THE CITY OF LONDON LAW SOCIETY

4 College Hill
London EC4R 2RB

Telephone 020 7329 2173
Facsimile 020 7329 2190
DX 98936 – Cheapside 2
mail@citysolicitors.org.uk
www.citysolicitors.org.uk

Mr Ric Wilding
Client Assets Policy
Prudential Banking and Investment Business Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

E-mail: cp10_09@fsa.gov.uk

30 June 2010

Dear Sirs
Consultation Paper 10/9 – Enhancing the Client Assets Sourcebook

The CLLS represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients, including multinational companies, financial institutions and Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Committee. Members of the CLLS Regulatory Committee (the "**Committee**") advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

The Committee supports FSA's intention to enhance the Client Assets Sourcebook ("**CASS**") and welcomes the opportunity to respond to Consultation Paper 10/09 (the "**CP**"). We set out below our responses to a number of the specific consultation questions. We note however that the CP is to be followed later this year by two further consultation papers and its proposals are subject to concurrent discussions between the FSA and the European Commission and that as a result, our current views may be modified and we may need to write again accordingly. As the FSA will see, we have a number of comments on the proposals. We understand the underlying concerns arising out of the post-Lehman difficulties with obtaining release of client assets. We agree that if solutions can be found that would speed up or simplify the process then they should be seriously considered, but there are other important factors that need to be taken into account. These include the fact that arrangements for holding securities and settling transactions will frequently involve complex operational and cross-jurisdictional issues, and that it is important that the measures do not lead to an increase in systemic risk because they prevent providers of core market services from properly protecting their own exposures to clients.

Chapter 2 of the CP: Increasing re-hypothecation disclosure and transparency in the prime brokerage community

General observations

We are concerned by FSA's suggestion at paragraph 2.2 of the CP that it will consider whether the proposals in this chapter should apply "to other market participants who enter into rights of use arrangements to ensure there is a level playing field in the market". This is worrying if it results in extra obligations for a much wider range of services than just prime brokerage. Conversely, we note that the additional client money and lien restrictions in Chapter 3 of the CP are proposed for all UK authorised firms and not just prime brokers. In light of this difference, we would ask FSA to confirm the intended scope of its proposals.

Q2: Do you agree with our proposed glossary definitions regarding prime brokerage as stated above?
We consider that the proposed definition of "prime brokerage services" requires clarification, as prime brokerage services do not always include all of the services listed. However, care is needed with the clarification, as entities which are not prime brokers e.g. custodians and settlement agents, also provide some of the services listed.

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?
In paragraph 2.13 of the CP, FSA proposes that the annex will "highlight the relevant definitions, including net client indebtedness, the contractual limit on re-hypothecation and it will also include a statement setting out the risk to the client's assets upon the prime broker's default" and will cross-refer to "detailed provisions" in the PBA. FSA explains that, *inter alia*, this "may help reduce the amount of time spent conducting the legal due diligence undertaken by an IP's legal advisor following a prime broker's collapse".

We are unable to support FSA's reasoning in this respect. As it is proposed that the annex will not have legal effect, anyone checking documentation terms will still need to check the main terms of the PBA. In addition, if a client fails to read or understand the main PBA, it is unclear why it will pay any more attention to an additional non-binding disclosure such as the annex. As a result, prime brokers will incur expense in amending agreements but without a significant benefit to clients. The requirement for a summary is out of place in what is almost exclusively a non-retail market.

Q5: Do you agree that we should introduce a requirement that prime brokers offer daily reporting to all clients?
We agree that this is, in principle, a sensible proposal, provided that prime brokers have the systems capacity to achieve it, and subject to the content requirements of the report being reasonable.

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

• 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;

We would ask FSA to provide clarification as to whether the firm must specify separately the *value* of the assets subject to the right of use and/or identify *which* assets are subject to the right of use. We do not consider that a daily report would be helpful to clarify the situation regarding the right of use unless such details are disclosed.

We would also ask FSA to provide clarification on the meaning of the phrase "right to use", in order to avoid any overlap in the application of relevant rules. Is it limited to a right of use (re-hypothecation) under e.g. regulation 16 of the Financial Collateral Arrangements (No. 2) Regulations (the "FCARs")? Or does it

extend to a right of appropriation upon enforcement of security under regulation 17 and/or a "title transfer financial collateral arrangement" within the meaning of regulation 3 of the FCARs?

• ***all other safe custody investments held for that client;***

We do not consider that specifying the cash value rather than simply identifying the assets held will provide greater clarity in an insolvency situation, which is the stated intention of the report.

• ***the location of all safe custody assets, including the sub-custodian where the assets are held;***

We are not confident that compliance with such an obligation is necessary or practicable on a daily basis, in particular as this information changes regularly. Moreover, custodians may hold securities of the same type with different sub-custodians, depending on, for example, the person who delivered the securities or the purpose for which the securities are to be used. A custodian may not be able to identify that specific securities held with a particular sub-custodian are held for a particular client, especially where there is a large sub-custodian network and a complex variety of services being provided by the custodian and/or its group entities.

In any event, so long as the securities held by the prime broker for the client are identified to the client and in the prime broker's records, we do not consider it to be necessary to identify where those securities are held by the prime broker, nor relevant, since the client cannot claim directly from the relevant delegate.

• ***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.***

It is not clear that this is practicable for reasons similar to those set out above in relation to the location of all safe custody assets.

Chapter 3 of the CP: Enhancing client money and asset protection

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?

We do not consider that FSA's concerns here are well founded, for the following reasons:

1.1. In some cases there may be good arguments for holding cash with a group bank if it has a better credit rating than other banks and/or there are benefits in terms of coordination, or other efficiencies. FSA acknowledges these factors at paragraph 3.9 of the CP and we urge FSA to reconsider their significance more carefully.

1.2. We do not believe that this requirement makes sense in a situation where a firm only holds cash for intra-group entities and these entities hold such cash for their own account.

1.3. It is not clear that compliance with the limit is practicable. The proposed new rule provides that the limit cannot be exceeded "at any point in time", but since client money holdings vary constantly, and there will be fluctuations in FX rates which will have an impact, it may not be possible for a firm to know whether the limit has been exceeded until after the event. Furthermore, although the firm may then remedy the situation, in principle it will have breached the client money rules and will need to consider disclosure to FSA.

1.4. We would ask FSA to confirm that it is the intention that the limit only applies to cash held with banks or qualifying money market funds (even though CASS 7.5.2R permits the holding of client money with intermediate brokers, exchanges and clearing houses in certain circumstances).

1.5. We would ask FSA to clarify how the 20 per cent limit applies in a secondary pooling event.

1.6. It is not clear how the 20 per cent limit applies where a client specifically instructs that its client money is held with a group bank. FSA notes that it will "address this on a case by case basis", which we presume means that in such cases the firm would need to seek a specific waiver, but we would ask FSA to provide clarification and guidance on this point to minimise the possibility of significant delay for firms which regularly receive such instructions.

Given the difficulties with imposing a specific limit, it would it be preferable to reinstate the pre-MiFID client money rule which required that (i) the client must be informed that a firm is holding, or intends to hold, client money with a bank in the same group, and (ii) the client money must be moved to a non-group bank if the client so requests, and (iii) that the firm applies due diligence procedures in selecting and monitoring the group banks used which are "at least as rigorous" as the procedures applicable to the selection and monitoring of non-group banks.

Q11: Do you consider it is appropriate to exclude client money held in client transaction accounts?
A client transaction account means "an account maintained by the exchange, clearing house or intermediate broker, as the case may be, in respect of transactions in contingent liability investments undertaken by the firm with or for its clients". CASS 7.5.2R permits the holding of client money with intermediate brokers, exchanges and clearing houses in slightly wider circumstances. We agree it is reasonable to exclude client transaction accounts from the limit, since there are specific transactional reasons why such arrangements are necessary, and for the same reason consider that any cash held with intermediate brokers, exchanges and clearing houses should be excluded from the limit.

Q12: We also invite your views on amending all the guidance currently contained within CASS 7.4.9G into a rule.
We agree with this proposal.

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?
In paragraph 3.14 of the CP, FSA concludes that some firms have "inappropriately allowed custodians and sub-custodians to include a general lien in contractual agreements". We understand this to mean that FSA considers that a firm that deposits client safe custody assets with a third party must not permit that third party to have a lien which entitles the third party to retain such assets where amounts due to the third party (or its affiliates) under other agreements between the firm (or its affiliates) and the third party (or its affiliates) have not been paid. FSA's reasoning is that this contributes "to significant delays or obstacles in an IP's ability to recover assets from deposits not under their direct control".

We believe that FSA's conclusions are flawed for the following reasons:

1.1. A third party appointed by a firm will be subject to the local law of the jurisdiction from which it provides custody services to the firm. Such local law may require the third party to have wide lien rights over custody assets, or may imply such lien rights which cannot be waived.

1.2. The third party appointed by the firm may be a central securities depository or settlement system, the participation terms of which impose a mandatory "general" lien or similar security right.

1.3. Due to the common mis-match of timing in deliveries of securities and receipt of payment, it is common for custodians to make advances to a client for the purposes of settling trades that are for that client's account. This may therefore also apply at the sub-custodian level. If the advance is made by sub-custodian to facilitate the settlement of a transaction for the account of the firm's underlying

client, the sub-custodian will need to have a lien over the underlying client securities for advances made by it for the acquisition of such securities. If such protection is not available, either alternative security arrangements will be required, or clients will not be able to obtain advances for settlement purposes, which will considerably reduce the efficiency of settlement processes.

1.4. If FSA's concerns relate to prime brokerage arrangements, it is not clear why this restriction should apply to all custodians. This would affect any service where a firm holds assets on behalf of clients (such as general custody services, escrow services or similar).

1.5. The paper does not really explain how the FSA differentiates the term "general liens" from any other lien or security interest. It is also important to recognise (and we are not sure that the paper does) that a lien is generally constituted as a right of a party to retain an asset of some kind until payment is made, it does not automatically bring with it any other enforcement rights such as a power of sale or netting.

It is not clear why clients should be prohibited from agreeing to authorise wider lien wording, as there may be significant commercial reasons why such arrangements are appropriate. Provided that there is appropriate disclosure of the relevant lien rights, the client will be aware of, and able to make its own decision regarding, the level of protection granted by the firm to the relevant third party. It is strongly arguable that a wide lien is no less appropriate than more complex security arrangements (e.g. title transfer arrangements which would appear to be a readily available mechanism to circumvent the proposed restriction on general liens). If wider lien or charge rights are not permitted, entities needing such protection are likely to require more complex security arrangements to be put in place or to provide unsecured credit, and this is likely to increase the overall costs of the arrangements for the client. If the FSA is intending to prohibit other forms of security then the risk to custodians would be considerable and there would be significant implications for systemic risk. If they could not use security rights over assets to secure liabilities incurred for the account of the client then they might follow the prime broker example and require outright title transfer (or charge coupled with "right of use" arrangements), which has even more serious implications for clients than delay in transfer of assets.

1.6. It is in any event difficult to see why this requirement should apply to situations where a firm only holds securities for intra-group entities, except where such entities are in turn holding such securities for non-group clients.

1.7. The recovery of assets held by a firm with a third party will always take some time. The question of lien rights is only one of the issues which need to be considered, and restriction of such rights will not prevent issues arising in relation to the speedy return of client assets.

For the reasons above we consider that this proposal is inadvisable and likely to be unworkable. An alternative approach would be to consider how lien terms can be more clearly disclosed. In this context, we note that there are already disclosure requirements in COBS 6.1.7R(2)(b), although this provision currently refers to a "depositary" rather than a "third party". This unfortunately reproduces an error in the MiFID Implementing Directive, where in the course of the drafting the term "depository" (which is not defined in the final MiFID Implementing Directive) was replaced with "third party" but by an oversight the term was not changed in Article 32(6). In the interests of appropriate disclosure, and in keeping with the intention of the relevant Directive, FSA could with advantage amend COBS 6.1.7R(2)(b) to correct this error.

In addition, we are struggling to understand the reference to "client money" at 6.3.5R of the draft Handbook (Appendix 1 of the CP) given that liens do not apply to cash, and set off rights are covered in Chapter 7 of CASS. We would ask FSA to provide further explanation in this regard.

Chapter 4 CP: Increased CASS oversight

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

Q20: Do you agree with our proposal for the CMAR?

Q22: Would you experience any difficulty in supplying the information requested in the CMAR? If so, please provide us with examples to illustrate.

Q21: Do you consider monthly reporting for large and medium firms and bi-annual reporting for small firms appropriate frequencies?

It is clear that these requirements will increase the administrative burden for entities holding client assets. We note in this regard that they apply to all firms subject to CASS, not just to prime brokers. We consider these additional compliance processes to be reasonable in principle, however are concerned with their potential effect in practice.

We would be very happy to engage with FSA in constructive dialogue in respect of any of the above issues. You may contact me on +44 (0)20 7295 3233 or by e-mail at margaret.chamberlain@traverssmith.com.

Yours faithfully,

Margaret Chamberlain
Chair CLLS Regulatory Law Committee

Members of the Committee:

Chris Bates, Clifford Chance
David Berman, Macfarlanes
Peter Bevan, Linklaters
Patrick Buckingham, Herbert Smith
John Crosthwait
Richard Everett, Lawrence Graham LLP
Robert Finney, Denton Wilde Sapte
Ben Kingsley, Slaughter and May
Jonathan Herbst, Norton Rose
Mark Kalderon, Freshfields Bruckhaus Deringer
Nicholas Kynoch, Mayer Brown International
Tamasin Little, SJ Berwin
Simon Morris, CMS Cameron McKenna
Rob Moulton, Nabarro LLP
Bob Penn, Allen & Overy
James Perry, Ashurst
Richard Stones, Hogan Lovells