

## **Client money: The Global Minefield: Recent UK developments and how to manage them Questions to ask a broker-dealer on its global client money management**

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**28 August 2009**

This is the second part of a two part series on client money. The first looked at the significant developments in the UK around client money during the first part of 2009. This part suggests how to manage these developments.

### **Fundamental requirement: - Ensure that post MIFID a broker-dealer is still contractually obliged to segregate client money and if necessary request written confirmation**

Global Trader (PDF) highlighted the concern that during the implementation of MIFID in 2007 many clients' money were unilaterally taken from client money segregation status to where the title to their money was transferred to the broker-dealer pursuant to CASS 7.2.3.

Many clients may be unaware of this change of status because:

- Many standard broker agreements have amendment clauses which could be used to unilaterally take title to clients' money which previously was segregated.

In Global Trader (PDF) such an amendment was upheld even if it was done by way of an e-mail which was hyperlinked to the new terms and conditions. Subsequent trading by clients constituted consent to the new terms.

- During the implementation of MIFID in 2007, clients of broker-dealers were bombarded with lengthy MIFID related agreements, circulars and electronic communications, all within a short period prior to implementation on 1 November 2007.

Many of these vital messages are possibly still sitting undiscovered in e mail boxes or on clients' desks and unbeknown to them, their money may be outside of client money segregation.

### ***Suggested actions to be taken by clients of broker-dealers:***

- Review all MIFID and other client money communications received from broker-dealers to ensure client money has not been unilaterally taken out of CASS rules segregation.

- If still unsure, obtain written confirmation from broker-dealers that money is under CASS rules segregation. However, ensure this confirmation, the broker terms and relevant MIFID circulars :
  - include all the required elements of the CASS rules segregation. (In Global Trader (PDF) the new MIFID terms did not include all the required CASS language and ironically, title transfer of money, was in some cases held to be ineffective).
  - are not in conflict with one another or other overriding agreements with the broker-dealer (often a prime broker agreement) where title transfer of money may have been given under CASS rules.

Question 1.16 of the Lehmans application (*See part one of this two part series*) is a direction requested on whether segregation is valid if given by a broker-dealer without a contractual obligation to segregate. A direction in the negative will put more emphasis on synchronising conflicting contractual client money undertakings. However, both Global Trader and the administrators support a direction to the positive which would mean client money segregation becomes more of a factual than contractual issue.

- Review and renegotiate, if necessary, the amendment clause to broker agreements to limit the unilateral amendment rights in favour of broker-dealers.

### **Ensure that client money is factually held in a segregation account**

Global Trader (PDF) held that client money protection is effectively lost if a broker-dealer was contractually obliged to provide segregation, but did not hold the money in segregation accounts, in which case a tracing action will also be difficult to prove.

This is where the choice of a broker-dealer becomes important because ultimately it comes down to trusting a broker-dealer to keep money in segregated accounts.

A certain level of due diligence can be conducted and it is worth asking for clear evidence that money is held in segregation accounts and how this is accurately reflected on the broker-dealer's statements.

Look at the creditworthiness of the banks where a broker-dealer keeps its client money accounts because CASS rules however do not protect clients against the unsecured creditors of the bank where the broker-dealer keeps client money, if such bank goes into liquidation.

**Alternatively**, instead of the broker-dealer, credit cash balances can rather be held at an independent third party custodian whose primary objective is to provide custodial services.

### **Open trading and clearing relationships with more than one broker-dealer**

It was held in Global Trader (PDF) that clients will lose client money protection to all their profitable (in-the-money) positions when these are closed out after a broker-dealer goes into administration. Having more broker-dealer relationships will position clients for possible transfer of open positions to its other broker-dealers, before the troubled broker-dealer goes into administration.

### **Questions to ask a UK broker-dealer on its client money management in other jurisdictions**

In accordance with CASS 7.4.7 -7.4.10 a broker must conduct due diligence on the choice of bank, credit institution or qualifying money market funds where it holds client money, including legal requirements that could adversely affect their clients' rights to client money segregation.

Some of this information will be confidential but it is in the broker-dealer's best interest to disclose as much information as possible on this due diligence process.

Suggested questions to ask a broker-dealer on jurisdictions with lesser client money protection than the UK:

- What are the reasons for posting money to segregated accounts in these jurisdictions?

Is it for trading reasons or to obtain a better rate of return?

Most broker agreements have a standard warning clause that client money could be held at jurisdictions with lesser client money protection. If a client's trading activities are only in the UK or other safe client money jurisdictions, this clause should be renegotiated to limit client money to be held only in these safe jurisdictions.

- Do broker-dealers have a policy in place where client money is safely kept in the UK but their own money is then used for margin calls in these other jurisdictions? What is the corresponding finance charge to clients? Broker-dealers sometimes provide this free of an additional finance charge.

- Whether their risk management policy only keeps minimum balances in accounts in these jurisdictions and how often are they swept for surplus balances?

- Did their due diligence show discrimination against international creditors in favour of domestic creditors?

- Are there any insurance or government guarantee schemes for the default of banks in other jurisdictions? Are both professional and retail clients covered and what is the maximum amount?

### **Conclusion**

Clients of broker-dealers increasingly want their assets with broker-dealers safeguarded and are increasingly held with independent custodians according to a recent hedge fund survey (See specifically page 16 exhibit 17). Some broker-dealers now build their prime brokerage services around segregation of client assets. (See article).

Managers increasingly favour exchange traded derivatives above OTC derivatives due to counterparty risk (See article), which may result in increased cash balances becoming eligible for client money segregation.

Client money segregation will increasingly play a role in this shift in financial services and broker-dealers should prepare themselves for more scrutiny by clients on their CASS rules segregation program but even more so on their client money management in other jurisdictions.