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By email: fca-cp13-05@fca.org.uk

15 October 2013

Dear Sirs

Re: FCA CP 13/5 – Review of the client assets regime for investment business

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world.

This paper has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets, including many firms who are subject to the client money and client asset rules.

The Committee has only responded to certain specific questions as set out below.

Question 10: do you agree with our proposal to clarify the application of the client money rules in this way?

We agree with the removal of the reference to "investment agreement" but we believe that the closing words of the current rule "unless otherwise specified" should be retained. We could not identify the proposed new guidance referred to in paragraph 4.6 as being in the application provisions.

Question 11: do you agree with our proposals in relation to the banking exemption?

The comments in CP 13/5 regarding the banking exemption that "banks that hold money for clients in relation to investment business hold client money unless they apply the banking exemption" do not reflect the current CMR – as required by Article 18(1) of the MiFID Implementing Directive, the banking exemption applies to cash held by a bank, and there is nothing which a bank needs to do to "apply" the banking exemption. There is an obligation to notify clients where the banking exemption applies, but this is not and must not become a precondition to the application of the banking exemption. This would not be consistent with Article 18(1) of the MiFID Implementing Directive, and introduces new risks and complexities when it comes to identifying what is within the scope of the client money pool. Therefore we recommend amendment of the drafting proposals for CASS 7.1.8R and related provisions, since the current proposals suggest that the banking exemption is to be made conditional on notification to clients.

It is unclear why more detailed notification requirements are to be required in relation to the banking exemption. As currently drafted, it appears that a bank will be required (before providing MiFID business and/or designated investment business services to the client) to notify the client, in addition to the current notification, that if the firm is insolvent, the client money distribution rules will not apply to those sums, and the client will not be entitled to share in any distribution under the client money distribution rules. The suggested notification is misleading in that it suggests there will be a client money pool, this may well not be so in this case. We think it is clearer and sufficient to state that in the event of failure of the bank the client will be an unsecured creditor.

It is also proposed that a bank explain to its clients the circumstances, if any, under which the bank will cease to hold any money in respect of those services under the banking exemption and will hold the money as trustee in line with the client money rules, and set out such circumstances in its terms of business so that they form part of its agreement with the client. We think that such a statement would be difficult to draft comprehensively, and a more general statement would not enable a customer to understand the position. Moreover, we think the proposal is misconceived. If it is a "disclosure" requirement then generally disclosures are required to be made where the client needs to be notified of "risks", not where the outcome is positive. If the intention is to create a binding contract then we cannot see how this can be effective or desirable.

Question 14 and Question 33: do you agree with the proposal of clarifying the requirements around the DvP window?

We understand that issues have arisen in relation to the use of the DvP window but it was not possible to understand from the commentary the nature of the principal concerns. We explain below that we had some difficulties with the proposed definition of "commercial settlement system", and it occurs to us that if the concerns about current practice are relatively confined it might be better to deal with the issue by guidance. We agree that money or assets must only be held under the DvP window for a very limited period of time. However, it must also be recognised that the existence of the window represents a commercial and practical reality, but that the use of it does give rise to risks and therefore it is appropriate for its scope to be appropriately limited.

Application of DvP rule

We do not agree that CASS 7.2.8R should be amended to commence with the words "where required by the very nature of the transaction and with the agreement of the relevant client". The words "where required by the very nature" would seem to force firms to consider whether they can settle the transaction outside of the settlement system. Most securities held through the CREST system can be re-materialised and settled in certificated form. We do not think that firms should have to do this. Similarly, the words "with the agreement of the client" open up the issue as to whether money is client money if there is no such agreement, and indeed what any such agreement should say. We suggest that it would be better to impose a separate notification requirement that clients be notified that in these circumstances and for a limited duration of time their money is not client money. (In that regard it would be better if the phrase "need not be treated as client money" in CASS 7.2.8R were itself clarified so that it is clear that the money is not client money.)

Definition of commercial settlement system

We suggest that the reason there have been many interpretations of the definition of "commercial settlement system" is that in practice firms need to rely on the DvP window not just in relation to domestic transactions being settled through CREST but also in relation to transactions in a wide range of instruments traded on or through venues outside the UK.

We have some concerns about the proposed definition of "commercial settlement system" as set out below, and question if it is necessary as it may exclude inadvertently systems which ought to be within scope. The FCA clearly has concerns about some current interpretations, but it is not clear what they are. We can see scope for abuse if firms treat their own internal systems for settlement with clients as constituting a "commercial settlement system", but if this is the concern we think it may be better to make it clear in guidance that these are not within scope, rather than introduce a definition.

If a definition is retained then we consider that it needs further thought, for the following reasons:

- the CREST settlement system could be described as "commercially available to firms that are qualified to act as participants" (i.e. participants in the CREST system), but (i) this concept may not be so appropriate for systems tied to particular venues, and(ii) not all FCA firms will actually be direct participants. It is not clear if the FCA envisages that the firm must be a direct participant in any system - it may well not be and the definition should make it clear that this is not intended.

- the word "system" is potentially too narrow if it is to be taken as referring only to an electronic facility and the reference should be to "a system and/or arrangements".

- if we consider the definition in relation to the CREST system (which is clearly intended to be within scope) the purpose of the CREST system is both to facilitate the dematerialisation of securities as well as the clearance and settlement of transactions.

Although our preference is that the term is not defined (as explained above), if there is to be a definition then, taking the above points into account, we suggest that a possible definition might be:

> "a system and/or arrangements commercially available to firms that are qualified to act as participants, or which is connected to a trading venue or similar trading facility, a purpose of which is to facilitate the clearance and/or settlement of transactions using money and/or assets held on a settlement account."

Question 17: do you agree with these proposals on money ceasing to be client money?

We did not agree with the additional wording proposed to be inserted in CASS 7.2.15 (3)R. If a firm pays money into a bank account of the client, then the money should cease to be client money. The additional requirement which is proposed, which is that the money only ceases to be client money if it is paid into the client's bank account on the client's instruction or with its specific consent, will only introduce additional unnecessary complexity. This could cause problems for a firm if it is trying to cease holding client money for an unco-operative client, and it is unclear why a client needs protection against payment to its own account. If the concern if that the client will not know, it would be preferable to include an obligation for the firm to notify the client in such a case rather than requiring consent or an instruction.

Once the money has been transferred into the client's own bank account we can see no policy or other reason why there should be any risk that the firm would have to treat it as client money. The imposition of an additional condition increases the operational risk that a firm might fail to have a specific instruction or consent. There is no client detriment which this rule addresses, we strongly suggest that this additional wording is not included. Whilst a firm should be required to notify the client of the transfer, the loss of client money status should not be conditional on any such notification.

Question 19: do you agree with our proposals in relation to allocated but unclaimed client money?

We do not agree because the effect is to leave the firm with a potential monetary liability but to force it to pay the money that it might use to meet that liability to a registered charity. We agree that the current rule is unclear but we would have thought that, provided that a firm wrote an amount back to its balance sheet but also recognised the creditors for that amount on its balance sheet, then this would not be an improper treatment under the current rule. Similarly we see no reason why a firm could not transfer the unclaimed balance to an account which it holds on trust to pay out valid claims.

Question 23: do you agree with our proposal to clarify the existing requirements around the immediate segregation of client money?

We have no objection to the proposal in principle provided that it is recognised that a firm will not be in breach of CASS 7.4.1A.R if a client or third party transfers money directly into the firm's own account on its own initiative or by mistake.

Question 24: Do you agree with our proposed clarification of how client money segregated into units in a QMMF should be treated? If not please provide reasons

We were confused by the proposed amendments to the CMR regarding qualifying money market funds. If client money is deposited into a QMMF, the units in such QMMF are held as custody assets not client money, and must be held for specific clients in accordance with CASS 6. Units held in a QMMF, in the same way as any investments which a client has instructed to be made with client money held for it, are held by the firm as custodian subject to general trust law, not subject to the CMR. A firm will therefore have no authority from its client to liquidate the QMMF units and include the sale proceeds in the client money pool, and the FCA cannot grant this authority in the CMR. Even if the CMR require each firm to obtain the agreement of each client to such liquidation, it is unclear why this would be necessary or advisable. Client money pooling is primarily to resolve the complexity of trying to identify which client money is held for each client. In a situation where it is clear that QMMF units are held for a specific client, it is difficult to see the justification for removing the protection for the client for whom the QMMF units are held, and making the situation more complex by liquidating the units rather than simply delivering them to the relevant client.

Question 28: do you agree with our proposal to clarify the requirements around how a firm should treat client money transferred to a third party?

We are concerned that the proposals introduce greater risk of confusion as to when a firm is subject to the client money rules. Paragraph 4.99 states that "if a third party ends up holding money for a client which is a client of the firm (rather than a client of the third party), the money remains client money of the firm". Simply because a third party holds money for a person who is a client of a firm cannot mean that that money is client money. There are, however, situations where client money arises in the hands of a third party, in particular in a custody situation as recognised by CASS 7.5.5R.

Where client money does arise with a third party the guidance in proposed CASS 7.5.3G is however too narrow and does not cover the key situation identified above, as it ties the rules concerning the holding of client money by a third party to transactions. We think this guidance should therefore be made wider and indeed recognise that where money is held for transactions it might not be held for specific transactions, but for transactions generally.

Where a third party holds money which "belongs" to a client of the firm but which is not client money it is appropriate to emphasise the importance of Principle 10 (which could potentially cover a wider range of situations than where a firm holds client money or assets) and the mandate rules.

Question 29: Do you agree with our proposal to allow firms to hold client money in client transaction accounts at custodians? If not please provide reasons

The proposed amendment is that where safe custody assets are held with a non-bank custodian, the firm and custodian could establish a contractual agreement to cover the holding of client money by the custodian in a client transaction account.

This appears to restate the guidance in CASS 6.1.2G (reminder that payments of money received on safe custody assets should be treated as client money "where appropriate"), and propose amendments to CASS 7.5 to allow cash to be held in an account with a non-bank custodian, which account will be a client transaction account which is not subject to the restrictions for use described in CASS 7.5.2R to 7.5.3G. If so we welcome this but it would be helpful if the FCA could confirm that this is the intention (since the comments in section 4.103 of CP 13/5 are not wholly clear), and that there is no intention to require entities not subject to the CMR (for example, operating under the banking exemption) to hold cash derived from custody assets as client money.

Question 31: do you agree with our proposals for the exchange of acknowledgement letters?

The proposed changes will give rise to a number of serious practical problems. The acknowledgement will be required from all banks, whether or not the relevant account is in the UK, and must be in a prescribed form which cannot be varied. Based on our experience we know that in practice it will be not be possible to obtain the acknowledgement in an unamended form from non-UK banks since experience to date shows that entities in other jurisdictions do not understand the CMR or the purpose of the acknowledgement. We do not therefore agree that there can be only one form of letter. Firms must be free to agree an appropriate form which achieves the intended objective of the requirement. In addition we do not see what benefit there is in a wholesale re-papering exercise. In particular if that exercise is to require the use of a specific form it may introduce uncertainty and difficulties in situations which are in fact already adequately covered by an existing document. For example, a firm might have exchanged a suitable letter with an overseas bank, but that the bank might not be willing to accept a letter in the prescribed form. The ensuing uncertainty while the issue is discussed will create risks for clients. We suggest, therefore, that further thought is needed on this issue.

Question 35: do you agree with our proposal to limit the circumstances where a firm may register or record legal title to its own applicable assets in the same name as that in which legal title to client save custody assets are registered or recorded?

We understand the proposal to be that if client and firm safe custody assets are to be registered in the same name, then that must be in the name of the firm itself. Whilst we agree that the registration of client and firm safe custody assets in the same name should only occur in limited circumstances, we cannot see the benefit of requiring them in such a case to be registered only in the name of the firm itself. For example, it might be better for clients if the name used were that of a nominee rather than of the firm, where that is a possible outcome. In addition, it is not clear how such a prohibition would be workable if it is intended to extend beyond the record in which the firm/clients interests are recorded. In the common situation where a firm holds its own assets and client assets with the same settlement system, and such settlement system is not itself the record of legal title, the ultimate legal title to all securities held by the settlement system is likely be registered in the name of a nominee for the settlement system (or a nominee for the settlement system's depositary). In such a case, the firm cannot prevent such registration in the same name.

It is also unclear why this proposal is necessary. There is no risk that "the client's safe custody assets may not be easily identifiable" since CASS 6.2.5R already requires the firm to do this only if the firm's records separately identify the firm's assets and client assets.

Question 45: Do you agree with our proposals around the information that firms should be required to provide to clients about their holdings of client assets? If not, please provide reasons

The information obligations under COBS 6.1.7R currently only apply in full where there are retail clients. This is consistent with Article 32 of the MiFID Implementing Directive. It is unclear why there is any reason to extend the information obligations to professional clients in advance of any change to the MiFID Implementing Directive. Such a change will be onerous for holders of client money or custody assets who currently have no retail clients, and the benefit of such change is doubtful.

Question 46: Do you agree with our proposals for the introduction of a Client Assets Disclosure Document? If not, please provide reasons

The new requirements appears to be referring to title transfer arrangements, liens and set-off, but CASS 6 and 7 do not limit the ability of an entity holding client assets to agree or exercise such rights. If there are specific statements which the FCA requires to be made in these specific situations then it would be better for the FCA to specify the wording required.

We suggest this because:

- the meaning of "key provisions ... which modify rights of protections which would otherwise be available to the client under CASS 6 or CASS 7" is unclear. As a result of COBS 2.1.2R, a firm cannot exclude by contractual agreement "any duty or liability it may have to a client under the regulatory system".

- the provision of a statement of likely consequences is very onerous and not appropriate since it appears to oblige the firm to provide advice regarding the legal consequences of holding the relevant assets and the impact of insolvency law.

It is also unclear what benefit the "key provisions" will provide for professional clients, since professional clients will be aware of the relevant terms, and in any event clients will need to review the operative terms rather than the summary.

Other comments

1. CP 13/5, Section 5.4. - Share certificates. The FCA considers that safekeeping and administration of physical share certificates should fall within Art 40 of the RAO on the basis that "loss or destruction of share certificates could harm the client in certain circumstances". We agree that where a firm has safekeeping of a physical share certificate and is also responsible for administration then it is carrying out the regulated activity of providing custody. However, it is not always the case that a firm which has a document in safekeeping is also responsible for administration. This distinction needs to be clear. It must also be recognised that a share certificate is not, and does not (unless it is a bearer document) give legal title to, a share, and therefore the loss or destruction of many share certificates will not harm the client.

2. New CASS 6.5.10B R. There is a new definition of shortfall referring specifically to a shortfall of safe custody assets, and this new rule requires a custodian to "make good the shortfall" if reconciliations reveal a shortfall. There is no reference, as in the current CASS 6.5.10R, to making good only where "there are reasonable grounds for concluding that the firm is responsible". As currently drafted therefore, there appears to be an absolute requirement for a custodian to make good any shortfall, regardless

of the reason for it. Such a change brings potential systemic risk, strict liability for loss regardless of fault or contractual agreement is a radical change for which detailed consultation would be necessary.

3. CASS 7.1.8A R. The words "Subject to CASS 7.1.8B R" should be deleted because this rule should reflect the MiFID Implementing Directive and therefore cannot be conditional.

4. CASS 7.1.8A R(1). This should read "a BCD credit institution in relation to deposits ..."

5. CASS 7.1.8A R(2). This should read "... designated investment business for its clients in relation to any money held by it as banker in relation to that business ..."

6. CASS 7.1.8B R(1). The words "subject to (2)" should be deleted because the disapplication of the CMR to banks is not conditional on compliance with CASS 7.1.8D R to CASS 7.8.10 G.

7. CASS 7.1.8D R (2). This is confusing and it is recommended that it should read "in the event of the appointment of a liquidator, receiver or administrator, or trustee in bankruptcy, or any equivalent procedure in any relevant jurisdiction, in relation to the firm, the client money distribution rules ..." (Otherwise most firms will copy "fails" into their standard terms without defining it, causing confusion as to what this means.)

8. CASS 7.2.7C R. This wording is confused and requires clarification. Do the words "does not have effect from time to time" mean "at any time does not have effect because there are no outstanding or future obligations"? Does "must treat that money as client money" mean that the firm must take steps to do so, or that the relevant money will automatically be regarded as client money held on trust?

9. CASS 7.2.14A R(3). This is a new requirement and appears to apply to all clients, and whether or not the firm and client have agreed otherwise. Is that the intention?

10. CASS 7.4.1B G(2). This states that investment of client money in QMMFs can only be done using client money which has first cleared into client money accounts. It is not clear why cash to be received by a firm which, when received by the firm would be client money, cannot be paid directly into a QMMF (provided of course that the firm records for which clients the QMMF units are held).

11. CASS 7.4.3A R, 7.4.3B R(2), 7.4.23A R. For the purposes of clarity and plain English, all uses of the phrase "in line with" should be replaced by "in accordance with".

12. CASS 7.4.31G (states ability of firm to segregate client money in a currency other than that in which it was received does not apply where a client instructs the firm to convert and hold in a particular currency). It is unclear why this has been deleted.

13. CASS 7.4.33G. A firm is required to undertake to the CFTC for certain purposes that it will not allow its clients to opt out of client money protection. This Guidance has been expanded to state that the firm will not make use of the bank exemption or title transfer arrangements. We did not understand why this should be so because such arrangements are not opt outs.

14. CASS 7.8.-1G(3). This should be amended by the insertion at the end of the sentence of the words "other than amounts owed by the firm to such bank, exchange, clearing house, intermediate broker, OTC counterparty or other person (as the case may be) in connection with such client bank account or client transaction

account". There is no reason why a bank or clearing house should not have recourse to the relevant cash account for amounts owed in connection with that account.

15. Pro forma client money acknowledgement letter from banks. We have already commented that we do not agree with a single form for this letter, but to the extent that there is a recommended form we suggest the following amendments. In the second paragraph, the first line should read "You acknowledge that we have notified you that:"

    In paragraph (d), for clarity the words "in respect of any sum owed to you, or to any third party, on any other account" should be moved to the end of that paragraph, and the words "including but not limited ... against money in the Client Bank Accounts" should be in brackets.

    In paragraph (e), in the second line, after "any other account" insert "in your books".

    In paragraph (f), at the end insert "subject to any set-off rights to which you are entitled under applicable law or any contractual terms agreed without breach of (d) above."

16. Pro forma client money acknowledgement letter from clearing houses etc. Similar amendments as above, except that there is no equivalent of para (f) noted above.

17. CASS 7A.2.4D R. At the end of (1), should be "and" not "or".

18. CASS 7A.2.4V E. This is unhelpful since it will be a question of fact whether or not initial pool entitlements can be determined.

19. CASS 7A.2.6A R(2). This should say "subject to CASS 7A.2.6A R(3)" not "subject to (3)(c)".

20. CASS 7A.2.6B G (1B) and (2). The cross-references seem to be wrong.

21. CASS 7A.2.6F. Apparently numbering error - this Rule (or Guidance) is missing.

22. CASS 7A.3.3 G. We did not understand why the final sentence has been deleted.

23. CASS 7A.3.5A G. Does this mean clients may be able to claim bank compensation as if they were the clients of the bank? If so, it would be helpful to clarify.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact me in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

Yours faithfully

Margaret Chamberlain
Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Members of this Committee are as follows:

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