

Client money segregation: the global minefield — part four: suggestions to manage recent developments

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May 18 2010

Part three in this series discussed the developments since September 2009 on client money and asset protection. These included proposals made by the recently released Financial Services Authority consultation paper on enhancing the Client Assets Sourcebook and the ongoing Lehman Brothers International Europe litigation. Part four suggests more practical ways of managing the impact of these developments by using some of the recent findings of the FSA, certain LBIE litigation points, and some proposals made in the FSA consultation paper and the HM Treasury consultation paper (PDF) on establishing resolution arrangements for investment banks.

Any firm authorised to keep client money should compare its procedures with the FSA's 'Dear CEO' letter on client money and asset report

In the midst of all the debates and litigation relating to CASS client money and asset rules, at last some specific practical guidance appeared on the horizon when the FSA released its "Dear CEO" letter in January 2010. This letter reported on the findings of the FSA's increasingly well resourced CASS risk team, which resulted from their visits made to firms during the course of 2009. For commentary on these findings, see also "Compliance and senior managers under spotlight after FSA finds client money failures". Some of the findings included:

- Inadequate senior management oversight.
- Overly complex processes were amplified by human error.
- Periods of transitional change caused increased operational and systems risks.
- Due diligence on the selection of banks was inadequate and poorly documented.
- Inappropriate claiming of ownership rights over client money.

Additional focus points for the FSA CASS risk team in 2010 will be:

- Form and content of CASS audit teams.
- The overuse of title transfer arrangements on client money and other client assets.
- The application of unallocated excess cash in segregated accounts.
- The use of "alternative approaches" to client money segregation.
- To team up with HM Treasury on its proposals for investment firms.

The FSA's message is stern and many firms should not be caught by surprise as to the extra effort (and complexity) involved in complying with the "Dear CEO" letter's focus points, specifically the additional points. Firms should start reviewing their own factual situation with the findings. At least, they should start with the easier ones — for instance, ensuring that the trust acknowledgement letters are available and easily accessible. Asset protection is clearly a top priority for the FSA and if a firm's senior managers are not yet involved, they should be involved as soon as possible.

Use this handy LBIE reference to understand the factual situation of client money segregation at a global broker firm

Irrespective of the multitude of litigation and debates currently surrounding the CASS rules, the factual management of client money is still one of the dominant factors in determining if clients' money enjoys protection. For instance, is money in or out of the client money account and was the account set up properly? Any client of a broker firm who takes client money segregation seriously should at least read the useful overview of around 10 pages covered by paragraphs 2.1 to 2.49 of the judgment in the LBIE Client Money application. This overview will help the client to understand the inner workings of a global investment bank/broker. In turn, the client could then ask more specific questions about the client money management and asset protection. Specifically, the following:

- Paragraph 2.6 as to the architecture of agreements in relation to client money segregation.
- The various types of trading products and other categories to which client money segregation applies (paragraphs 2.16.1-2.16.8).
- Liquidity management specifically on a cross-border scale (paragraphs 2.21-2.27).
- The operational aspects of margin in exchange-traded derivatives, the interaction thereof with client money segregation and exchanges and clearing houses (paragraphs 2.28-2.49).

The more clients of broker firms are informed on the operational process of client money at such a firm, the better factual questions such clients can ask to ensure proper client money protection.

Do not fall victim to the *Global Trader* ghost

In the *Global Trader* case, during the implementation of the Markets in Financial Instruments Directive in 2007, customers were unilaterally taken out of client money protection by way of an e-mail. In its "Dear CEO" letter, the FSA reported great concern about the overuse of title transfer of assets; rights in favour of broker firms could have been unilaterally introduced back in 2007 with the implementation of MiFID. The FSA consultation paper proposes mandatory warnings in prime broker agreements as to the dangers of title transfer. The FSA will release a further quarterly consultation paper on title transfer during July 2010. MiFID-introduced trading agreements/terms should be reviewed. Specifically, the architecture of trading agreements should be looked at to ensure agreements under which a client thought to have client money protection are not overridden by other agreements in favour of title transfer — the usual suspect is the equity finance prime broker agreement.

Use some LBIE pointers to ensure assets held under a prime broker agreement are held on trust

Unlike International Swaps and Derivatives Association agreements for over-the-counter derivatives or the Futures and Options Association terms for exchange-traded derivatives, there is not an acceptable industry standard agreement for prime broker services specifically on the equity finance side. Prime broker agreements generally have to be interpreted

separately. LBIE had two types of prime broker agreements — one named title transfer and the other named a charge agreement, which meant that assets were held on trust. Any prime broker client who wants its assets to be held on trust, or thinks it should be held on trust, should consider reviewing its agreement according to the useful guidance in the judgment in the LBIE Charge IPB Agreement. Prime broker agreements, therefore, should ensure:

- Custody language in the agreement and the trust intention is clearly stated.
- Cash income stream resulting from trust/custody securities do not form part of the title transfer regime for cash.

Clients can now ask questions about a broker firm's client money segregation in other jurisdictions Part two of this series included questions to ask a broker firm on its client money segregation in other jurisdictions. The need to ask these questions has been amplified by the following recent developments:

- The HM Treasury consultation paper proposes a restriction on keeping client money at a firm's affiliates in jurisdictions whose laws will weaken CASS rules protection.
- In the "Dear CEO" letter, the FSA expressed concern about firms doing inadequate due diligence on banks/institutions where client money is held.
- The FSA consultation paper proposes:
 - A restriction on firms to hold only 20 per cent of client money intra group.
 - The guidance in CASS 7.4.9 on choosing where a firm should keep its client money should become mandatory.

The LBIE litigation has flagged the dangers of keeping client money in other jurisdictions and the momentum is clearly behind clients of broker firms to ask the hard questions. A good starting point is to ask questions according to the guidance in CASS 7.4.9, which soon may become mandatory.