidity rules – which are deliberately designed to require banks to maintain a larger buffer of liquid assets than previously – rather than a likely outcome of the changes proposed in CP10/9. One of the key objectives of the new liquidity regime is to provide a margin of safety to cover a bank's short-term liquid liabilities, and in our view it is entirely appropriate for client money to be treated as such.

4.25 It is also not clear that the money would flow to less highly-rated institutions if larger banks were reluctant to accept it. The money could flow to other large institutions that are willing to meet the more demanding liquidity requirements, either because they are already in a strong liquidity position or because they see a competitive advantage in doing so (or both). Such firms could find that their cost of funding falls, as they will attract client money deposits from institutions that would have previously placed client money with members of the same group.

4.26 One trade association suggested that there could be a liquidity drain in the UK as assets are placed with foreign banks. However, the proposed restrictions would apply to foreign banks operating in the UK, as well as UK-incorporated banks. In relation to placing assets with foreign banks operating outside the UK (as discussed in the competitiveness section above), we regard the benefits provided by diversification as increasing the attractiveness of the UK as a centre for investment business. Also, the measures we have taken to tighten liquidity standards are likely to be mirrored by other regulators in coming years, as they are largely a response to the global financial crisis, which highlighted major deficiencies in liquidity management practices at internationally active banks.

4.27 One trade association noted that the proposed restrictions on intra-group holdings of client money could result in a situation where client money that is deposited by investment firms with other group members would in future receive lower interest yields, creating some client detriment. We have taken this possibility into account in our CBA, but consider that the cost to clients is likely to be limited. Experience of the financial crisis suggests that any resulting costs are likely to be more than offset by the benefits of diversification.

4.28 One firm suggested that the proposed 20% ceiling should not apply to a QMMF – however, we consider it essential for the ceiling to apply to QMMFs to ensure that firms are not able to avoid the policy by placing client money with QMMFs managed by entities within their group. As the definition of QMMF does not require an independent custodian/depositary of the assets (nor does it preclude an independent depositary from then appointing an affiliate of the manager as a sub-custodian)we have included QMMFs within the 20% limit.

4.29 One trade association saw no potential liquidity impacts as a result of this policy.

Our response

We believe the responses received did not invalidate the proposal to apply a 20% limit on intra-group placement of client money, nor did they undermine the CBA set out in CP10/9.

We will, however, monitor the impact of the policy when implemented to ensure that no material unintended consequences arise.

4.30 We asked:

> Q11: Do you consider it is appropriate to exclude client money held in client transaction accounts?

4.31 We consulted on the basis of excluding client transaction accounts because client money in these accounts is only deposited for the purpose of entering a transaction, or to meet a client's obligation to provide collateral for a transaction for a client through or with an exchange, clearing house or intermediate broker. Retail clients must be notified of this fact.

4.32 A number of firms noted the operational complexity of including money in client transaction accounts and agreed with our proposals.

Our response

We confirm that we will exclude client transaction accounts from the 20% limit, but note that firms are prohibited from holding excess money in client transaction accounts. If we uncover firms holding excess client money in client transaction accounts, for example to avoid the amount of client money that can be deposited intra-group, we will consider referring the case to enforcement. We are actively pursuing our credible deterrence enforcement strategy in relation to CASS breaches.

4.33 We also consulted on converting CASS 7.4.9G into a Rule. CASS 7.4.9G states:

'In discharging its obligations when selecting, appointing and reviewing the appointment of a credit institution, a bank or a qualifying money market fund, a firm should also consider, together with any other relevant matters:

1) the need for diversification of risks;

2) the capital of the credit institution or bank;

3) the amount of client money placed, as a proportion of the credit institution or bank's capital and deposits, and, in the case of a qualifying money market fund, compared to any limit the fund may place on the volume of redemptions in any period;

4) the credit rating of the credit institution or bank; and

5) to the extent that the information is available, the level of risk in the investment and loan activities undertaken by the credit institution or bank and affiliated companies.'

Our response

The responses provided sufficient support for making the amendment but we will not do so immediately. We will review this Guidance in due course.

We also agree with certain feedback that the obligation in CASS 7.4.9 requires firms to satisfy themselves on an ongoing basis, with formal reviews being undertaken as frequently as necessary.

Prohibiting the use of general liens in custodian agreements

4.34 We had found that some firms in the UK, principally prime brokers, had allowed custodians and sub-custodians to include general or omnibus liens covering, for example, group indebtedness to the custodian or sub-custodian in contractual agreements, or had failed to pay due regard to this issue in negotiating their agreements. Experience during the financial crisis shows that this can result in significant delays or obstacles in the ability of IPs to recover assets from depots not under their direct control.

4.35 In CP10/9 we asked:

> Q13: Do you agree that we should introduce a rule prohibiting the use of general liens in custodian agreements and amending existing guidance to clarify our requirements?
>
> Q14: Do you think that we should go further and prohibit all liens in custodian agreements?
>
> Q15: Do you foresee any unintended consequences in implementing this proposal?

4.36 There was general support for the proposal to prohibit general or omnibus liens. However, a number of trade associations noted that one core function performed by custodians is to advance funds to clients and make intra-day payments, and that any prohibition should not impair the ability of custodians to provide this service. Firms also argued that liens should not apply to contractual settlement arrangements, assured income payments, the provision of overdraft arrangements or other credit lines in relation to custody services provided to the client whose account is subject to the lien. A number of respondents argued that these custody services are necessary for the efficient functioning of the market.

4.37 Some respondents also felt that central securities depositories and international securities depositories should be excluded from the proposed prohibition in relation to liens that arise only for the purpose of settling a client's trades.

4.38 Respondents noted that, in certain jurisdictions, liens arise in favour of central depositories in the course of settling securities trades for the accounts of depositary participants, where custodians have no choice in the selection of the central depositary. This typically happens in circumstances where all securities trading is concentrated on-exchange, as in many emerging markets.

4.39 A number of firms and trade associations expressed concern that we might implement the proposed prohibition of general or omnibus liens in a way that would increase the cost or complexity of custody business.

Our response

The main purpose of the proposals in CP10/9 was to prevent the possibility of a client's assets being used to set off the liabilities of a firm in the event of a default, or being exercised by a third party with no direct interest in the underlying client assets. It has never been our intention to restrict the provision of core custody services that relate directly to an underlying client and its assets and we have taken full account of the feedback we received on this point.

We received general support for the prohibition of liens that do not relate directly to the provision of services by the custodian. We have therefore introduced a prohibition on general or omnibus liens. This means that, when the rules are implemented, a firm will need to ensure that any agreements it enters into for the provision of custody services does not put its clients' assets at risk in the event of its own insolvency. The onus will be on the firm to ensure that an agreement with any third party with which the firm deposits safe custody assets belonging to a client does not include a lien, right of retention or sale over those assets or any client money derived from them other than one which is expressly permitted by the rules.

In response to feedback we received on specific questions raised in CP 10/9, the final rules also contain a small number of clearly defined exceptions to the prohibition on general or omnibus liens:

- The prohibition does not apply to liens relating to charges and liabilities properly incurred as a result of the provision of custody services to a particular client and that client's safe custody assets. This would cover, for example, charges and liabilities arising directly from the provision of custody and custody-related services, such as intra-day payments, contractual settlement and standing credit lines.
- We have further excluded from the prohibition liens created in favour of international securities depositories, central securities depositories and securities settlement systems, provided the lien in question arises only for the purpose of settling that client's trades.
- Finally, we have excluded liens which arise in jurisdictions as a result of local regulatory requirements or market practice and the firm has determined that holding assets in that jurisdiction is in the best interests of the client.

These exceptions should allow clients to enjoy a full range of custody services. They should also support the efficient functioning of securities markets and allow clients to undertake overseas business in countries where liens operate as a result of statutory requirement and/or market practice.

The final rules will come into force on 1 March 2011. However, we have incorporated a transitional provision which will enable firms to re-paper agreements if necessary until 1 October 2011.

We will perform a post-implementation review of the prohibition of general or omnibus liens during Q4 2011.

5 Increased CASS oversight

5.1 In Chapter 4 of CP10/9 we consulted on the basis of proposals to establish a new CASS operational oversight controlled function and re-introduce a Client Money and Assets Return. For these purposes, we proposed to categorise firms as large, medium or small, based on the highest level of their holdings of client money and assets in the previous calendar year. In introducing a proposed scheme of classification, our main policy objective is to ensure that the new requirements, designed to enhance CASS oversight, are applied in a proportionate way to the firms that pose the highest risk to our statutory objectives.

Scope

5.2 The rules in this chapter relating to the new Client Money and Asset Return (CMAR) and CASS operational oversight controlled function (CF10a) will apply to all UK-authorised firms that hold client money and/or client assets, as well as overseas branches of these UK firms. These proposals will also capture branches of firms authorised in a non-EEA third country that are subject to CASS.

Establishing a new CASS operational oversight controlled function

5.3 At many of the firms we have visited, we found that there was a fragmentation of CASS operational oversight, with responsibility for CASS being split between a number of staff across the compliance, operations, finance and/or corporate treasury functions. This often results in poor senior management oversight and a poor control environment that increases the likelihood of non-compliance and client detriment. So we proposed to create a new CF10a that would be both a required function and a significant influence function (SIF) and held by only one person at each firm.

5.4 To improve our oversight of firms and ensure that our proposals within this chapter were proportionate, we consulted on the basis of creating a CASS stratification

of firms. The proposed stratification reflects the fact that the general distinction drawn by small and relationship-managed firms for supervisory purposes does not necessarily reflect the extent to which these firms' holdings of client money or assets pose a risk to our statutory objectives. For example, larger relationship-managed firms may not hold client money and/or assets, whereas small firms supervised by our Small Firms and Contact Division may in fact hold significant sums of client money and/or assets. We proposed the following stratification:

CASS firm type	**Highest total amount of *client money* held during the *firm's* last calendar year or as the case may be that it projects that it will hold during the current calendar year**	**Highest total value of *safe custody assets* held by the firm during the *firm's* last calendar year or as the case may be that it projects that it will hold during the current calendar year**
CASS *large firm*	more than £1 billion	more than £100 billion
CASS *medium firm*	an amount equal to or greater than £1 million and less than or equal to £1 billion	an amount equal to or greater than £10 million and less than or equal to £100 billion
CASS *small firm*	less than £1 million	less than £10 million

5.5 We consulted on the basis that small firms would not be required to apply for an individual to be approved for the CF10a role by the FSA. We proposed to require small CASS firms to allocate responsibility for CASS operational oversight to a member of the firm's governing body. We also proposed that small CASS firms should be required to notify us of the identity of this director.

5.6 After receiving feedback on this proposal and paying due regard to the principles of good regulation, we have concluded that the proposed notification process would be unduly burdensome on small CASS firms. We consider that the individual responsible for CASS oversight at a small CASS firm does not need to be an FSA-approved person. This will avoid the need for a significant number of small firms to apply for a CF10a and for us to review these applications.

5.7 We are going to proceed on the basis that the holder of the Compliance Oversight controlled function in a small CASS firm will be held responsible for CASS operational oversight unless the firm has decided to allocate that responsibility to a person approved to perform a SIF role and recorded that fact appropriately.

5.8 We anticipate that the majority of small firms will assign responsibility for CASS operational oversight to the holder of the CF10 function (although the operational processes may still be split across several departments), and so we will hold the CF10 responsible. The result of this policy is that either the compliance officer, or another SIF holder in a small CASS firm will be held responsible for CASS operational oversight along with the firm's senior management as a whole, as part of our credible deterrence agenda.

5.9 As noted above, this means that small firms who consider that it would be more appropriate to assign responsibility for CASS operational oversight to a SIF holder other than the compliance officer will be able to do so under the new rules. This apportionment would need to be explicitly recorded by the firm and we would

expect the decision to be made by the board and recorded in the board minutes, the CASS policies and procedures, and in job descriptions. If a firm fails to give responsibility to another SIF holder and record that fact, we will hold the CF10 function responsible.

5.10 One consequence of this approach is that the compliance officer, when not directly responsible for CASS operational oversight, will need to ensure that the firm has apportioned responsibility to another SIF holder and made a record of that fact.

5.11 The approach we are now proposing for small CASS firms is less burdensome than the approach set out in CP10/9, but should ensure that there is a clear focus of accountability for CASS operational oversight in all firms that hold client money or assets. For supervisory and other purposes, we will regard that individual as the primary focus of responsibility for CASS within the firm. Accordingly, we consider that the benefits now further outweigh the costs of this proposal.

5.12 In CP10/9 we reserved the right to interview any applicant to the CASS operational oversight controlled function. We estimate that interviews will need to be held for the largest 50 firms. Generally, however, we do not anticipate that we will subject applicants for medium-sized CASS firms to the competency-based interviews that applicants to the large CASS firms will be subject to.

5.13 We will proceed as follows:

i) We will require firms to apportion CASS operational oversight from 1 January 2011. From this date, an interim set of rules will require all firms that hold client money and/or client assets to apportion responsibility for CASS operational oversight to an appropriate senior manager or director performing a SIF role within the firm. As part of our January 2011 data collection exercise firms will have to notify us of their apportionment by 31 January 2011.

ii) Once a firm has determined in early 2011 where it falls within the CASS stratification discussed in this paper, if it is a CASS large firm or a CASS medium firm, it must apply to us in time to ensure that an appropriate person will be approved to carry out the CASS operational oversight function. We will require large CASS firms and medium CASS firms to have applied and received approval for the controlled function by 1 October 2011. It will be possible for firms to apply for an individual to be approved for the CASS operational oversight function from 1 May 2011. This applicant may be the same person to which the allocation was made on 1 January 2011. A CASS small firm may continue to rely on its apportionment of that function to a person who is performing role without the need to apply to us.

5.14 In CP10/9, we asked:

> Q16: Do you agree that we should establish the CASS oversight controlled function?

Q17: Do you agree that one person within the firm holding the controlled function should have ultimate oversight and control?

5.15 The vast majority of respondents supported these proposals and we will proceed with them.

5.16 We repeat the guidance we provided to firms in CP10/3 *Effective Corporate Governance* Chapter 4 which explained our more intrusive approach to approving and supervising SIFs.[5]

5.17 We understand feedback from respondents who stated that, for large and medium CASS firms, the CASS operational oversight controlled function should not be numbered CF10a. Some firms considered that if the controlled function was numbered CF10a it would result in the oversight being attached to the existing compliance officer's responsibilities without due regard being given to the most effective oversight arrangements at that firm. Our decision to designate the CASS operational oversight function as CF10a was intended to reflect the reality that the compliance function at most firms is closely involved in the monitoring and oversight of CASS compliance and the current structure of the Approved Persons Regime. But at some firms it may well be more appropriate for staff in another area (such as Finance or Operations) to be the focus of accountability for CASS operational oversight. Where this occurs, it will of course not affect the overall responsibility of the compliance function for ensuring compliance with our requirements.

5.18 The CASS operational oversight function does not reduce the scope of the compliance function. A compliance officer must continue to advise and assist relevant persons within a firm to comply with the relevant obligations in relation to its holding of client money and client assets. They must also monitor and assess the adequacy and effectiveness of relevant measures and procedures taken by the firm. This will continue to include such duties as: ensuring that monitoring of the control environment is performed; and updating policies/procedures with Handbook changes.

5.19 The CASS operational oversight function will introduce a new, distinct function, which is the operational role of ensuring that the appropriate client assets and client money protections are actively being achieved by the firm in the course of its business. Firms will have to appoint the most appropriate person to carry out this additional function and, for CASS medium and large firms, apply for the role specifically.

5.20 One firm commented that the CASS operational oversight controlled function will need to have access to and support from the board, and we agree.

Our response

We confirm our intention to implement the CASS operational oversight controlled function, subject to the changes we have made for smaller CASS firms and the steps we are taking to phase in the new requirements.

5 Page 19 onwards

5.21 With regard to the CASS stratification of firms, we asked:

> Q18: Do you agree with our stratification of firms as small, medium and large with regard to client money and/or asset holdings? If not, please provide us with your thoughts as to an appropriate method of stratification.
>
> Q19: Do you consider an assessment based on the previous calendar year is appropriate? If not, why?

5.22 We received very broad support for the stratification of firms that hold client money and assets into small, medium and large. This will be a novel stratification scheme, which focuses explicitly on the protection of client assets, based on an annually measured dynamic data field.

5.23 Two firms commented on the broad scope of CASS medium firms, noting that the category would apply to relatively small intermediaries as well as large global firms. Our objective was to capture the top 400 firms whom we understand to be holding the majority of client money and assets in the UK. We consider that the medium CASS firm category is appropriate, but our assumptions are based on imperfect data. If, during the January 2011 data collection exercise, we find that the stratification has ranked firms inappropriately we will of course respond accordingly.

5.24 We received feedback that suggested that the financial year should be used rather than the calendar year and that firms should have a longer period in which to determine their highest balance from the previous year. While we have some sympathy with this feedback, to achieve the policy objectives stated in CP10/9 we will need to use data for the calendar year.

5.25 To gather data we plan to survey firms at the start of 2011 to determine their size for CASS stratification purposes. We will use the data gathered as part of this exercise to determine whether a firm needs to nominate a director or senior manager for the CF10a role and whether it should submit a CMAR on a monthly or half-yearly basis. Thereafter, once the new reporting system is in place, we intend to use data gathered from the CMAR to assess, on an annual basis, whether a firm remains correctly stratified. It is this process which drives the requirement that firms must submit the data within 15 business days of the CMAR. Making an annual assessment will provide certainty to firms that their categorisation will not change during the calendar year in a way that would, for example, trigger the need to appoint a CF10a or submit returns on a monthly basis when the firm has previously been submitting them half-yearly.

5.26 One firm noted that the proposal does not reflect the potential ratio of client assets and money and the number of clients. While there is some merit in this point, any metric has both advantages and disadvantages and we consider that the highest amount of client money and assets held in the previous calendar year is the simplest and easiest metric to calculate, providing us with the most relevant measure on which to pursue risk-based supervision.

5.27 A number of firms considered a daily valuation of client assets to be excessive and that it would be difficult to value some asset classes accurately. The final

rules require the firm to use its internal records to confirm the highest value on a yearly basis. We will require firms to use the valuations on the same basis as their reconciliations. For example, a global custodian would be performing reconciliations on a daily basis and we would expect the custodian to determine the highest value of assets held on a daily basis for the previous calendar year. Where reconciliations are undertaken on a less frequent basis, the calculation will have to be performed as frequently as those reconciliations.

5.28 Some respondents suggested that we should require more frequent reporting from small firms. We consider that bi-annual reporting will provide us with sufficient information in the short to medium term. While we consider that we require greater oversight of client assets and money, we have sought to ensure that our policies are as proportionate as possible and the new stratification is the first iteration of this enhanced oversight. It will be subject to refinement and development over the course of 2011 and 2012.

Our response

We confirm that we are proceeding with the CASS stratification and reporting as consulted on.

Re-introducing a Client Money and Assets Return (CMAR)

5.29 We proposed a new reporting framework, the CMAR. The CMAR will be reviewed and approved by the holder of the CF10a function on a monthly basis for medium and large firms, and by the individual who has responsibility for CASS operational oversight on a half-yearly basis for small firms.

5.30 The decision to classify a firm as small, medium or large will be made consistently with our approach to the controlled function as discussed earlier in the paper.

5.31 The CMAR will give us an overview of firm-specific CASS positions and an overview of UK investment firms' CASS holdings, enabling us to make regulatory interventions on a timely, firm-specific or thematic basis. We expect that the requirement to produce this information may also help ensure that information is available to IPs and clients of the firm in the event of a firm's failure.

Our response

We received almost unanimous support to introduce the CMAR and we are implementing it. The CMAR requirements will commence on 1 June 2011 and all CASS firms will be required to report their June 2011 holdings in July 2011.

5.32 In CP10/9 we published a draft CMAR and we invited comments about the data fields. The CMAR will be an electronic form that firms will have to complete and we accept that the Annex in CP10/9 could have been clearer. We have included the final version of the CMAR in the attached Rules and we will aim to publish on our website an example of the electronic form that firms will have to complete in due course. The online form is much clearer and more accessible than the paper reproduction. We consider that the majority of firms' queries stemmed from the difficulty in reproducing the electronic form on paper.

5.33 During the consultation period we have been trialling the CMAR with 40 'early adopter' firms and we have modified the CMAR in response to their feedback, after analysing the data we received. We consider that the CBA has not altered materially since CP10/9 and we have incorporated instructions on how to complete the return into the form to assist firms. We are finalising the operational procedures to receive the CMAR and will publish how the CMAR will be disseminated and how it should be returned to the FSA on our website in due course.

5.34 Some firms suggested that they would require longer than ten business days to complete and return the CMAR to us. Having noted that the online version of the CMAR should be more accessible and easier to use, we have extended the submission period to 15 business days to address this concern. Firms may have to expend more resources initially to complete the data, but the data should be held by the firm and used as part of the firm's Management Information. We also intend to the use the information collected on a pro-active, rather than reactionary, basis. We will use the December CMAR to categorise firms for the forthcoming calendar year. The data will give us a macro-prudential view of UK client assets, which will inform our supervisory agenda and enable us to direct resource to the areas of greatest risk.

Our response

We confirm our intention to amend the data fields consulted on in accordance with the feedback we have received. The responses have not changed the CBA in CP10/9 and the amendments made to the data fields should make it easier for firms to provide this data.

5.35 In CP10/9 we asked:

> Q22: Do you consider monthly reporting for large and medium firms and bi-annual reporting for small firms appropriate frequencies?

5.36 Responses to this question were more balanced, with a majority agreeing with our proposal. We will ensure consistency of reporting periods between small and larger firms by setting the reporting periods for small firms to 30 June and 31 December, rather than 31 March and 30 September, as proposed in our draft rules in CP10/9. This will give smaller firms a further three months to prepare for their first report. Two firms suggested that firms should only report on a half-yearly basis. However, we believe that this would not give us the level of oversight we are seeking for medium and large firms.

5.37 A number of firms suggested that medium CASS firms should only be required to report on a quarterly basis to differentiate them further from large CASS firms. While we understand the rationale behind this feedback, it fails to recognise that the medium and larger categories include firms that hold and control approximately 70-80% of client money and assets in the UK. Medium CASS firms pose significant risks to our objectives and we consider that we require this information to be able to target thematic reviews effectively and to obtain a macro-prudential view of the market.

5.38 Requiring firms to provide this information on a monthly basis will also allow us to monitor changes in the amount of client money placed with members of the same

group. This will help us to ensure that firms comply with the proposed 20% ceiling on intra-group client money deposits.

5.39 Firms asked for more time to implement the proposals and that nil returns be excluded from the reporting requirement. We disagree with these objections because firms should already have the Management Information required to complete the data fields set out in the CMAR. Nil returns will allow us to manage the permissions of firms more accurately – i.e. we encourage firms to hold permissions that reflect the activities they undertake.

Our response

We confirm that we will proceed with the reporting periods as consulted on, apart from changing the dates of the bi-annual report for CASS small firms to 30 June and 31 December. All CASS firms will have to complete their first CMAR in July 2011, reporting data on their June 2011 holdings of client money and assets.

We have also clarified our proposal that the obligation to submit the CMAR to us should apply to all firms with permission to hold client money and/or client assets.

January 2011 CASS stratification data collection exercise

5.40 In early January all firms with the relevant investment business and client assets permissions and requirements will be sent an email requesting certain information about their client money and asset holdings.

5.41 This email will, at a minimum, request the following information:

a) the name of the firm and its firm reference number (FRN);

b) the firm's highest client money holding during the 2010 calendar year;

c) the firm's highest value of client assets during the 2010 calendar year; and

d) the name of the individual within the firm who has been assigned responsibility for client assets oversight before the implementation of the CASS operational oversight controlled function – we will hold this individual responsible for CASS operational oversight until the CF10a is introduced for medium and large firms.

5.42 Firms will have until 31 January 2011 to complete this return and submit it to us.

5.43 Large CASS firms will be emailed from the CASS Sector informing them that they will be required to submit a monthly CMAR from June 2011 and that they will have to apply for a CASS operational oversight controlled function. The CASS operational oversight controlled function will generally be interviewed for the (approximately) 50 largest CASS firms.

5.44 Medium CASS firms will be emailed from the CASS Sector informing them that they will be required to submit a monthly CMAR from June 2011 and that they will have to apply for a CASS operational oversight controlled function. For these firms, we reserve the right to interview the CASS operational oversight controlled function if we consider it necessary, but generally we will not.

5.45 Small firms will be emailed from the CASS Sector informing them that they will be required to submit a half-yearly CMAR within 15 business days of 30 June 2011 and 31 December 2011. The first report due in July 2011 will only need to cover the period from 1 June 2011 until 30 June 2011.

5.46 The CASS operational oversight function will share the same competences as the other SIF functions but we will expect applicants to have detailed knowledge of the CASS regime.

5.47 The information contained with the December 2011 CMAR will be used to determine the CASS firm size for 2012 and on an annual basis thereafter.

Part III

6 Post implementation review of insolvency – remote special purpose vehicles that hold client money and assets

Introduction

6.1 Following the failure of the LBIE and the wider group, it became clear that client money and assets would be subject to a complex administration, which would take a considerable period of time to resolve. In response to underlying investor demand, a number of prime brokers began to create insolvency-remote special purpose vehicles (SPVs) that are intended to hold generally fully paid up client assets. These vehicles have been designed to be legally and operationally independent of the prime broker, so that in the event of prime broker default the client money and assets are readily available to be returned to their owners.

6.2 We note the Treasury papers *Developing effective resolution arrangements for investment banks* and *Establishing resolution arrangements for investment banks*, supported this market-led solution of insolvency-remote SPVs. The industry responses to the latter consultation also generally supported this approach.

6.3 This paper sets out some broad characteristics of the entities that prime brokers have implemented or are planning to implement. We have conducted a review of a sample of these SPVs and consulted with buy-side market participants.

6.4 The small number of SPVs that have been launched have all been designed along highly individual lines as a result of each prime broker's business, structure, client base, etc. We will restrict our comments to a high-level, but we note that the insolvency of a prime broker is always likely to be subject to the jurisdiction of the Court. Any insolvency event that a prime broker enters into is likely to result in related legal proceedings and/or operational difficulties. We cannot foresee the outcome of any such event and consider the adoption of the SPVs or any other model adopted by a prime broker and their clients to be a matter for them and their underlying investors.

Summary of review findings

Purpose

6.5 The purpose of the vehicles is generally to hold some of the client assets not taken as collateral by the prime broker and, on the insolvency of the broker, to return the assets as quickly as possible to their owners or to hold the assets beyond the reach of IPs. The vehicles are not generally designed to process a large amount of corporate actions or asset servicing on an ongoing basis. Corporate actions are usually serviced in the prime brokerage entity and clients can request that assets are segregated to enable clients to vote for example. Post-insolvency, the SPVs would generally be able to perform these functions to some degree.

Single or multiple purpose vehicles

6.6 Not all SPVs reviewed are single-purpose vehicles purely created to custody client money and assets. One approach involves the use of an existing entity operating other business lines. Other approaches favoured using a single-purpose vehicle. We note that certain funds have required fully paid (or unencumbered assets) to be held by a third-party custodian.

Practical arrangements

6.7 The SPVs reviewed did not generally have a large number of permanent staff in post. Generally, staff employed by the prime broker are involved on a day-to-day basis to ensure the operational efficacy of the SPV. In the event of the prime broker insolvency, they then become solely and permanently employed by the SPV on the insolvency of the broker. Various staff retention incentives are in place to ensure staff would fulfil their employment duties at the SPV.

6.8 Offices are sometimes permanently available and held vacant or sometimes available in an outsourcing agreement on the prime broker's insolvency. The prime broker normally funds the SPV some time in advance and will have provided significant capital to ensure its continued effective operation after the insolvency of the prime broker.

6.9 The processes for transferring assets between broker and SPV are highly automated, with clients having access to reports detailing securities that are held in the vehicles and in their prime brokerage accounts.

Client agreements and fees

6.10 Clients either enter into agreements, which are supplemental to the prime brokerage agreements, or they enter into separate agreements in relation to the SPV.

6.11 Clients pay fees in relation to custody based on:

1) market value of assets in custody;

2) transaction fees; and/or

3) minimum standing fees if no assets have been held or transferred.

Legal mechanism to release assets

6.12 The SPVs we reviewed had varying approaches regarding their security over assets held in them. The SPVs created by some prime brokers are designed so that the prime broker can retain a charge over the assets in the event of their clients' insolvency. In the event of the default of the prime broker itself, there is generally an arrangement that allows their interest over the assets in the SPV to expire the intention being the assets will be free to be disbursed to their owners. However, some of the SPVs reviewed did not have any charge over the assets held in them, either before or after insolvency.

6.13 Some of the SPVs reviewed held collateral in them, while others held only excess amounts above collateral requirements. In general, pre-insolvency, assets could only be transferred out of the SPVs in limited circumstances – namely for the processing of corporate actions and on the default of the client to the prime broker. Not all assets were suitable to be held in the SPVs.

6.14 Prime brokers were confident that the vehicles they had created would be insolvency-remote and operate effectively if needed, despite the fact that all such vehicles remain untested. Brokers had sought legal advice from external counsel and obtained advice from IPs on the viability of the structures they had developed. In particular, brokers were confident that they had sound legal opinions that their SPVs did not amount to preferential treatment of creditors in the event of insolvency. The brokers we surveyed designed their vehicles with the intention that they would operate effectively within current legislation.

Non-SPV solutions

6.15 Not all prime brokers have created a new structure in response to the issues arising from the LBIE insolvency and administration. A custody bank solution has also been proposed, whereby unencumbered client assets are held on a custody basis at an affiliate or a third party custodian. This is another method by which prime brokers hope to keep their clients' unencumbered assets outside of the scope of any insolvency proceedings. The solutions reviewed did not rely on special legal mechanisms for freeing assets upon the insolvency of the prime broker, but did include an expiring charge over those assets, which would still be enforceable in the event of the client's default.

SPV development

6.16 The prime brokers were confident that clients would begin to take up the SPV models in greater numbers to hold much greater amounts of client money and assets. Some prime brokers noted that European developments in financial regulation may also create opportunities for the SPV to provide services to clients. The prime brokers did however note that the SPV development would be subject to client (and underlying investor) requirements.

Buy-side views

6.17 The prime brokers under review had varying take up rates among their clients. The SPVs were, in general, regarded as a viable solution by the buy-side but the buy-side have been slow to begin using the vehicles. The buy-side noted that the SPVs are not a universal solution and will only be appropriate for a proportion of clients. The buy-side also had to undertake extensive due diligence and spend considerable time reviewing the arrangements and legal agreements. The buy-side noted that the vehicles are also only of real appeal during systemic crises, where the multi-prime model (of using a selection of prime brokers) would not address counterparty risk in the market.

6.18 It seems that a sizeable proportion of funds using the SPVs had tested their effectiveness and maintained access to them, but did not habitually keep a large proportion of their assets in the vehicles; many funds appeared to use them as an insurance policy.

Underlying investor interest

6.19 There are varying attitudes towards the SPVs, dependent on the characteristics of the funds. Some predominantly long-only funds were sceptical about using SPVs, especially where they currently used a separate third-party custodian and had less reliance on their prime broker. Other funds (generally leveraged funds) used SPVs or were strongly considering using their services. Smaller funds would consider adopting SPVs subject to underlying investor requirements, but they considered that investors did not now have great concerns regarding this issue. In the event of market turmoil, however, several fund managers anticipated renewed interest.

6.20 Some funds reported that their investors were pleased to hear that SPVs were available as an option, but were often reticent about the cost of using the vehicles.

Conclusion

6.21 There is a small but growing market trend in producing special purpose entities designed to hold the assets of prime brokers' clients without putting them at risk in the event of the broker's insolvency.

6.22 Prime brokers that have created these entities are confident that they are sound and there has been some buy-side support. None of these SPVs have been tested in real insolvency proceedings or in court. The models are open to all clients and it is for market participants to consider whether or not any particular model would be appropriate and suitable to their circumstances.

6.23 Buy-side participants should consider whether such services are suitable for their own needs and those of their clients.

Summary of the prime brokerage market SPV models

Model			
Multi-prime brokerage model	*SPV*	*Affiliate custodian*	*3rd party custodian*
A fund uses more than one prime broker to reduce counterparty concentration and credit risk	Generally single purpose insolvency-remote entity created intra-group to custody assets	Fully paid up securities or excess collateral may be transferred to an affiliate custodian (rather than SPV or third party custodian)	Fully paid up securities or excess collateral is transferred to a third party custodian
Security interest over assets			
Prime broker retains security interest and right to use over client money and assets held	Security interest or charge against assets held in SPV which is intended not to survive the insolvency of the prime broker	Security charge over assets held in custody	No security interest
Clients			
Small and/or highly leveraged funds with small holdings of fully paid up securities/ excess collateral	Long/short funds with a reasonable amount of leverage but also holding some fully paid up securities/ excess collateral. May support more highly volatile trading strategies	Long/ short funds with a reasonable amount of leverage but also holding material fully paid up securities/ excess collateral	Large funds which are mainly long equity funds with little or no leverage which hold large amounts of fully paid up securities/ excess collateral

Annex 1

List of non-confidential respondents

1. Alternative Investment Management Association (AIMA)
2. Association of Financial Mutuals (AFM)
3. Association of Foreign Banks (AFB)
4. Association of Global Custodians
5. Association of Private Client Investment Managers and Stockbrokers (APCIMS)
6. Association for Financial Markets in Europe (AFME)
7. Aviva plc
8. Baillie Gifford
9. Barclays Group
10. The Bank of New York Mellon
11. BNP Paribas Securities Services London Branch
12. Brevan Howard
13. British Banking Association (BBA)
14. Cambridge Fund Managers
15. CFA Society of the UK (CFA UK)
16. Citi Global Transaction Services (GTS) Business
17. City of London Law Society
18. Compos Mentis
19. Depositary and Trustee Association (DATA)
20. Deborah Sabalot
21. Family Investments
22. Financial Services Consumer Panel

23. The Futures and Options Association (FOA)
24. Gartmore Investment Management Limited
25. Institute of Chartered Accountants in England and Wales (ICAEW)
26. International Financial Data Services
27. Investment & Life Assurance Group (ILAG)
28. Investment Management Association (IMA)
29. Linklaters LLP
30. Michael Holmes, CFA
31. NM Pensions Trustees Limited
32. Northern Trust
33. Pensions Pitstop
34. Pershing Securities Ltd
35. PricewaterhouseCoopers LLP (PwC)
36. RBC Capital Markets
37. RBC Dexia
38. Rensburg Sheppards IM
39. The Society of Pension Consultants (SPC)
40. State Street Corporation

In addition to the above, there were ten confidential responses to the consultation.

Table of commencement dates

Policy proposal	Commencement date	Any transitional
CASS operational oversight apportionment	1 January 2011	
CASS firm classification	1 January 2011	
(PB) Disclosure annex	1 March 2011	
(PB) Daily reporting	1 March 2011	
20% Group bank limit	1 June 2011	
Restricting liens	1 March 2011	1 October 2011
CASS operational oversight function	1 October 2011	*Applications open from 1 May 2011*
CMAR	1 June 2011	

Final Instrument

CLIENT ASSETS SOURCEBOOK (ENHANCEMENT) INSTRUMENT 2010

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 59 (Approved persons);
(2) section 138 (General rule-making power);
(3) section 139 (Miscellaneous ancillary matters);
(4) section 156 (General supplementary powers); and
(5) 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 as follows:

(1) Part 1 of Annex A and Part 1 of Annex B come into force on 1 January 2011;
(2) Part 2 of Annex A and Part 2 of Annex B and come into force on 1 March 2011;
(3) Part 3 of Annex B and Part 1 of Annex C comes into force on 1 June 2011; and
(4) Part 3 of Annex A, Part 4 of Annex B and Part 2 of Annex C come into force on 1 October 2011.

Amendments to the Handbook

D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Client Assets sourcebook (CASS)	Annex B
Supervision manual (SUP)	Annex C

Citation

E. This instrument may be cited as the Client Assets Sourcebook (Enhancement) Instrument 2010.

By order of the Board
13 October 2010

Annex A

Amendments to the Glossary of definitions

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

Part 1: Comes into force on 1 January 2011

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

CASS large firm	has the meaning in *CASS* 1A.2.7R (CASS firm types).
CASS medium firm	has the meaning in *CASS* 1A.2.7R (CASS firm types).
CASS small firm	has the meaning in *CASS* 1A.2.7R (CASS firm types).
CMAR	a Client Money and Asset Return, containing the information specified in *SUP* 16 Annex 29R.

Part 2: Comes into force on 1 March 2011

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

prime brokerage agreement	an agreement between a *prime brokerage firm* and a *client* for *prime brokerage services*.
prime brokerage firm	a *firm* that provides *prime brokerage services* to a *client* and which may do so acting as *principal*.
prime brokerage services	a package of services provided under a *prime brokerage agreement* which gives a *prime brokerage firm* a right to use *safe custody assets* for its own account and which comprises each of the following: (a) *custody* or *arranging safeguarding and administration of assets*; (b) clearing services; and (c) financing, the provision of which includes one or more of the following: (i) capital introduction; (ii) margin financing; (iii) *stock lending*;

(iv) stock borrowing;

(v) entering into repurchase or reverse repurchase transactions;

and which, in addition, may comprise consolidated reporting and other operational support.

Part 3: Comes into force on 1 October 2011

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

CASS operational oversight function	*controlled function* CF10a in the *table of controlled functions*, described more fully in *SUP* 10.7.9R.

Annex B

Amendments to the Client Assets sourcebook (CASS)

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

Part 1: Comes into force on 1 January 2011

After CASS 1 insert the following new chapter. The text is not underlined.

1A CASS firm classification and operational oversight

1A.1 Application

1A.1.1 R (1) This chapter applies to a *firm* to which either or both of *CASS* 6 (Custody rules) and *CASS* 7 (Client money rules) applies.

(2) In relation to a *firm* to which *CASS* 5 (Client money: insurance mediation activity) and *CASS* 7 (Client money rules) apply, this chapter does not apply in relation to *client money* that a *firm* holds in accordance with *CASS* 5.

1A.2 CASS firm classification

1A.2.1 G The application of certain *rules* in this chapter depends upon the 'CASS firm type' within which a *firm* falls. The 'CASS firm types' are defined in accordance with *CASS* 1A.2.7R. The 'CASS firm type' within which a *firm* falls is also used to determine the reporting obligations that apply to it in *SUP* 16.14 (Client money and asset return).

1A.2.2 R (1) A *firm* must once every year, and within the time limit provided for by *CASS* 1A.2.9R, determine whether it is a *CASS large firm*, *CASS medium firm* or a *CASS small firm* according to the amount of *client money* or *safe custody assets* which it holds, using the limits set out in the table in *CASS* 1A.2.7R.

(2) For the purpose of determining its 'CASS firm type' in accordance with *CASS* 1A.2.7R, a *firm* must:

(a) if it currently holds *client money* or *safe custody assets*, calculate the higher of the highest total amount of *client money* and the highest total value of *safe custody assets* held during the previous calendar year ending on 31 December and use that figure to determine its 'CASS firm type';

(b) if it did not hold *client money* or *safe custody assets* in the previous calendar year but projects that it will do so in the

current calendar year, calculate the higher of the highest total amount of *client money* and the highest total value of *safe custody assets* that it projects that it will hold during that year and use that figure to determine its 'CASS firm type'; but

(c) in either case, exclude from its calculation any *client money* held in accordance with *CASS* 5 (Client money: insurance mediation activity).

1A.2.3 R For the purpose of calculating the value of the total amounts of *client money* and *safe custody assets* that it holds on any given *day* during a calendar year a *firm* must:

(1) in complying with *CASS* 1A.2.2R(2)(a), base its calculation upon internal reconciliations performed during the previous year;

(2) in relation to *client money* or *safe custody assets* denominated in a currency other than sterling, translate the value of that *money* or that *safe custody asset* into sterling at the previous *day's* closing spot exchange rate; and

(3) in relation to *safe custody assets* only, calculate their total value using the previous *day's* closing mark to market valuation, or if in relation to a particular *safe custody asset* none is available, the most recent available valuation.

1A.2.4 G One of the consequences of *CASS* 1A.2.2R is that a *firm* that determines itself to be a *CASS small firm* or a *CASS medium firm* will, at least if it exceeds during the course of a calendar year either of the limits in *CASS* 1A.2.7R that applies to it, become in the next calendar year:

(1) in the case of a *CASS small firm*, a *CASS medium firm* or a *CASS large firm*; and

(2) in the case of a *CASS medium firm*, a *CASS large firm*.

1A.2.5 R (1) Notwithstanding *CASS* 1A.2.2R, provided that the conditions in (2) are satisfied a *firm* may elect to be treated:

(a) as a *CASS medium firm*, in the case of a *firm* that is classed by the application of the limits in *CASS* 1A.2.7R as a *CASS small firm*; and

(b) as a *CASS large firm*, in the case of a *firm* that is classed by the application of the limits in *CASS* 1A.2.7R as a *CASS medium firm*.

(2) The conditions to which (1) refers are that in either case:

(a) the election is made by including it in the notice to the *FSA* provided under *CASS* 1A.2.8R or *CASS* 1A.2.9R;

(b) it is given at least one week before the election is intended to take effect; and

(c) the *FSA* has not objected.

1A.2.6 G *CASS* 1A.2.5R provides a *firm* with the ability to opt in to a higher category of 'CASS firm type'. This may be useful for a *firm* whose holding of *client money* and *safe custody assets* is near the upper categorisation limit for a *CASS small firm* or a *CASS medium firm*.

1A.2.7 R CASS firm types

CASS firm type	Highest total amount of *client money* held during the *firm's* last calendar year or as the case may be that it projects that it will hold during the current calendar year	Highest total value of *safe custody assets* held by the *firm* during the *firm's* last calendar year or as the case may be that it projects that it will hold during the current calendar year
CASS large firm	more than £1 billion	more than £100 billion
CASS medium firm	an amount equal to or greater than £1 million and less than or equal to £1 billion	an amount equal to or greater than £10 million and less than or equal to £100 billion
CASS small firm	less than £1 million	less than £10 million

1A.2.8 R In relation to the calendar year ending on 31 December 2011, a *firm* must notify the *FSA* in writing:

(1) by 31 January 2011 of the highest total amount of *client money* and the highest total value of *safe custody assets* held during the previous calendar year, if it held *client money* or *safe custody assets* in that previous year; or

(2) by 31 January 2011 of the highest total amount of *client money* and the highest total value of *safe custody assets* that the *firm* projects that it will hold during 2011, if it did not hold *client money* or *safe custody assets* in the previous calendar year but at the date of its notification to the *FSA* projects that it will do so in 2011; or

(3) in any other case, before the date on which the *firm* begins to hold *client money* or *safe custody assets*, of the highest total amount of *client money* and the highest total value of *safe custody assets* that the *firm* projects that it will hold during the remainder of 2011; and

(4) in every case, of its 'CASS firm type' classification.

1A.2.9 R In relation to each calendar year beginning with that which ends on 31 December 2012, a *firm* must notify the *FSA* in writing:

(1) within 15 *business days* of 31 December of the previous calendar year, of the highest total amount of *client money* and the highest total value of *safe custody assets* held during the previous calendar year, if it held *client money* or *safe custody assets* in that previous calendar year; or

(2) within 15 *business days* of 31 December of the previous year, of the highest total amount of *client money* and the highest total value of *safe custody assets* that the *firm* projects that it will hold during the then current calendar year, if it did not hold *client money* or *safe custody assets* in the previous calendar year but at the date of its notification to the *FSA* projects that it will do so in the then current calendar year; or

(3) in any other case, before the date on which the *firm* begins to hold *client money* or *safe custody assets*, of the highest total amount of *client money* and the highest total value of *safe custody assets* that the *firm* projects that it will hold during the remainder of the then current calendar year; and

(4) in every case, of its 'CASS firm type' classification.

1A.2.10 R For the purpose of the annual notification to which *CASS* 1A.2.8R and *CASS* 1A.2.9R refer, a *firm* must apply the calculation *rule* in *CASS* 1A.2.3R.

1A.2.11 G For the purpose of *CASS* 1A.2.9R(1), the *FSA* will treat that obligation as satisfied if a *firm* submits a *CMAR* for the period or month ending 31 December in compliance with *SUP* 16.14.5R.

1A.3 Responsibility for CASS operational oversight

1A.3.1 R A *firm* must allocate to a *director* performing a *significant influence function* or a *senior manager* performing a *significant influence function* responsibility for:

(1) oversight of the *firm*'s operational compliance with *CASS*;

(2) reporting to the *firm's governing body* in respect of that oversight; and

(3) completing and submitting a *CMAR* to the *FSA* in accordance with *SUP* 16.14.

1A.3.2 R A *CASS large firm* and a *CASS medium firm* must not later than 31 January 2011 notify the *FSA* in writing of the identity of the *person* to whom responsibility has been allocated in accordance with *CASS* 1A.3.1R or,

where *CASS* 1A.2.8R(3) applies, before the date on which that *firm* begins to hold client *money* or *safe custody assets*.

1A.3.3 R (1) Subject to (2), a *firm* must make and retain an appropriate record of the *person* to whom responsibility is allocated in accordance with *CASS* 1A.3.1R.

(2) A *CASS small firm* must make and retain such a record only where it allocates responsibility to a *person* other than the *person* in that *firm* who performs the *compliance oversight function*.

(3) A *firm* must ensure that the record made under this *rule* is retained for a period of five years after it is made.

…

Sch 1 Record keeping requirements

…

Sch 1.3 G

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
CASS 1A.3.3R	Allocation of the *CASS* oversight responsibilities in *CASS* 1A.3.1R	The *person* to whom the *CASS* oversight responsibilities have been allocated, subject to the provisions of *CASS* 1A.3.3R	Upon allocation	5 years (from the date the record was made)
…	…	…	…	…

…

Sch 2 Notification requirements

Sch 2.1 G

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
CASS 1A.2.5R	Election to be treated as a *CASS medium firm* or a *CASS large firm*	The fact of that election	The fact of that election	To be made at least one week before the election is intended to take effect

CASS 1A.2.8R(1) - (3)	The highest total amount of *client money* and the highest total value of *safe custody assets* held by a *firm*, as more fully described in *CASS* 1A.2.8R	The highest total amount of *client money* and *safe custody assets* held by a *firm*, as more fully described in *CASS* 1A.2.8R.	The coming into force of *CASS* 1A.2.8R	31 January 2011 unless contrary provision is made in *CASS* 1A.2.8R.
CASS 1A.2.8R(4)	A *firm's* 'CASS firm type' classification	A *firm's* 'CASS firm type' classification	The coming into force of *CASS* 1A.2.8R	31 January 2011 unless contrary provision is made in *CASS* 1A.2.8R.
CASS 1A.2.9R(1) – (3)	The highest total amount of *client money* and the highest total value of *safe custody assets* held by a *firm*, as more fully described in *CASS* 1A.2.9R	The highest total amount of *client money* and *safe custody assets* held by a *firm*, as more fully described in *CASS* 1A.2.9R.	The need to comply with *CASS* 1A.2.9R(1) – (3)	Within 15 *business days* from the end of December of the previous calendar year unless contrary provision is made in *CASS* 1A.2.9R
CASS 1A.2.9R(4)	A *firm's* 'CASS firm type' classification	A *firm's* 'CASS firm type' classification	The need to comply with *CASS* 1A.2.9R(4)	Within 15 *business days* from the end of December of the previous calendar year unless contrary provision is made in *CASS* 1A.2.9R
CASS 1A.3.2R	The *person* to whom the responsibilities in *CASS* 1A.3.1R have	The name of the *person*	Upon allocation	Until 31 January 2011

	been allocated			
…	…	…	…	…

Part 2: Comes into force on 1 March 2011

3 Collateral

…

3.1.8 G A *prime brokerage firm* is reminded of the additional obligations in *CASS* 9.3.1R which apply to *prime brokerage agreements*.

…

6 Custody rules

6.1 Application

…

Prime brokerage agreements

6.1.9A G A *prime brokerage firm* is reminded of the additional obligations in *CASS* 9.3.1R which apply to *prime brokerage agreements*.

…

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* standing to the credit of the account;~~ [deleted]

…

…

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 A *firm* may conclude an agreement with a third party relating to the custody of *safe custody assets* which does confer on that third party, or on another *person*, 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* 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*; 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 *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; or

(3) arises in relation to a *client's 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; and

(b) the *firm* has taken reasonable steps to determine that holding those assets or that money subject to such a lien or right is in the best interests of that *client*.

…

6.5.2A R A *firm* must keep a copy of every executed *client* agreement that includes that *firm*'s right to use *safe custody assets* for its own account, including in the case of a *prime brokerage agreement* the disclosure annex referred to in *CASS* 9.3.1R.

...

After CASS 8 insert the following new chapter. The text is not underlined.

9 Prime brokerage

9.1 Application

9.1.1 R This chapter applies to a *firm*:

(1) to which *CASS* 6 (Custody rules) applies; and

(2) which is a *prime brokerage firm*.

9.2 Prime broker's daily report to clients

9.2.1 R (1) A *firm* must make available to each of its *clients* to whom it provides *prime brokerage services* a statement in a *durable medium*:

(a) showing the value at the close of each *business day* of the items in (3); and

(b) detailing any other matters which that *firm* considers are necessary to ensure that a *client* has up-to-date and accurate information about the amount of *client money* and the value of *safe custody assets* held by that *firm* for it.

(2) The statement must be made available to those *clients* not later than the close of the next *business day* to which it relates.

(3) The statement must include:

(a) the total value of *safe custody assets* and the total amount of *client money* held by that *prime brokerage firm* for a *client*;

(b) the cash value of each of the following:

(i) Cash loans made to that *client* and accrued interest;

(ii) *securities* to be redelivered by that *client* under open short positions entered into on behalf of that *client*;

(iii) current settlement amount to be paid by that *client* under any *futures* contracts;

(iv) short sale cash proceeds held by the *firm* in respect of short positions entered into on behalf of that *client*;

(v) cash margin held by the *firm* in respect of open *futures* contracts entered into on behalf of that *client*;

(vi) mark-to-market close-out exposure of any *OTC* transaction entered into on behalf of that *client* secured by *safe custody assets* or *client money*;

(vii) total secured obligations of that *client* against the

prime brokerage firm; and

(viii) all other *safe custody assets* held for that *client*.

(c) total collateral held by the *firm* in respect of secured transactions entered into under a *prime brokerage agreement*, including where the *firm* has exercised a right of use in respect of that *client's safe custody assets*;

(d) the location of all of a *client's safe custody assets*, including assets held with a sub-custodian; and

(e) a list of all the institutions at which the *firm* holds or may hold *client money*, including money held in *client bank accounts* and *client transaction accounts.*

9.3 Prime brokerage agreement disclosure annex

9.3.1 R (1) A *firm* must ensure that every *prime brokerage agreement* that includes its right to use *safe custody assets* for its own account includes a disclosure annex.

(2) A *firm* must ensure that the disclosure annex sets out a summary of the key provisions within the *prime brokerage agreement* permitting the use of *safe custody assets*, including:

(a) the contractual limit, if any, on the *safe custody assets* which a *prime brokerage firm* is permitted to use;

(b) all related contractual definitions upon which that limit is based;

(c) a list of numbered references to the provisions within that *prime brokerage agreement* which permit the *firm* to use the *safe custody assets*; and

(d) a statement of the key risks to that *client*'s *safe custody assets* if they are used by the *firm*, including but not limited to the risks to the *safe custody assets* on the *failure* of the *firm*.

(3) A *firm* must ensure that it sends to the *client* in question an updated disclosure annex if the terms of the *prime brokerage agreement* are amended after completion of that agreement such that the original disclosure annex no longer accurately records the key provisions of the amended agreement.

9.3.2 G (1) *Principle* 10 (Clients' assets) requires a *firm* to arrange adequate protection for *clients'* assets when it is responsible for them. As part of these protections, the *custody rules* require a *firm* to take appropriate steps to protect *safe custody assets* for which it is

responsible.

(2) A *prime brokerage firm* should not enter into "right to use arrangements" for a *client's safe custody assets* unless the *person* to whom the responsibilities set out in *CASS* 1A.3.1R have been allocated and each of the *firm's* managers who are responsible for those *safe custody assets* are satisfied that the *firm* has adequate systems and controls to discharge its obligations under *Principle* 10 which include:

(a) the daily reporting obligation in *CASS* 9.2.1R; and

(b) the record-keeping obligations in *CASS* 6.5.

TP 1 Transitional Provisions

…

TP 1.1

(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
…					
8	*CASS* 6.3.5R	R	The *rule* listed in column (2) does not apply in relation to agreements executed before 1 March 2011.	1 March 2011 until 1 October 2011	1 March 2011

…

Sch 1 Record keeping requirements

…

Sch 1.3 G

Handbook reference	**Subject of record**	**Contents of record**	**When record must be made**	**Retention period**

…	…	…	…	…
CASS 6.5.2AR	*Client* agreements that include a *firm*'s right to use *safe custody assets* for its own account	A copy of every executed *client* agreement that includes a *firm's* right to use *safe custody assets* for its own account	Maintain up-to-date records	5 years (from the date the record was made)
…	…	…	…	…

Part 3: Comes into force on 1 June 2011

7.4 Segregation of client money

…

7.4.9A R A *firm* must limit the funds that it deposits or holds with a relevant group entity or combination of such entities so that those funds do not at any point in time exceed 20 per cent of the balance on:

(1) all of its *general client bank accounts* considered in aggregate;

(2) each of its *designated client bank accounts*; and

(3) each of its *designated client fund accounts*.

7.4.9B R For the purpose of *CASS* 7.4.9AR an entity is a relevant group entity if it is:

(1) a *BCD credit institution*, a bank authorised in a third country, a *qualifying money market fund*, or the entity operating or managing a *qualifying money market fund*; and

(2) a member of the same *group* as that *firm*.

7.4.9C G The *rules* in *SUP* 16.14 provide that a *firm* must report to the *FSA* in relation to the identity of the entities with which it deposits *client money* and the amounts of *client money* deposited with them. The *FSA* will use that information to monitor compliance with the diversification *rule* in *CASS* 7.4.9AR.

…

Part 4: Comes into force on 1 October 2011

1A.2 CASS firm classification

1A.2.1 G The application of certain *rules* in this chapter depends upon the 'CASS firm type' within which a *firm* falls. The 'CASS firm types' are defined in accordance with *CASS* 1A.2.7R. The 'CASS firm type' within which a *firm* falls is also used to determine whether it is required to have the *CASS operational oversight function* described in *CASS* 1A.3.1AR and the reporting obligations that apply to it in *SUP* 16.14 (Client money and asset return).

…

1A.3 Responsibility for CASS operational oversight

1A.3.1 R A *CASS small firm* must allocate to a *director* performing a *significant influence function* or a *senior manager* performing a *significant influence function* responsibility for:

(1) oversight of the *firm*'s operational compliance with *CASS*;

(2) reporting to the *firm's governing body* in respect of that oversight; and

(3) completing and submitting a *CMAR* to the *FSA* in accordance with *SUP* 16.14.

CF10a: the CASS operational oversight function

1A.3.1A R A *CASS medium firm* and a *CASS large firm* must allocate to a *director* or *senior manager* the function of:

(1) oversight of the operational effectiveness of that *firm's* systems and controls that are designed to achieve compliance with *CASS*;

(2) reporting to the *firm's governing body* in respect of that oversight; and

(3) completing and submitting a *CMAR* to the *FSA* in accordance with *SUP* 16.14.

1A.3.1B G *CASS* 1A.3.1AR describes the *controlled function* known as the *CASS operational oversight function*. The *table of controlled functions* in *SUP* 10.4.5R together with *SUP* 10.7.9R specify the *CASS operational oversight function* as a *required function* for a *firm* to which *CASS* 1A.3.1AR applies.

1A.3.2 R ~~A *CASS large firm* and a *CASS medium firm* must not later than 31 January 2011 notify the *FSA* in writing of the identity of the *person* to whom responsibility has been allocated in accordance with CASS 1A.3.1R or, where *CASS* 1A.2.8R(3) applies, before the date on which that *firm* begins to~~

~~hold client *money* or *safe custody assets*.~~ [deleted]

1A.3.3 R (1) Subject to (2), a *firm* must make and retain an appropriate record of the *person* to whom the responsibility or function is allocated in accordance with *CASS* 1A.3.1R or *CASS* 1A.3.1AR.

(2) A *CASS small firm* must make and retain such a record only where it allocates responsibility to a *person* other than the *person* in that *firm* who performs the *compliance oversight function*.

(3) A *firm* must ensure that the record made under this *rule* is retained for a period of five years after it is made.

9.3 Prime brokerage agreement disclosure annex

9.3.2 G (1) …

(2) A *prime brokerage firm* should not enter into "right to use arrangements" for a *client's safe custody assets* unless:

… (a) in the case of a *CASS small firm*, the *person* in that *firm* to whom the responsibilities set out in *CASS* 1A.3.1R have been allocated; or

(b) in the case of any other *firm*, the *person* who carries out the *CASS operational oversight function*; and

(c) ~~and each of the~~ those of that *firm's* managers who are responsible for those *safe custody assets*;

are each satisfied that the *firm* has adequate systems and controls to discharge its obligations under *Principle* 10 which include:

~~(a)~~ (i) the daily reporting obligation in *CASS* 9.2.1R; and

~~(b)~~ (ii) the record-keeping obligations in *CASS* 6.5.

...

Sch 1 Record keeping requirements

…

Sch 1.3G

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
CASS 1A.3.3R	Allocation of the *CASS* oversight responsibilities in *CASS* 1A.3.1R or of the *CASS operational oversight function*, as relevant	The *person* to whom the *CASS* oversight responsibilities have been allocated, subject to the provisions of *CASS* 1A.3.3R, or to whom the *CASS operational oversight function* has been allocated in accordance with *CASS* 1A.3.1AR	Upon allocation	5 years (from the date the record was made)
…				

Annex C

Amendments to the Supervision manual (SUP)

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

Part 1: Comes into force on 1 June 2011

16 Reporting requirements

…

16.1.2 G The only categories of *firm* to which no section of this chapter applies are:

(1) an *ICVC*;

(2) an *incoming EEA firm* or *incoming Treaty firm*, unless it is:

(a) a *firm* of a type listed in *SUP* 16.1.3 R as a type of *firm* to which *SUP* 16.6, *SUP* 16.7, *SUP* 16.9 ~~or~~, *SUP* 16.12, or *SUP* 16.14 applies; or

…

…

16.1.3 R Application of different sections of SUP 16

(1) Section(s)	(2) Categories of firm to which section applies	(3) Applicable rules and guidance
…		
SUP 16.14	A *firm* with *permission* to conduct *MiFID business* or, to the extent that any business is not *MiFID business*, *designated investment business*, except for those categories of *firm* which are excluded by *SUP* 16.14.2R.	Entire section

…

16.3.2 G This chapter has been split into the following sections, covering:

…

(9) integrated regulatory reporting (*SUP* 16.12); ~~and~~

(10) reporting under the *Payment Services Regulations*; and

(11) client money and asset return (*SUP* 16.14).

…

After SUP 16.13 insert the following new section. The text is not underlined.

16.14 Client money and asset return

Application

16.14.1 R Except as provided for in *SUP* 16.14.2R, this section applies to a *firm* with *permission* to conduct *MiFID business* or, to the extent that any business is not *MiFID business*, *designated investment business*.

16.14.2 R This section does not apply to a *firm* that falls into any of the following categories:

(1) The *firm* is:

(a) an *ICVC*;

(b) a *UCITS qualifier*;

(c) an *incoming EEA firm* but this exclusion only applies with respect to its *passported activities*;

(d) an *authorised professional firm* but this exclusion only applies with respect to its *non-mainstream professional activities*; or

(e) an *insurer* unless it is a *long-term insurer* which is also a *MiFID investment firm*.

(2) The *firm's permission* prevents it from holding *safe custody assets* and:

(a) the *firm* is an *authorised professional firm* and it complies with the requirements in *CASS* 7.1.15R in respect of any money received or held by it that falls into *CASS* 7.1.1R; or

(b) the *firm*'s *permission* prevents it from holding *client money* in relation to either:

(i) all the activities in *SUP* 16.14.1R for which it has permission; or

(ii) all the activities in (i) except for *insurance mediation activities* in relation to *life policies* but in

this case this exclusion only applies if the *firm* has validly elected to act in accordance with *CASS* 5 (Client money: insurance mediation activity) in relation to its *client money*.

(3) The *firm*'s *permission* prevents it from holding *client money* and it meets the following conditions:

(a) it acts as the *operator* of a *regulated collective investment scheme* or it is a *personal investment firm*; and

(b) either it holds no *safe custody assets* or all the *safe custody assets* that it holds are exempt from *CASS* 6 (Custody rules) due to *CASS* 6.1.16BR (Operators of regulated collective investment schemes) or *CASS* 6.1.16CR (Personal investment firms).

16.14.3 R The exclusions in *SUP* 16.4.2R only apply to a *firm* with respect to the obligation to submit a particular *CMAR* if it meets the conditions for the whole of the period that would have been covered by that *CMAR* and for the period up to the date by which the *CMAR* would otherwise have had to be submitted.

Purpose

16.14.4 G The purpose of the *rules* and *guidance* in this section is to ensure that the *FSA* receives regular and comprehensive information from a *firm* which is able to hold *client money* and *safe custody assets* on behalf of its *clients*.

Report

16.14.5 R (1) A *CASS large firm* and a *CASS medium firm* must submit a completed *CMAR* to the *FSA* within 15 *business days* of the end of each *month*.

(2) A *CASS small firm* must submit a completed *CMAR* to the *FSA* within 15 *business days* of the conclusion of each six *month* period ending on 30 June and 31 December.

… (3) In *SUP* 16.14.5R *month* means a calendar month and *SUP* 16.3.13R(4) does not apply.

16.14.6 R For the purposes of the *CMAR*:

(1) *client money* is that to which the *client money rules* in *CASS* 7 apply; and

(2) *safe custody assets* are those to which the *custody rules* in *CASS* 6 apply.

16.14.7 G For the avoidance of doubt, the effect of *SUP* 16.14.6R(1) is that any *client money* held in accordance with *CASS* 5 is to be excluded from any

calculations which the *CMAR* requires.

16.14.8 G Nil returns are required for reporting in this section. In other words, if this section applies to a *firm* but it does not hold *client money* to which the *client money rules* in *CASS* 7 apply then it should still complete the *CMAR*. It should report that it does not hold *client money*. The same applies to *safe custody assets* under *CASS* 6.

…

After SUP 16 Annex 28BG insert the following new annex. The text is not underlined.

16 Annex 29R Client Money and Asset Return (CMAR)

This annex consists only of one or more forms. Forms are to be found through the following address:

Client Money and Asset Return: [insert link to form included below]

see next page

Section 1 – Firm information

For further guidance please go to section 0 and validation at section 9

Please ensure all monetary values are entered in GBP thousands (000's): (£1000 =1)

1a) Firm Name
1b) FSA firm reference number
1c) Reporting Period End Date
1d) What is your reporting frequency?
1e) Name of CASS audit firm
1f) Name of CASS audit firm (if Other was selected above)
1g) Does the firm hold Client Money?
1h) Does the firm safeguard and administer custody assets?
1i) Are you subject to the CFTC Part 30 Exemption Order?

Alternative Approach:

1j) Do you operate the Alternative Approach? (CASS 7.4.14G)
1k) Has the Alternative Approach been signed off by your auditors (as detailed in CASS 7.4.15R)?

Overview of firm's activities subject to CASS

1l) Please complete the table below with all business types undertaken for segregated clients

Type of Business Activity	Number of clients	Balance of Client Money as at reporting period end date	Value of Custody Assets as at reporting period end date

Section 2 - Balances

Please ensure all monetary values are entered in GBP thousands (000's): (£1000 =1)

CASS – Client Money and Client Asset balances

Firms are reminded that this form should not be completed for client money subject to CASS 5

Please provide the following information:

2a)	Highest Client Money balance during this reporting period:	
2b)	Lowest Client Money balance during this reporting period:	
2c)	Highest value of Custody Assets held during this reporting period:	
2d)	Lowest value of Custody Assets held during this reporting period:	

Provision of the above figures does not have any immediate effect on your categorisation. Any re-assessment of a firm's categorisation will normally take place on an annual basis, based on year end data.

Section 3a – Segregation of Client Money

Please ensure all monetary values are entered in GBP thousands (000's): (£1000 =1)

Firms are reminded that this form should not be completed for client money subject to CASS 5

Where the firm holds client money as at reporting period end date

	Type - Select from drop down box	Institution where client money held	Client Money Balances Total: 0	Country of incorporation of the institution (select from list)	Is this a group entity?
1					
2					

Section 3b – Segregation of Safe Custody Assets

Please ensure all monetary values are entered in GBP thousands (000's): (£1000 =1)

Where the firm holds safe custody assets as at reporting period end date

	Where & How Held? - Select from drop down box?	Name of Institution	Number of lines of stock	Value of Assets as at reporting period end date Total: 0	Country of incorporation of the institution (select from list)	Is this a group entity?
1						
2						

Section 4 - Client Money Requirement and Resource

Please ensure all monetary values are entered in GBP thousands (000's): (£1000 =1)

Client Money Requirement and Resource		CASS 7 Annex 1G
		Enter Amount
4a)	Client Money Requirement	
	of which:	
		Enter Amount
4ai)	Unallocated to individual clients but identified as client money	
4aii)	Unidentified client money in client money bank accounts	
4aiii)	Uncleared payments e.g. unpresented cheques sent to clients	
4aiv)	Excess cash in segregated accounts	
4b)	Client Money resource	
	: Money Requirement v Resource	(Autocalc: 4a – 4b)
4bi)	Any adjustments made to withdraw an excess or rectify a deficit identified as a result of an internal reconciliation?	

Section 5a – Safe Custody Asset Reconciliations

Please ensure all monetary values are entered in GBP thousands (000's): (£1000 =1)

Safe Custody Asset unreconciled items

	30days	60days	90days
Please enter value:			

	Method	Frequency	Type of custody asset	Frequency (if 'g' is Other)
1				
2				

Section 5b - Client money reconciliations

Please ensure all monetary values are entered in GBP thousands (000's): (£1000 =1)

Client money reconciliations

	Type	Frequency
5a)	Client Money Internal Reconciliation	
5b)	Frequency (if Other was selected above)	
5c)	Client Money External reconciliation	
5d)	Frequency (if Other was selected above)	

Client Money unreconciled items

6-29 days	30-59 days	60-90 days	90+ days

Enter number of unreconciled items even if it is 0

Section 6 - Record Keeping & Breaches

Record Keeping

	Type of Account:	Total number of accounts held at beginning of reporting period	Number of new accounts opened during the reporting period	Number of accounts closed during the reporting period	Total number of accounts at the end of the reporting period	Number of trust status letters and/or acknowledgement letters in place which cover these accounts	Explanation of Discrepancies.
6a)	Client Bank Account						
6b)	Client Transaction Account						
		(Enter values even if 0)		TOTAL:			

Breaches

6c) Has the firm reported any of the following notifiable breaches? ☐ Must be completed either Yes or No

Custody Asset Notification requirements (CASS 6.5.13R)

6d) Has the firm complied with the requirements in CASS 6.5.1R, 6.5.2R and 6.5.6R? ☐ Must be completed if 6c is Yes

6e) Following reconciliation, is the firm able to comply with the requirements in CASS 6.5.10R without material differences? ☐ Must be completed if 6c is Yes

Client Money Notification Requirements CASS 7.6.16R)

6f) Has the firm complied with the requirements in CASS 7.6.1R, 7.6.2R and 7.6.9R? ☐ Must be completed if 6c is Yes

6g) Following reconciliation, is the firm able to comply with the requirements in CASS 7.6.13R and 7.6.15R without material differences? ☐ Must be completed if 6c is Yes

6h) Are there any other CASS matters you wish to draw to our attention? ☐

Section 7 - Does the firm outsource and/or offshore any of your client money and/or custody asset operations? ☐

	Who do you outsource and/or offshore these operations to? (name of entity)	What function of your CASS operations do you outsource and/or offshore?	Location of outsourcer/ TPA
1			
2			

Are there any significant changes being made or planned changes being considered to the firms existing outsourcing arrangements? Please provide the detail of any such consideration:

TP 1 Transitional Provisions

…

TP 1.2

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision applies		Transitional Provision	Transitional provision: dates in force	Handbook provisions: coming into force
…					
13B	*SUP* 16.14.5R(2)	R	In the case of a *CASS small firm* with a reporting period ending on 30 June 2011, that period begins on 1 June 2011	1 June 2011 until 30 June 2011	1 June 2011

…

Sch 2 Notification requirements

…

Sch 2.2 G

…

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
…	…	…	…	…
SUP 16.13.3 D to *SUP* 16.13.4 D	…	…	…	…
SUP 16.14.5R	*CMAR*	The items listed in the form contained in *SUP* 16 Annex 29R	For *CASS large firms* and *CASS medium firms*, the end of each *month*. For *CASS small firms*, the conclusion of each six *month*	For *CASS large firms* and *CASS medium firms*, within 15 *business days* of the end of each *month*. For *CASS small firms*, within 15

			period ending on 30 June and 31 December.	*business days* of the conclusion of each six *month* period ending on 30 June and 31 December.
…				

Part 2: Comes into force on 1 October 2011

10.4 Specification of functions

…

10.4.5 R Controlled functions

Type	CF	Description of controlled function
…		
*Required functions**		
…		
	10a	*CASS operational oversight function*
…		

…

10.7 Required functions

…

CASS operational oversight function (CF10a)

10.7.9 ~~G~~ ~~[deleted]~~ In relation to a *CASS medium firm* and a *CASS large firm*, the
R *CASS operational oversight function* is the function of acting in the capacity of a *person* to whom is allocated the function set out in *CASS* 1A.3.1AR.

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