CP13/5: Review of the client assets regime for investment business

A response by the Futures and Options Association

October 2013

CP13/5: Review of the client assets regime for investment business

1 Introduction

1.1 This response (**Response**) is submitted on behalf of the Futures and Options Association (**FOA**), which is the principal European industry association for 160 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1 for a list of members).

1.2 The FOA is pleased to have the opportunity to respond to the FCA's Consultation Paper CP 13/5 – Review of the client assets regime for investment business (the **Consultation**) and welcomes the FCA's wholesale review of the client assets regime. The FCA will recall that the FOA has previously offered its members' suggestions as to various improvements that could be made to the FCA's Client Assets Rules (**CASS**). A copy of the paper submitted in June 2012 (the **First Response**) is attached at Appendix 2 to this Response and a copy of the FOA's response to Parts II and III of CP12/22 submitted in November 2012 (the **Second Response**) is attached at Appendix 3 to this Response. The FOA has already given its feedback on question 48 in relation to chapter 8 of the Consultation in August 2013 (the **Third Response**) and this is attached at Appendix 4 to this Response. This is, therefore, the FOA's response to the remainder of the Consultation (namely chapters 2 to 7 and chapter 9).

1.3 The FOA has put together this Response following consultation and discussion with its members and with the significant assistance of Norton Rose Fulbright LLP. The FOA would welcome the opportunity to discuss its members' comments with the FCA in more detail if this would be helpful.

2 General

Speed proposal

2.1 The FOA notes that the government-commissioned independent review is currently in a second phase and is likely to report later in 2013. The FOA also notes that the FCA may need to amend some of its current proposals, particularly those relating to the client money distribution rules, if there are material changes to legislation introduced by the government as a result of the independent review.

2.2 The FOA welcomes the FCA's efforts in seeking to improve the process for returning client assets on the default of a firm, bank or CCP and thereby restoring confidence in the UK's client assets regime. However, given the increasing complexity and costs of complying with changes to regulation (especially where regulation is proposed and then subsequently amended and re-consulted upon), and, as FCA concedes in paragraph 1.30 of the Consultation where it says "*We recognise that our proposals, in particular those in relation to the client money distribution regime, may need amending if the government introduces material changes to legislation",* the FOA would urge the FCA to wait for the outcome of the government's review before finalising its own proposals. The FOA does not suggest that the discussion about how best to achieve the FCA's objectives should not continue in the meantime and members are keen to participate actively in those discussions and have set out their immediate concerns regarding the speed proposal below.

Timing and re-papering issues

2.3 The FOA notes the FCA's intention to publish final rules during the first half of 2014 with a view

to their coming into effect six months later or possibly immediately thereafter for the client money distribution rules. Given the breadth of the changes and the fact that, while many of them are clarificatory, several of them require firms to amend both internal processes and client-facing documentation, members are concerned that six months does not allow sufficient time to make the necessary changes with the degree of care and involvement of all relevant members of their organisations that would be appropriate. For example:

- firms relying on the banking exemption or the title transfer carve-out may have to make changes to their terms of business;
- all firms will be required to repaper their client money acknowledgment letters;
- the proposed changes to the rules on reconciliations for both client money and custody will require some firms to obtain auditor's opinions before they can continue to use those methods; and
- firms are facing considerable implementation pressures and complexity and impossibly tight timetables in delivering changes to account structures required under EMIR which will also have to reflect appropriate client money arrangements.

2.4 The FOA assumes that the FCA does not intend firms to provide disclosure documents to existing clients to which they already provide services on the date on which the new rules come into effect but rather than they should start to provide such documents to those clients on an annual basis, but members would be grateful for clarification on this point as this would otherwise constitute another practical timing concern. The FOA also asks that the FCA considers the cost of amending contractual arrangements and, as such, where the FCA's objectives can be fulfilled by notification, CASS is clear that two-way agreements or written client acknowledgements are not required.

EMIR specific issues

2.5 Over the coming 12 months, FOA members anticipate the implementation of EU legislation which may require further amendments or will be relevant to decisions on timing of the proposed CASS rules. As a general matter, members would ask that national regulations should not be implemented in a manner that is at odds with an EU deadline. For example, in order to comply with Article 39 of EMIR, clearing businesses will be required to provide clients with detailed disclosures about omnibus and individual segregation and obtain client consent to the use of one or the other in the first months of 2014. The FOA would, therefore, ask that the FCA does not require that substantially similar CASS disclosures are made to clearing clients within the same year as this disclosure as this would be largely duplicative and additionally may confuse clients.

2.6 Additionally, as the FCA will be aware, a sub-committee of the FOA has been working on the implementation of EMIR and, in particular, Article 39 of EMIR, in relation to cash flows. As there is no specific question in the FCA's Consultation on this point, it is considered important to set out the main issues here. The problem stems from the fact that EMIR envisages both the creation of multiple accounts and, to the extent clients choose individual segregation, at least one account per client. In addition, CASS requires that cash that is client money remains segregated from cash received by the firm on a title transfer basis. Given limitations on the operational abilities of CCPs, settlement banks, custodians and firms, the FOA has proposed three possible models for transferring cash between a firm and a CCP on the one hand and a client and the firm on the other. For convenience, these models are set out in Appendix 5. Options 1 and 2 are the FOA's preferred models. They each propose a solution whereby a client electing an individually segregated account interacts with one single clearing member bank account and, similarly, the CCP interacts with one single clearing member bank account. The FOA believes this is both practical and workable for clients and CCPs and is achievable for clearing members to implement within the EMIR timetable. There are pros and cons to Options 1 and 2, as well as some implications on rules relating to, for example, mixed remittances, acknowledgment letters and the calculation of the client money requirement, which are

mentioned in the response to Questions 23, 30 and 31. Option 3, by contrast, describes a situation in which both clients and CCPs interact with multiple clearing member bank accounts. While this approach is permitted under the CASS rules, the FOA understands from CCPs and its members' experiences with clients that currently it is not operationally possible and would not be a workable solution within the EMIR timeframe.

General clarifications

2.7 There are also a number of rules that the FOA believes would benefit from clarification and, given that the stated purpose of many of the changes is to clarify existing rules, it would seem sensible to ensure that this is achieved before the changes become effective. In particular, the FOA would appreciate clarification on the intended effect of CASS 6.5.12 and 6.5.12A on the need to make good shortfalls in custody assets caused by third parties.

2.8 The FOA is also particularly concerned with the number of proposals that appear to extend what the industry may have perceived as retail standard requirements to wholesale clients. Many of the circumstances require the provision of information or agreement to certain terms. The scale of the exercise should not be underestimated given that some firms do not currently have written terms in place with such clients and that where they do, they are not necessarily executed as contracts so much as terms of business that take effect by course of dealing. While the extension of fiduciary type obligations appears to be the FCA's explicit intention in some areas, it is in places affected by the extended definition of client for the purposes of CASS. The FOA would, therefore, urge the FCA to review its rules to ensure that, where appropriate, the distinction in regulatory requirements is preserved. In particular, in relation to institutional business, it would be inappropriate to require firms to consider the best interests of clients. In a number of such relationships, firms will not be acting in an advisory capacity and will not be well placed to make such determinations.

2.9 As the FCA knows, FOA members have a number of long-standing concerns about the practical operation of certain aspects of the client money rules, some of which have not been addressed in the proposed changes and a few of which are exacerbated by them. An example is the diversification rule, whose application in certain circumstances (especially stressed market conditions) members find difficult to reconcile with client protection. Not only do some of the proposed changes to this rule develop some of the existing problems, but some of the new proposals (such as sub-pools and restrictions on term deposits) add to the challenges. The FOA has made some suggestions about how these issues could be addressed.

Navigation of proposed amendments

2.10 Finally, as a purely practical matter, the FOA would request that the FCA provides cross references in its feedback on the Consultation as the volume and diversity of proposed amendments has made it quite difficult to identify which drafting relates to which proposal. The FOA has tried to cross refer to what it believes to be the relevant sections of the text in this Response but would be grateful to know if the FCA believes that any of them have been misunderstood.

3 Chapters 2 to 7 and 9 of the Consultation

Question 1: Do you think we should implement the speed proposal or codify the existing regime? Please explain the reasons for your response.

3.1 The FOA supports the FCA's objective to amend CASS to enhance the likelihood of a timely distribution of client asset claimants. It agrees that the delays experienced in recent failures such as those of Lehman Brothers International (Europe) Limited (**LBIE**) and MF Global UK Limited (**MF Global**) were harmful to the reputation of the UK markets and agree with the FCA's statements of principle at the outset of chapter 2 of the Consultation.

3.2 While the FOA welcomes the FCA's recognition that certain aspects of the client money regime need to be addressed welcomes the FCA's willingness to be open-minded regarding the

proposed solutions and, in general, supports the FCA's assertion in paragraph 2.5 of the Consultation that "*a faster return of client money following an insolvency is important to maintain confidence in financial markets and reduce the effect on other participants*" (i.e. to reduce the risk of a financial "domino" consequence), the FOA is concerned that the speed proposal, as presented, contains a number of flaws that would need to be resolved and, as suggested in paragraph 3.5 below, may not, in a large number of circumstances, be practical.

3.3 The FOA understands that the FCA has the power to change the way in which client money is distributed because the statutory trust in section 137B of FSMA 2000 refers to the Client Money Distribution Rules. However, the FOA believes, as indicated in paragraph 2.2 above, it would make more sense to consider such significant changes to the client money regime at the same time, and in parallel with, the government considering whether any complimentary or supplementary changes should be made to insolvency law. The FOA understands that the government's review of the Special Administration Regime is in progress and that the FCA anticipates the possibility of having to re-consult if the government's conclusions affect the FCA's proposed changes, but the FOA believes there would be merit in postponing the introduction of the proposed changes until this work has been completed so that the new regime can be designed in the round.

3.4 The FOA believes the most important change required to insolvency law for the purposes of the speed proposal relates to the liability of UK insolvency practitioners. The FOA notes the way in which an insolvency practitioner's personal liability is restricted in the US, Canada and Hong Kong (as outlined in paragraph 2.36 of the Consultation) and would urge that similar qualifications are introduced in the UK. Indeed, the FOA would urge the FCA to encourage HM Treasury to address all the issues identified by the FCA in the Consultation which have the effect of undermining the ability of an insolvency practitioner to facilitate faster-track pay-outs of client money. Additionally, the costs of distributing client money should not be borne by the client money pool but rather by the insolvent estate of the firm.

3.5 Regardless of any changes that it might be desirable to make to insolvency law, the FOA considers that there are a number of issues with the speed proposal. In particular:

(a) The FOA queries whether the speed proposal (in the form of the creation of the initial client money pool) could ever work in practice, at least on the insolvency of a large bank. It doubts there are likely to be many situations where none of the three situations triggering the alternative approach would apply. For example, in relation to the MF Global administration, it seems likely that all three circumstances would have applied. Given that a bank is permitted to hold up to 20% of its client money in an affiliate bank, it seems relatively likely that the 10% difference test will apply on the insolvency of any large bank. In addition, while the FOA accepts that the FCA has taken several steps to try to improve firms' record-keeping and has proposed a more organised structure for switching to client money, the type of pressured activity that has tended to occur in the run up to an insolvency, some of the impediments itemised in paragraph 2.12 of the Consultation and the added complication of post-default management of sub-pools, makes the prospect of not being able to readily determine clients' entitlements quite realistic. Members continue to be concerned about the impact of complex sub-pools on the distribution of client money. Nevertheless, the FOA believes that the insolvency practitioner should not be restricted to the three circumstances identified and should have wider discretion not to create an initial client money pool if it considers that this would not be appropriate in a particular case. If these triggers revert to a combined client money pool, it therefore seems likely that the speed proposal might not constitute a significant change from the current regime in practice. In either case, it will be important to codify the existing regime in the sense of making the understanding reached in the LBIE cases clearer on the face of the rules. The FOA agrees with the FCA's suggestions in paragraph 2.31 of the Consultation but the FOA would also refer the FCA to paragraphs 3.3 to 3.5 of its First Response which contained suggested changes to confirm the existing regime.

(b) Even where it is possible to form an initial client money pool, the FOA believes there are

some issues resulting from the serious consequences and the financial prejudice that will result to clients not being part of that initial client money pool. It seems likely that the insolvency practitioners are going to be subject to significant pressure in determining whether it is possible to form an initial client money pool and what amounts are owed to each client and that this decision could be delayed by clients whose cash has not been held in a client bank or client transaction account seeking injunctions. It should be assumed that the insolvency practitioners' strict liability would also cause a delay in such circumstances as it is likely to consider it necessary to seek the court's guidance. It is likely that the distribution of the residual pool would be more costly and contentious. One means of reducing the impact upon claimants of the residual pool would be to change insolvency law so that the general estate bears the cost of distribution. The FCA has not articulated how it intends the client money entitlement to be determined (i.e. by reference to what information). If it remains the case that entitlement will be determined by contractual claims (per the LBIE judgement), this should be confirmed in the text of the rules. The FOA wonders whether there might be an alternative solution that provides more transparency for clients without them needing to continuously ask firms for information.

(c) The FOA would also note that it is well established that client money (along with other client assets held by a firm as trustee) may serve as collateral for a client's obligations to a firm, by way of a security interest granted by the client over its interest in the relevant client money/assets. This is supported in law and under the existing CASS rules. It is also an essential mechanic for (a) properly collateralising client obligations while (b) maintaining a segregation of the collateral assets, ring-fenced from the estate of a firm in its insolvency. This collateral mechanism is used throughout the investment services industry and, with this in mind, the FOA considers it unrealistic to envisage a process for distributing client money to clients in a matter of weeks based only on the firm's books and records at the time of a primary pooling event. The security interest may secure the client's obligations not only to a defaulting firm, but also to its affiliates (as in the LBIE cases). While the administrator must consider the interest of clients holding claims for client assets, it must also consider the interests of creditors and the affiliates with secured claims. In addition, the administrator must also reconcile the liabilities owed by clients to the firm and consider the interests of affiliates and liabilities owed by clients to those affiliates. In many cases, it will be the clients (as the non-defaulting parties) who calculate the value of those liabilities and submit close-out valuation notices to the defaulted firm (pursuant to their rights under the relevant agreements). The administrator must make his own calculations and reconcile these with the calculations and claims of clients. All this takes time and cannot be artificially accelerated. For these reasons, the FOA would suggest that it is not appropriate for the FCA to amend the client money distribution rules to allow for a 'speed method' of distribution.

3.6 If the FCA were to adopt the speed proposal, the FOA believes there are a few areas where the draft text would benefit from further work or which should otherwise be included in amendments to insolvency law. For example, it is not clear how the costs of the initial and residual pools would be borne and it does not seem right that the costs of either pool should be funded by the other. The FOA assumes that the costs related to the residual client money pool could be significant as they might include the work of trying to check clients' tracing claims. It seems unlikely that any clients are likely to benefit from the residual client money pool because of the difficulty of tracing cash which is the subject of legitimate claims and the likelihood of clients that have not recovered the full amount owing through the initial client money pool to make claims. Even if they were to recover a proportion of their cash, they might have to wait a very long time as the speed element of the proposals does not seem to address the residual client money pool. In addition, if a firm holds a buffer in its client money account, which pool would it form part of and who would be entitled to it? One possibility is that the buffer should be set aside to top up the residual pool as this is most likely to be the pool in relation to which clients whose cash should have been segregated (but which was not due to systems and controls failures) will suffer. Further, it may be helpful that clients hold buffers due to anticipated higher distribution costs.

3.7 In order to deal with some of the issues, the FOA would urge the FCA to consider amending its proposal whereby only a percentage of identifiable client money (e.g. 70%) should be returned on a fast-track basis to those whose client money has been recorded as such, so that those who have been paid out from the initial client money pool will still have a residual liability to any shortfall in client money and to any increased administration costs resulting from the administration of both pools. It seems unfair, in principle, if a minority of customers, through no fault of their own, have to bear the full force of any shortfall. This alternative suggestion has the merits of:

- being consistent with the underlying risk basis of an omnibus account, namely acceptance of the principle of mutuality of (all) fellow customer risk;
- avoiding the injustice of any shortfall being met by the unlucky few; and
- still allowing clients in the initial client money pool to have the benefit of a faster track pay-out of the majority of their client money.

3.8 In conclusion, the FOA does not think the speed proposal should be adopted as drafted for the following reasons:

(a) in the absence of a change in insolvency law;

(b) until further consideration has been given to client money that serves as collateral;

(c) until further consideration has been given to the message that the new regime could allow for distribution within two weeks because the FOA believes this is unrealistic and, as a result, advertising this as the aim of the new regime is unlikely to restore confidence in the UK system;

(d) until the pros and cons of a 70% (or similar) fast-track payout have been considered as an alternative to the current proposal for a 100% pay-out; and

(e) because, as indicated earlier, firms are already facing considerable complexity and a major burden on existing resources in implementing EMIR in the context of client money changes.

3.9 The FOA notes that it is inviting a number of insurance companies to give consideration as to whether or not they can provide some form of "top up" protection in the event of a shortfall in client money. Bearing in mind the strengthening of client money rules, tougher capital requirements, an improved default "waterfall" and a more intensive supervisory approach, it should be possible for an insurance solution to be made available to cover any shortfall on a reasonably economic and commercially viable basis. The FOA hopes to be able to revert to the FCA with some "first thoughts" on such a proposal shortly.

Question 2: Do you agree that, where used, this transfer proposal will be beneficial to clients? If not, please provide reasons.

3.10 The FOA questions whether the issue is not so much whether or not the transfer proposal will be beneficial to clients, but rather that it should not disadvantage them.

3.11 The FOA believes that the transfer proposal would benefit clients where there is no or very little shortfall in the client money pool on the basis that, if a purchaser can be found, it would presumably be able to continue to provide the services to the clients without requiring a top up of cash from them. However, it seems unlikely that there would ever be no shortfall, not least because the expenses of the insolvency practitioners in determining the value of the pool and organising the transfer process would presumably be deducted from the pool as indicated in paragraph 2.37 of the Consultation (and we note that the position in the US is that most costs

and expenses will be borne by the general estate).

3.12 It can be anticipated that clients may prefer the distribution process to be handled by an experienced insolvency practitioner that has the necessary resources rather than a third party firm with a business priority.

Question 3: Do you agree that 'hindsight' should be applied to the valuation of clients' cleared open margined positions to determine their entitlements to the relevant CMP? If not, please provide reasons.

3.13 The FOA supports this proposal and agrees that the delay in closing positions can create a further shortfall in the client money pool although notes that it may generate a surplus and that the changes made to CASS to implement the introduction of porting in EMIR should make this issue less significant than was previously the case for business conducted on EU markets. It also notes that having to wait for the CCPs or intermediate brokers to close the positions could delay the timing of distribution of the whole client money pool. However, on the whole, the FOA believes this is a sensible proposal that could have some impact.

Question 4: Do you agree that where a firm takes these reasonable steps, it should be able to use unclaimed client money entitlements to make good any CMP shortfalls? If not, please provide reasons.

3.14 The FOA agrees that a firm should be able to use unclaimed client money entitlements to make good any shortfalls in the client money pool provided it has taken steps to identify the relevant claimants. While the FOA agrees that it is important for firms to take all appropriate actions to try to locate missing clients, the steps proposed in draft CASS 7A.2.6E are numerous and quite repetitive (and are ultimately unlikely to be effective if a client has moved from his last known address). In particular, the FOA questions whether it is necessary to both advertise in the local media and attempt to communicate on at least three further occasions or whether a choice of one of those requirements would be more proportionate. It may also not be necessary to send a final communication three months in advance of the final distribution if a clear cut off time for claims were established.

3.15 The FOA assumes, given the time it is likely to take to establish that assets are unclaimed, that any such assets will form part of the residual client money pool, but would ask that this is clarified.

Question 5: Do you agree that these less onerous 'reasonable steps' should apply where a client's entitlement is less than £10? If not, please provide reasons.

3.16 The FOA agrees that it would be sensible to have de minimis requirements, but notes that £10 is a small amount when compared to what firms actually spend on trying to contact missing clients, especially when the draft text requires that, as well as the balance being £10 or less, there has been no movement on the client's balance for at least six years. The FOA considers that this approach is "over the top" when measured against the cost and effort of trying to communicate with a "gone-away" client. If the FCA considers that £10 is appropriate for retail clients, it might consider introducing different thresholds for different types of client so that the de minimis amount for a professional client or eligible counterparty was, for example, £100.

Question 6: Do you agree with the proposals regarding treatment of interest and currency conversion? If not, please provide reasons.

3.17 The FOA agrees with proposed CASS 7A.2.6C on the basis that these measures would undoubtedly reduce complexity and improve the speed of distribution and understands that it is what has happened in practice on previous administrations subject to two comments:

(a) as the "most common currency" is not defined, the FOA assumes it would be the currency forming the greatest percentage of the client money in the notional pool. The FOA would

request that insolvency practitioners be able to determine in their sole discretion whether it would not be appropriate to convert into the most common currency (e.g. it may not be appropriate where that currency is particularly risky or volatile). This would avoid conflicts between the CASS rules and the general duties of the insolvency practitioner under insolvency law; and

(b) as a firm must pay a retail client any interest earned on client money held for that client unless it has notified the client in writing that no such interest will be payable (proposed CASS 7.2.14AR), FOA members would also like to request further clarification from the FCA that to the extent that funds have already been paid to the client and there is residual interest, that that interest should be used to reduce any shortfall in that client money pool. To the extent that funds remain, FOA members would like to request that those funds should return to the estate of the firm for the benefit of the general creditors.

Question 7: Do you agree with the proposals regarding the treatment of client money received after a PPE? If not, please provide reasons.

3.18 The FOA agrees in principal with the proposal as set out in draft CASS 7A.2.7A to 7A.2.7C. However, the FOA would request further clarification from the FCA or additional guidance as to how the FCA expects firms (where they operate the normal approach) to treat money received after a PPE which may continue to be received into an account where funds are yet to be paid out of or moved into a new bank account or set of bank accounts.

Question 8: Do you agree with the proposals regarding a secondary pooling event? If not, please provide reasons.

3.19 The FOA agrees with the proposed amendments to CASS 7A.3 but wonders whether, if a ported individual client account is not to be pooled on the basis that other clients do not share any upside resulting from the client transaction account on a primary pooling event, the same should apply to an omnibus client account where no excess client money is held by the firm as margin and the amount attributable to each client is apparent from information provided to the firm by the CCP, as in CASS 7A.2.6A.

Question 9: Do you agree with the amended proposals to allow clearing firms to operate multiple client money pools? If not, please provide reasons.

3.20 The FOA gave its views on client money sub-pools in paragraphs 3.1 to 3.10 of its Second Response (see Appendix 3) and its views have not changed. In summary, the FOA believes that the benefits of having multiple client money pools do not outweigh the significant risks they entail. The significant risks include: (1) further complexity in CASS and legal risk in terms of distributing client assets; (2) operational risk of potentially operating multiple sub-pools alongside the main client money pool; (3) risk of reduced protection for general client money pool participants (e.g. if smaller general client money pools are held); and (4) the risk of potential unfair treatment (e.g. if hierarchical participation in sub-pools were to result from differences in the creditworthiness of different participants).

3.21 The FOA would ask, now it seems clear that the FCA intends to introduce this concept, that it should be possible to create a sub-pool that relates to multiple clients using more than one CCP rather than being restricted to a sub-pool for each group of clients with each CCP, as it is operationally difficult for some firms to split accounts between different CCPs. The FOA would also ask the FCA to confirm its understanding that it need only produce a disclosure document for each sub-pool on the creation if that sub-pool and should not have to revise the disclosure document when each new client joins the sub-pool. The FOA understands that firms must provide the disclosure document to each new client and that each new client must consent but this would be more manageable if it was not necessary to update the disclosure document on each occasion.

3.22 The FOA would also be grateful if the FCA would clarify that, if a firm chooses to set up a sub-pool for an omnibus account relating to either one or more CCPs, a client that has chosen an

omnibus client account should be required to participate in that sub-pool (and should not have the option of being able to not participate in that sub-pool). Many of the FOA members perceive it to be impractical and to create too much risk in terms of ensuring that cash is always in the correct account at the right time to operate a system where clients using the same omnibus account at CCP level are not treated as being in the same account at firm level. Members also believe that to allow such a bifurcation of treatment at firm level would undermine the intended purpose of the sub-pool to facilitate porting in the event of their failure because only the cash relating to some of the clients would be available to top up that which is already available to the CCP, while the rest would form part of the main client money pool. This would jeopardise any increased likelihood of porting for those clients that chose the sub-pool.

3.23 In addition, the FOA would note that if the FCA's objective in introducing the multiple pools approach is to provide a greater likelihood of porting for omnibus accounts (by ensuring the CCP has access to sufficient margin to cover all client positions), the FOA considers this would be more effectively met by use of gross margined omnibus accounts at the CCP and, additionally, would require less operational intensity, less costs and less risk.

3.24 The FOA does, however, recognise that the FCA has looked to develop "a more limited version of the multiple sub-pools proposal", but notes that there will still be significant continued operational complexity that would have to be taken into account in managing a default process. The issues that the FOA noted would create operational and regulatory risk around the operation of multiple pools would remain present in relation to those sub-pools which a firm may set up to support net omnibus accounts. The FOA would therefore like to reiterate its recommendation that the diversification requirement is lifted for sub-pools as this would significantly reduce some of the complexity and operational risk.

Question 10: Do you agree with our proposal to clarify the application of the client money rules in this way? If not, please give reasons.

3.25 The FOA has no comments on the proposed CASS 7.1.1A to 7.1.7BA. However, the FOA would note that, although it does not disagree that deposits are held on a bank's balance sheet, there is a concern about the FCA rules touching on matters that are fully dealt with by accounting standards. If the FCA rules contain references or incomplete commentary on accounting matters, this creates a risk of confusion, inconsistency and uncertainty. Additionally, firms subject to the FCA rules are subject to different accounting standards so it cannot be assumed that CASS needs only to be in line with International Financial Reporting Standards in this respect.

Question 11: Do you agree with our proposals in relation to the banking exemption? If not, please provide reasons.

3.26 The FOA does not have any particular issues with the proposed amendments given that its members already tend to notify their clients whether they will hold cash as banker or as client money in practice. However, the FOA notes that it could be quite difficult for firms to explain to clients in advance all the circumstances in which their cash may cease to be held as banker and start to be held as client money. The FOA would also appreciate confirmation that the obligation is a one-way notification requirement.

3.27 The FOA would also like clarification on a couple of points:

(a) The intended effect of CASS 7.1.10(2) (which imposes a five business day limit on allocating cash to the relevant client) is uncertain.

(b) It would be helpful if the FCA could confirm the intended relationship between proposed CASS 7.1.8E and CASS 7.1.10A.

Question 12: Do you agree with our proposals in relation to how trustee firms should hold client money when they are acting as such? If not, please provide reasons.

3.28 The FOA notes that paragraph 4.18 of the Consultation suggests that a trustee firm that has been instructed to hold all client money in a specific institution may be able to obtain a waiver from the diversification rules. The FOA has asked the FCA previously to consider allowing a firm not to comply with the diversification requirements in this and a few, limited, other circumstances and would do so again in light of the concession that appears to be made for trustee firms. (See our response to Question 21).

Question 13: Do you agree with the proposals relating to the TTCA provisions? If not, please provide reasons.

3.29 The FOA is keen to remind the FCA of the importance of title transfer arrangements in freeing up the use and realisation of collateral assets and with the reduction in formalities and impediments to enforcement of the security. The FOA understands that these arrangements are under discussion at an EU level, and the FOA urges the FCA to argue the case for keeping them. The FOA cannot stress this point enough and members will be happy to assist the FOA with practical examples and anything else that would be of use in defending the provisions in forthcoming discussions.

3.30 The FOA agrees that it is useful to make provision for switchover from treatment of cash as title transfer to client money. However, the FOA considers that the proposed CASS 7.2.7A to 7.2.7D could be improved by confirming more clearly in CASS 7.2.7A(3) that a firm is not required to make such a switch. The FOA believes it would also be helpful to include a provision to make clear to clients that their request has not been accepted if they do not receive a notification. The FOA does not consider it appropriate that such arrangements should be communicated orally. Finally, if a client asks a firm to terminate an arrangement relating to the transfer of full ownership of a client's money to a firm for the purposes set out in CASS 7.2.3(1) and CASS 7.2.3A(1), and such request was not made to the firm in writing, the firm must make a written record of the client's request. The FOA would suggest removing CASS 7.2.3A(1) on the basis that the additional steps for firms to prepare a written request is duplicative given the requirement to amend the client's documentation.

Question 14: Do you agree with the proposal of clarifying the requirements around the DvP window? If not, please provide reasons.

3.31 In relation to the proposed changes in draft CASS 7.1.15F to CASS 7.1.15L, the FOA agrees that it will be helpful to clarify what is meant by a "commercial settlement system" and that this should facilitate a level playing field in the operation of this rule.

3.32 However, the FCA should consider the timing and costs of the review of existing terms of business and potential renegotiation of agreements that would be required to clarify the DVP window. Given that the amendments are essentially a notification requirement combined with a codification and clarification of existing rules, and in order that they do not get confused with or delay amendments that need to be made for EMIR purposes, the FOA would suggest that these provisions are imposed on a forward-looking basis only. Clients should be notified of the possible loss of protection of client money or assets rather than being required to accept this in writing.

3.33 Further, in clarifying the DVP window, it is important that CASS makes clear that a custodian's responsibility should cease at the point of delivery.

Question 15: Do you agree with the proposal to remove the DvP window for delivery versus payment transactions for the purpose of settling transactions in relation to units in a regulated collective investment scheme? If not, please provide reasons.

3.34 The FOA does not have any comments on the proposed amendments in CASS 7.2.8 to 7.2.8AA.

Question 16: Do you agree with our proposal to clarify the rule in relation to the payment of interest and introduce guidance setting out the segregation and allocation requirements of interest? If not, please provide reasons.

3.35 While the FOA generally supports the proposed amendments to delete CASS 7.2.14 and insert a new draft CASS 7.2.14A, the FOA would ask the FCA to revisit the wording for the following two reasons:

(a) The FOA considers that the proposed CASS 7.2.14A could be read as meaning that either *all interest* earned on client money must be paid to clients or *no interest* at all. Some FOA members pay interest to their clients but on specific written terms agreed with the client (which may not equate to all the interest on a particular client money account) – this is currently permitted by CASS 7.2.14. The FOA does not consider that the FCA intends that a firm must pay all interest or no interest as the FCA's commentary in paragraphs 4.36 to 4.38 of the Consultation do not refer to this and the FOA would ask that the wording be revisited. If the FCA insists on all interest on client accounts being paid (or no interest), the current FOA members who do pay interest (but not all interest) will most likely cease paying any interest at all, which will be less beneficial for retail clients.

(b) Further, the FOA would ask the FCA to clarify that firms are only required to pay clients interest on client money where they have agreed to do so in writing (and not where there is no written agreement with the client in relation to interest payments). The FOA has concerns in relation to the meaning of "on client money" in CASS 7.2.14AR(3) – i.e. does it mean that firms have to pay interest on all client money or just where there is no written agreement with the client? The rule in CASS 7.2.14AR(1) is clear that a retail client does not have to be paid interest earned on client money if a firm has notified that client in writing that no such interest is payable, but proposed sub-section (3) could be read as implying that for non-retail clients, such an option does not exist.

Question 17: Do you agree with these proposals on money ceasing to be client money? If not, please provide reasons.

3.36 The FOA agrees that the proposed amendments to CASS 7.2.15 and 7.2.16 are useful amendments as it should be clear that payment into an account in the name of a client is sufficient to terminate the statutory trust. It would also ask whether it would be helpful to include a transfer that might occur at the direction of the FCA or another regulator in the event of severe market stress that does not, for some reason, occur pursuant to applicable law.

Question 18: Do you agree with our proposals in relation to the transfer of client money to a third party? If not, please provide reasons.

3.37 The FOA welcomes a rule allowing a firm to transfer client money as part of a transfer of business without needing to seek the consent of its clients at the time of transfer, at least where this is difficult or impossible. However, the FOA would make the following observations. It is not as clear as it might be from the wording of CASS 7.2.17B that the consent to assignment may have been given in an agreement that was entered into in advance of the transfer being foreseen. In other words, this provision could be read as meaning that the firm must enter into a special agreement for this purpose, which should not be the case.

3.38 The FOA is also conscious that, while the proposed new rule appears helpful from a regulatory perspective, firms will need to be conscious of the limits of contract law. For example, rights but not obligations can be assigned under English law, although we note that, with the requirement for consent, this is arguably more like an advance agreement to a novation. While there is some authority for advance agreement to novate being effective, the courts may not follow that in the future. In addition, where a firm is dealing with consumers, a term which binds consumers to terms which they have not previously had an opportunity to review before accepting is indicative of being unfair and it may be unrealistic to assume that the transferee will accept its new clients on identical terms. However, the more relevant question from the

members' perspectives is the extent to which sufficient consent could be given through unsigned terms of business, which would require firms to rely on a course of dealing argument.

3.39 Further, and again in relation to consumers, the FOA understands that both the OFT and the FSA have published guidance that a clause permitting a firm to transfer its rights and obligations under a contract to a third party where this serves to reduce the guarantees for the consumer without the consumer achieving a better guarantee might be unfair for the purposes of the Unfair Terms in Consumer Contracts Regulations 1999 and so transfers from a firm holding cash as client money to one holding cash as banker would require some thought.

3.40 In any event, the FOA queries how useful this rule is in practice if one of the reasons for needing to rely on it is that the transferring firm cannot locate all of its clients given that one of the firms has to make the notification in CASS 7.2.17B(3)(c). This is exactly why the client money waiver has been needed to date. We also note that the explanation of this rule suggests that it only applies where the transfer is made to another firm which holds cash as client money or a bank that is relying on the banker exemption, yet the wording of CASS 7.2.17B(3)(ii) could be interpreted more widely and could potentially cover firms regulated in other Member States, so we would ask the FCA to clarify which is correct.

Question 19: Do you agree with our proposals in relation to allocated but unclaimed client money? If not, please provide reasons.

3.41 The FOA agrees that a firm should be able to cease to treat unclaimed client money as such provided it has taken the steps suggested in draft CASS 7.2.20. While the FOA agrees that it is important for firms to take all appropriate actions to try to locate missing clients, the steps proposed are numerous and quite repetitive (and are ultimately unlikely to be effective if a client has moved from his last known address). In particular:

(a) the FOA would request the deletion of "following the last movement on the account" from CASS 7.2.19R(1) to take into account unclaimed balances held for clients that continue to trade with a firm but are unwilling to take receipt of residual balances owed to them;

(b) the FOA questions whether it is necessary to both advertise in the local media and attempt to communicate on at least three further occasions or whether a choice of one of those requirements would be more proportionate and requests the FCA to amend CASS 7.2.20E(1)(c) accordingly.

3.42 The FOA would also ask the FCA to take this opportunity to address unclaimed client money received by firms before terms of business were amended to set out the contractual basis for handling unclaimed client assets as many firms still hold residual amounts from many years ago. Given the fungible nature of cash, the presence of money originating from relationships documented by agreements which contained no provisions on unclaimed money presents firms with practical difficulties when seeking to address unclaimed client money, including that which has been received more recently.

3.43 The FOA would also question the benefit of the unclaimed client assets rules when the firm retains the obligation to pay a client that reappears in spite of the firm's attempts to contact them in accordance with the proposed steps. The FOA wonders whether it might be made permissible to make insurance payments from the unclaimed pool of funds and to include additional guidance on industry write-offs.

Question 20: Do you agree that unclaimed sums of less than £10 should cease to be client money if they are paid away to charity in accordance with the proposals above? If not, please provide reasons.

3.44 The FOA agrees that it would be sensible to have a de minimis concept but notes that the draft text requires that, as well as the balance being £10 or less, there should have been no movement on the client's balance for at least six years, and considers that this makes the test overly draconian when it should simply reflect the cost of trying to communicate with a client. If

the FCA considers that £10 is appropriate for retail clients, it might consider introducing different thresholds for different types of client so that the de minimis amount for a professional client or eligible counterparty was, for example, £100.

Question 21: Do you agree with our proposal to clarify the requirements around client bank accounts? If not, please provide reasons.

3.45 The FOA has discussed its members' long-standing concerns about the diversification rule with the FSA and FCA on several occasions (see, for example, paragraphs 4.9 to 4.11 of the First Response). In summary:

(a) complying with the diversification rule runs the real risk that client's assets may not be adequately protected, particularly for larger banks, in times of stressed market conditions and in overseas markets where there is a limited choice of banks and the FOA has long sought for the FCA to allow for a safe harbour in these instances;

(b) eligible counterparties should be able to request for the rule to be disapplied to reduce use of the title transfer carve out;

(c) the new Basel liquidity requirements may make it uneconomic for banks to accept diversified client money and firms are still experiencing this as being a difficulty; and

(d) the rule (due to its wording) can be technically breached intraday (usually for reasons outside a firm's control) whereas the FOA understands that the FCA only intends to measure it at the end of the business day (see Appendix 2, which contains an email sent out to firms regarding the application of the diversification requirements, following discussions with the FSA).

3.46 The FOA remains concerned about these issues and, while its members already take into account the factors described in the draft CASS 7.4.9BA, these concerns will be exacerbated by draft CASS 7.4.9BA. They also relate to the FCA's proposals on unbreakable term deposits and client acknowledgement letters. (See our response to Questions 22 and 12).

3.47 The FOA would also urge the FCA to give some thought as to the viability of disapplying the requirement in the context of client money sub-pools, which would be less diversified in terms of risk. The FOA also asked, in response to Question 12, about the possibility of a waiver from the diversification rules in respect of specific accounts, which could be limited to those held for specific client types, such as wholesale clients only.

3.48 Although the FOA welcomes the FCA's proposed amendment confirming that small balances may be held on an undiversified basis, further guidance on which accounts do not need to be diversified would be of assistance. This would help to ensure some consistency in application of the amendment.

3.49 Finally, FOA members would appreciate some clarification on due diligence requirements because, although they consider that they comply with CASS 7.4.9, the Consultation implies that firms are not doing enough. Further guidance in a form similar to that provided in relation to the new client acknowledgement letters might, for example, be helpful.

Question 22: Do you agree with our proposal to prohibit the use of unbreakable term deposits? If not, please provide reasons.

3.50 The FOA gave its views on term deposits in paragraph 4.17(d) of the Second Response. Some members are still experiencing difficulty with banks' attitudes to holding large amounts of cash on terms allowing immediate access and so, unless this changes, the proposed new CASS 7.4.11B will mean they may struggle to maintain diversification across a range of banks with appropriate creditworthiness. This, combined with the proposed amendments to due diligence

and diversification requirements, is likely to cause significant difficulty.

3.51 The FOA also noted that some of its members saw benefit in term deposits for reducing operational risk over bank holidays and short periods of unexpected stress and asked that they should be permitted, subject to risk committee approvals, to use short term deposits in such situations where they had modelled historic client money balances and identified an appropriate limit. The FOA does not believe that deposits with a term of one business day are adequate for this purpose.

3.52 Having now seen the FCA's proposed amendments to these rules, the FOA wonders whether the application of the term deposits rule should be calibrated to different business models and products. Where term deposits are not appropriate to client money which is provided in relation to exchange traded derivatives, it may be appropriate that a percentage of money may be held on term deposits in relation to other products - e.g. where deposits are demonstrably static. Even for margined derivatives it may be appropriate for a portion of funds to be placed on term deposits (e.g. where there is appropriate historic modelling).

3.53 In addition, the proposal appears inconsistent with banks' funding profile requirements under Chapter 12 of the BIPRU Sourcebook. BIPRU 12 includes a requirement to include breakable term deposits at their earliest possible maturity, meaning that they are treated no differently from same or next day access deposits. Further, as a general observation relating to costs, the FOA would note that, in line with Basel rules, the market is moving away from providing short term deposits and that under the proposed changes, client directed products which allow the use of fixed term cash deposits will be significantly impacted. Renegotiating terms with banks to allow for breaking term deposits will therefore be challenging in the current environment. The FOA would requests that, where a client requests that money may be placed in unbreakable term deposits, such arrangements should be permitted. Failing this, the FOA would ask that the FCA allows sufficient time to renegotiate and repaper these relationships to allow clients to find an alternative solution.

Question 23: Do you agree with our proposal to clarify the existing requirements around the immediate segregation of client money? If not, please provide reasons.

3.54 The FOA generally supports the proposed clarification in draft CASS 7.4.1 subject to two points. First, and more generally, FOA members find that clients pay money into the wrong bank accounts despite their best efforts to prevent this happening and would therefore ask the FCA to confirm that a firm is not in breach where, in such circumstances, it segregates such money as soon as it becomes aware of such a mistake and, in any event, within one business day.

3.55 Secondly, in relation to EMIR, the proposed amendment does not allow sufficient flexibility to enable firms that are clearing members to operate the cash flows relating to individual segregation accounts at a CCP in one of the preferred two models referred to in paragraph 2.6 (and set out in Appendix 5). FOA members believe that many, if not all CCPs, will not be able to or will choose not to return cash that is client money to a client bank account and cash that is not client money to another account. FOA members are, therefore, preparing for the likelihood that they will have to receive all cash in a single account and transfer the appropriate amount to a client bank account or the house account. The existing mixed remittance rule would allow for this provided the transfer of client money from the firm account to the client account is made promptly but the proposed revision does not. The FOA would, therefore, request the FCA create a carve-out to the new rule along the lines of the previous rule to enable missed amounts paid by a CCP to a clearing member to be received into the firm account of the clearing member to address this specific EMIR-related situation. For the purposes of drafting such a carve-out, it is important to note that the mixed remittance paid by CCP to the clearing member may contain client money in respect of both individually segregated accounts and omnibus segregated accounts, because certain CCPs are proposing to net all cash remittances to clearing members in respect of all types of client into one single cash payment. Following the FOA's discussions with the FCA on this topic and with its member firms, the FOA suggests some wording below (in underlined text) that it believes would enable this proposal to work within the existing rulebook

with some slight amendments:

"*7.4.1AR (Segregation of Client Money)*

(1) Except as set out in 7.4.1A(2), unless a firm is using the alternative approach, it should ensure that all client money it receives is paid directly into a client bank account at an institution in CASS 7.4.1R(1) to (3), rather than being first received into the firm's own account and then segregated.

(2) Except as set out in CASS 7A.2.6AR [money remitted to the firm from an authorised central counterparty following a primary pooling event], if, in connection with a regulated clearing arrangement, client money or a mixed remittance is remitted directly to the firm either from an authorised central counterparty or from a clearing member, such client money or mixed remittance may be received into the firm's own account, provided that the money that is client money is transferred into a client bank account promptly, and in any event no later than the next business day after receipt."

"7.4.23A (Mixed Remittances)

Except as set out in CASS 7.4.1A(2), where a firm using the normal approach receives a mixed remittance it should:

(1) in line with CASS 7.4.1AR, take necessary steps to ensure it is paid directly into a client bank account; and

(2) promptly and, in any event no later than one business day, after the payment of the mixed remittance into the client bank account has cleared, pay the money that is not client money out of the client bank account."

3.56 The FOA supports the FCA's rationale for amending the existing mixed remittance rules and would be willing to explore measures to mitigate the risks identified in paragraphs 4.68 and 4.69 of the Consultation. Such measures could include, for example, the holding of a buffer of firm money in the client account that would be available to clients in the event that the clearing member became insolvent, while holding a mixed remittance in the firm account.

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.

3.57 The FOA welcomes the clarification around the status of units in a qualifying money market fund and does not have any other comments on this proposed clarification in draft CASS 7.4.3.

Question 25: Do you agree with our proposals in relation to physical receipts and the allocation of client money? If not, please provide reasons.

3.58 The FOA welcomes the proposed rule changes however they may inadvertently cause practical issues in relation to businesses where there are established margin processes, as follows:

(a) where margin calls are paid by the use of payment cards (both debit and credit), funds are not generally received into the client's account until 2 to 3 business days after the card payment is authorised, leading one client to inadvertently fund another client; and

(b) intra-day shortfalls could also arise in the clearing businesses where margin is taken by clearing houses prior to clients paying their daily margin call, again leading to one client inadvertently funding another client.

The Consultation seems to suggest that neither of these should occur. Therefore, it would be helpful if the FCA could be clearer in articulating what should happen during the delay in receiving funds from an authorised card payment and if intra-day shortfalls occur and whether firm provisions to cover these shortfalls (e.g. in the form of prudent margining / use of a buffer)

will be acceptable.

Question 26: Do you agree with our proposals to clarify the proper use of prudent over-segregation of client money? If not, please provide reasons.

3.59 The FOA welcomes the new CASS 7.4.21 to 7.4.21D and strongly supports that the FCA is acknowledging that it is acceptable to over-segregate in certain circumstances and believes that the circumstances and the conditions proposed are reasonable. As a general matter, prudent over-segregation will operate as an additional protection to clients and is not necessarily indicative of poor record keeping. As stated in paragraph 4.19(a) of the Second Response, the benefits from this position are: (1) it provides funds to cover the costs of distribution; (2) it covers potential losses caused by a firm's failure; (3) it helps cover shortfalls and (4) it benefits firms in the reduction of movements intraday into and out of the client money account.

3.60 The FOA questions whether prudent over-segregation should always be linked to ascertainable risks of a shortfall. A consequence of such an approach is that it will always be the clients that bear the risks of an unforeseeable event or circumstances that produce a shortfall. The FOA would welcome further dialogue with the FCA to establish a universal minimum amount for over-segregation and does not consider that capital concerns voiced by some institutions would stand in the way of client protection.

Question 27: Do you agree with our proposals in relation to the use of the alternative approach to client money segregation? If not, please provide reasons.

3.61 Several members of the FOA use the alternative approach for some or all of their business lines and would suffer significant operational difficulty if they were not permitted to do so, especially when the clearing obligation under EMIR becomes live. While the FOA understands the FCA's desire to limit its use to certain circumstances, the FOA is concerned about the proposed scope in a couple of respects. Firstly, the FOA does not think the alternative approach should be limited to the largest investment banks as other firms operate in a multi-product and multi-currency environment and may be able to demonstrate the same risks of using the normal approach. Secondly, the FOA believes the test whether the normal approach would lead to greater operational risks is too narrow as there may be other types of risk which the alternative approach can help to mitigate. Thirdly, the FOA would question whether the term "exceptional circumstances" in CASS 7.4.17A is an appropriate description because the alternative approach is not used on a one-off basis.

3.62 The FOA queries why the FCA needs three months' notice before a firm can adopt the alternative approach, particularly since we assume the firm will have been required to undertake its analysis under CASS 7.4.17B and 7.4.17C before this point, and whether the firm is required to submit its auditors report at that point. Those members already using the alternative approach believe that six months should be enough to assess whether using the alternative approach remains appropriate but would ask the FCA not to make them undertake a further audit if their previous client money audit was undertaken in the last twelve months and that the ongoing audit report requirement form part of the annual client money audit cycle.

3.63 The relevant FOA members would also welcome a little more prescription of the way they should calculate the buffer.

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? If not, please provide reasons.

3.64 The FOA does not have any comments on this proposed clarification in CASS 7.5.1 to 7.5.3 save for a request to clarify the meaning of "likely to occur" in CASS 7.5.2A.

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.

3.65 As regards custody providers, the suggestions that income from custody assets or the proceeds

of sale of custody assets should be treated "as client money (where appropriate)" is unhelpful as it suggests that cash is client money when it has traditionally been treated as cash held on deposit at the bank custodian. On this model, the global custodian appropriates cash in local markets and records in its books that its debt to its clients is increased by the corresponding amount and currency. If the intention is to undo this model, it means that deposit balances in global custody would be eliminated. To avoid this interpretation of the provision, "where appropriate" should be replaced with "where the bank treats such balances as client money".

3.66 Additionally, where a firm provides clearing services, it should be able to agree with its clients that, while it holds non-cash collateral under the custody rules, it may hold cash on a title transfer basis. Where small amounts are received as income from collateral, firms should not be obliged to hold them differently to receipts of cash taken by way of deposit or under a title transfer arrangement.

3.67 Finally, the FOA queries whether CASS 7.5.6 should refer to both the client bank and the client transaction account as suggested in paragraph 4.103 of the Consultation.

Question 30: Do you agree with our proposals in relation to internal and external client money reconciliations and notification and recordkeeping requirements? If not, please provide reasons.

3.68 The FOA does not have any comments on CASS 7.6.6 to 7.6.15 in relation to the frequency and purpose of client money reconciliations (both internal and external) as the proposed clarification reflects the majority of its members' current practices. However, the FOA would request that, where a firm uses the non-standard method of internal client money reconciliation, the requirement for an auditors report should form part of the annual client money audit rather than being a stand-alone obligation.

3.69 The FOA does not have any comments on the standard method for internal client money reconciliation or the introduction of the text from Annex 1 into CASS 7.6A although it would like to raise two other issues relating to the client money calculation. The first is to repeat a point it made in the First Response that has not been dealt with. The FOA suggests that firms should be permitted to undertake the client money reconciliations in CASS Annex 1 (1) and (2) on each business day but using the aggregate balance on the client bank accounts and the client money requirement as at the close of business on the previous day on which the firm was open for business rather than the previous business day. This is because many firms execute transactions on markets outside the UK on non-UK business days and any resulting changes in the amounts that need to be segregated are not dealt with as quickly as they might be if the firm has to look back to the previous business day. This suggestion would ensure that firms' client money calculations are as up to date as possible.

3.70 The second issue relating to the calculation relates to EMIR and the FOA's suggested models for making the cash flows between firms and CCPs relating to individual segregation accounts work referred to in paragraph 2.6 (and set out in Appendix 5). The client money calculation methodology must be updated to ensure that there is a balanced reduction between assets and the client money requirement. Either the balance on an individual segregation account should not be included in the calculation and there be a corresponding requirement on the client's account in the firm's books and records, or the calculation should be amended to reduce both the location balance and the requirement by the actual value of collateral on the individual segregation account at the CCP. In relation to Option 1, under which margin payments to the CCP in respect of individually segregated accounts are always paid out of the firm account on a title transfer basis, the FOA would suggest that such amounts are not client money and, therefore, should never be included in the client money calculation. The basis for this view is that these payments are made to the CCP out of firm money from the firm account. Such payment effectively gives rise to a 'debt' on the part of the client to the clearing member, which is subsequently discharged after the client pays the relevant margin payment into the client account and the firm then transfers the relevant amount due and payable to the firm account. While the cash held on the individually segregated account at the CCP would be outside the scope of the rules in CASS, it is important to note that it would enjoy protection under EMIR,

such that were the clearing member to default, that cash would be ported to a back-up clearing member or returned to the client, even if the client had not at that stage discharged its 'debt' to the clearing member. Accordingly, where a clearing member operates cash flow in the manner set out in Option 1 (title transfer payments to the CCP out of the firm account), the FOA members propose that the calculation should be amended to expressly exclude amounts held on individually segregated accounts at CCPs on the basis that those amounts should not be considered client money.

3.71 The FOA notes the more prescriptive triggers for notification of breaches to the FCA and the fact that the FCA has declined to provide further guidance on materiality in this context, save on a case by case basis. However, the FOA believes it would be helpful if the FCA were to provide some factors that firms should take into account in determining materiality as there may otherwise be a risk of firms taking different views and confusing clients' expectations. The FOA believes it would also be useful to have an explanation of the intended difference between both CASS 7.6.16 (2) and (3) and CASS 7.6.16(4) and (5).

Question 31: Do you agree with our proposals for the exchange of acknowledgment letters? If not, please provide reasons.

3.72 The FOA welcomes the introduction of standardised client money acknowledgement letters and accompanying guidance notes, as well as the incorporation of the FCA's expectations into CASS. However, the FOA believes there are some practical problems in relation to client bank accounts and some additional issues in relation to client transaction accounts.

3.73 Starting with client bank accounts, the FOA believes that the loss of the grace period should be manageable in relation to client bank accounts with banks in mainstream jurisdictions as firms should be able to find alternative banks if their first choice does not return the acknowledgement letter sufficiently quickly to meet the client's requirements. However, this is likely to be a greater problem in relation to client bank accounts in jurisdictions where there are fewer banks, where it may make it even more difficult to comply with the diversification requirements. It could also pose a problem in relation to all banks in times of market stress where a firm wants to move cash away from a particular bank quickly. The FOA considers that there might be a few solutions that would go some way towards dealing with these potential problems:

- The FOA would like the FCA to consider whether, in a particularly serious case, it would be possible for the firm to place cash in an account if the client were to understand and agree to the risk. Even if this possibility were limited to eligible counterparties, it could be a useful last resort for exceptional cases.

- Members assume that, if they were to have difficulty in respect of a particular bank, they could, as a last resort, place their own cash in the account and effectively double segregate. Although the FOA notes that this may not be possible in light of other proposals, namely (1) the requirement for funds to be placed directly and immediately in client bank accounts (question 23 and draft CASS 7.4.1) which may not be achievable if there is no acknowledgement letter; and (2) the restrictions on the use of the alternative approach (i.e. would a firm be deemed to be using the alternative approach with a bank (who has not provided an acknowledgement letter) if it chooses to segregate elsewhere? If so, clients could be deemed to be paying into the firm's own account and the firm would then have to comply with the restrictive provision (and costly auditor provisions) for what may be a small subset of business).

- Where accounts contain multiple currencies, it would be helpful if the FCA could confirm that set-off between different currencies in such accounts does not offend against the obligation not to set off between client money accounts.

- It would be helpful if the rules could include a definition of client money deposit.

3.74 The problems that would be caused by an inability to obtain an acknowledgement from a bank are even more serious with a CCP once the clearing of certain OTC derivatives becomes

mandatory and, as the FCA knows, FOA members have historically experienced difficulty in obtaining even the old style acknowledgements from several CCPs. The problem would not necessarily be solved by requiring firms to notify a CCP that a particular account contains client money without requiring a response because some CCPs are likely to respond and express their disagreement to the fact the cash is held on trust for the client which would risk making the legal analysis of the status of the cash unclear. Firms therefore believe that the acknowledgement requirement should be lifted in relation to client transaction accounts that are individual segregation accounts altogether.

3.75 While firms appreciate the FCA's faith in the provision, it has to be accepted that the client acknowledgment does not add anything to a client's protection on the failure of its firm because the provisions of Article 39(9) of EMIR have the same effect and the likelihood that cash in an individual segregation account ever being returned to the failed firm should be much reduced by Article 48 of EMIR and the FCA's amendments to CASS 7A. Requiring an acknowledgement letter is also problematic to the FOA's proposed cash flow models for transferring client money and title transfer cash between firms and CCPs referred to at paragraph 2.6.

3.76 While the FOA feels strongly that client acknowledgement letters are problematic and unnecessary in relation to client transaction accounts, if the FCA were to retain them for any purpose, it is imperative that the FCA liaises with all regulators of the appropriate CCPs to ask them to require the CCPs under their jurisdiction to sign and return acknowledgement letters in accordance with the CASS rules. Otherwise firms will be required to either cease providing clearing services for clients or fund such activities themselves, neither of which is viable on any scale or for any duration.

3.77 The FOA would also ask the FCA to clarify draft CASS 7.8.10R to make it clearer that, in line with the legal position, a firm does not need to ask a bank or CCP to re-execute a client acknowledgement letter just because the authorised signatory who signed it ceases to be an authorised signatory after the date of signing.

3.78 The FOA notes the proposal that firms re-paper their entire client bank and client transaction accounts during the six month transitional period but would urge the FCA to consider an alternative which does not involve all such accounts being repapered at the same time. For example, the FCA could require firms to repaper each bank and CCP at the time of their next due diligence exercise and provide grandfathering arrangements in the interim. Additionally, it would be helpful if the FCA could confirm that firms will not be expected to close accounts where firms use best efforts to obtain new style acknowledgement letters but do not receive timely cooperation from banks and CCPs or where banks had historically refused to provide acknowledgement letters. For example, it has been the experience of some of the members of the FOA that in certain jurisdictions (e.g. Germany) there is a lack of acknowledgement of the principle of trust and in other jurisdictions (e.g. Switzerland) there are complications with requirements to identify the beneficiaries of the trust. The FOA would ask that if the FCA does not agree with the grandfathering suggestion set out above, that if there was a full repapering exerciser, that firms be given 18 months to do so rather than six given the fact that all FCA regulated entities would be attempting to repaper the letters with the same banking and CCP institutions simultaneously.

Question 32: Do you agree with our proposed guidance on the Part 30 Exemption Order and LME Bond Arrangements? If not, please provide reasons.

3.79 The FOA agrees with the clarifications that will be provided by the proposed amendments to draft CASS 7.4.32 to 7.4.36 and CASS 7.6A.34. However, there is a wider issue in the sense that the Part 30 exemption is limited in its scope and does not cover, for example, situations where a firm is trading on a US exchange or clearing OTC derivatives through a US CCP. It is possible that, in such circumstances, there could be clashes between the CASS rules and protections provided by US requirements. Any such issues are likely to become more apparent as the EMIR and Dodd Frank requirements start to come into effect and FOA members would be keen to discuss these further with the FCA at the appropriate time.

Question 33: Do you agree with the proposal of clarifying the requirements around the DvP window? If not, please provide reasons.

3.80 As with the similar amendments to the client money provisions relating to DVP, the FOA is supportive of the amendments to CASS 6.1.12 but requests that the FCA consider the timing and costs of reviewing and amending existing terms of business and clarifies that these provisions require only a one-way notification and are imposed on a forward looking basis only. Again, it is important that CASS makes clear that a custodian's responsibility should cease at the point of delivery.

Question 34: Do you agree with the proposal relating to unclaimed custody assets? If not, please provide reasons.

3.81 The FOA agrees that a firm should be able to cease to treat unclaimed custody assets as such provided it has taken the steps suggested. While the FOA agrees that it is important for firms to take all appropriate actions to try to locate missing clients, the steps proposed are numerous and quite repetitive and are ultimately unlikely to be effective if a client has moved from his last known address. In this context (i.e. combined with the rigorous process processed), 12 years seems an unnecessarily long period. As with the similar proposed amendments to the client money rules, the FOA queries whether, in order to give any benefit to these rules, once a firm has taken the required steps, it should not then be able to dispose of the assets.

3.82 In addition, the FOA would also propose that the FCA considers the following:

(a) that firms should be allowed to make insurance payments from the unclaimed pool of funds;

(b) that the following language in CASS 7.2.19R(1) be deleted: "*following the last movement on the account"*. The reason for this request is to take into account unclaimed balances held for counterparties who continue to trade with a firm (e.g. other banks) but are unwilling to take receipt of residual balances owed to them; and

(c) that the FCA include additional guidance on industry write-offs within the scope of the changes.

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 safe custody assets are registered or recorded? If not, please provide reasons.

3.83 It should remain the case in CASS 6.2.3 that a one-way notification rather than written consent is required. The FOA also queries why the FCA considers it necessary to expressly require a legal opinion in CASS 6.2.3B.

Question 36: Do you agree with our proposals for requiring written custody agreements and clarification on the terms and details which ought to be included? If not, please provide reasons.

3.84 The FOA notes that its members tend to enter into written agreements with third parties with whom they deposit safe custody assets already. Although the FOA welcomes the guidance provided in CASS 6.3.4B to 6.3.4C, it is concerned that the level of prescription may be overly intrusive in relation to commercial relationships in the wholesale markets. However, one area where confirmation would be appreciated is on self-attestation of the adequacy of a third party's regulatory permissions, as opposed to independent due diligence being required. It would also be helpful if the rules could clearly state that the new requirements apply to future relationships and do not require review and repapering of existing agreements.

Question 37: Do you agree with our proposals to provide the two different methods for the internal custody assets reconciliation? If not, please provide reasons.

3.85 The FOA does not have any comments on the proposed amendments to CASS 6.5.4 to 6.5.4IA.

Question 38: Do you agree with our proposals in relation to the provision of an auditor's report before a firm can use the internal evaluation of custody records system method? If not, please provide reasons.

3.86 The FOA believes that, as with all the other requirements for an auditors report, this should not be a stand-alone requirement and should instead form part of the annual CASS audit cycle. In addition, in order to avoid the risk of duplication or confusion, the rules should make it clear that an AIFMD assurance report meets the FCA's requirements for the purposes of this rule also.

Question 39: Do you agree with our proposals in relation to physical custody reconciliations? If not, please provide reasons.

3.87 The FOA does not have any views on the proposed changes in CASS 6.5.4J to 6.5.4S.

Question 40: Do you agree with our proposals in relation to the provision of an auditor's report before a firm can use 'the rolling stock' method? If not, please provide reasons.

3.88 The FOA believes that, in line with its comments on other proposed amendments, the requirement for an auditors report in CASS 6.5.4R and 6.5.4RA should not be a stand-alone requirement and should instead form part of the annual CASS audit cycle.

3.89 The FOA would also ask the FCA to confirm that the rolling stock method can be used in relation to some but not all business lines within a firm as some of the larger firms include businesses with very different models that can be difficult to align.

Question 41: Do you agree with our proposals for frequencies of custody reconciliations and those relating to the handling of discrepancies? If not, please provide reasons.

3.90 The FOA does not have any comments on CASS 6.5.8 in relation to the frequency of custody reconciliations (both internal and external) as the proposed clarifications reflect what the majority of its members' current practice.

3.91 However, the FOA believes that the proposed changes in CASS 6.5.10 to 6.5.12A warrant further discussion. It is difficult to object to the proposal that the firm should make good a shortfall that it has caused but the members are not clear what is expected where the firm believes that another person is responsible for the shortfall. The revised text in CASS 6.5.12 makes clear that the firm must take reasonable steps to resolve the position but the reference to not being required to make good the shortfall has been deleted. The FOA assumes that the FCA is not seeking to impose strict liability or retail type standards on the market given that this would constitute a significant change and cut across other legislative developments and that the FCA has not referred to this in any detail in the Consultation. However, members believe that the revised text could be read as implying just that and would appreciate clarification. Members would also appreciate confirmation of the meaning of "promptly" in this context.

3.92 The FOA also has concerns about the requirement to consider whether to notify the affected clients as it may not always be apparent whether or not it is in their interests and, even if it is, it may not always be practical to do so – for example, if the account is dormant.

3.93 The FOA would also appreciate clarification on the intended link between this custody rule and client money and, in particular, whether the combined effect of the end of CASS 6.5.10B and CASS 6.5.12A means that a shortfall should only be made good where the firm holds that client's cash as client money or just that, where that is the case, the cash should be held in a client bank account.

Question 42: Do you agree with our proposals to require firms to document their own internal policies and procedures for their custody reconciliations? If not, please provide reasons.

3.94 The FOA appreciates the importance of documenting a firm's procedures and processes and keeping records of its arrangements and does not therefore object to the principles behind the changes in CASS 6.5.1A to 6.5.3A. However, as the FCA recognises, continued compliance with these requirements could require significant resource and with so many other changes to implement during the same period, both as a result of the Consultation and numerous other legislative and regulatory initiatives, six months from the date of publication of the final rules is unlikely to be long enough for some firms to make the improvements necessary with the degree of thought or involvement from all relevant parties within their organisations they would normally wish to exercise. In addition, the FOA would reiterate that the new requirements for auditors' reports (in relation to both client money and custody) should form part of the annual CASS audit cycle rather than requiring stand-alone arrangements to be put in place.

Question 43: Do you agree with our proposals in relation to TTCA? If not, please provide reasons

3.95 The FOA agrees that it is prudent that title transfer arrangements should be set out in a written agreement, although it assumes that the FCA does not require the written agreement to be signed by both parties where the client is a professional client or eligible counterparty as many agreements including title transfer provisions with such parties are made in the form of terms of business which become legally binding through course of conduct. The FOA also notes that it could be difficult to explain all the circumstances in which assets may transfer back to the client, although it believes it would be possible to give non-exhaustive examples.

3.96 As with the proposals for client money, the FOA agrees that it is useful to make provision for termination of treatment of assets as title transfer to custody assets but notes that, in circumstances where the client wants its assets to be held under custody, this is likely to be a more involved process than the equivalent cash arrangements, not least because the firm will have to provide its custody terms to the client.

3.97 Again, the FOA considers that the new CASS 6.1.8A to 6.1.8D could be improved by confirming more clearly in CASS 6.8.1A(3) that a firm is not required to make such a switch. The FOA wonders whether it would also be helpful to include a provision to make clear to clients that their request has not been accepted if they do not receive a notification.

3.98 The FOA also notes the proposed insertion of CASS 3.1.7A to remind firms of the client's best interests rule in the context of right of use agreements. The imposition of such a requirement would be wholly inappropriate to non-fiduciary trading relationships where firms simply do not have enough information about their counterparties' circumstances to be able to second guess whether the grant of a right to re-use assets is in their best interests. It needs to be remembered that in many cases the firm may need to have a right of use arrangement to provide certain services such as clearing services for margined transactions and even where this is not the case, such a right may significantly reduce a client's funding costs. In addition, while members endeavour to take this rule into account in all their advisory dealings with professional and retail clients, its application to dealings with eligible counterparties, as well as for unadvised business lines, would be a significant change. The FOA believes that the FCA understands some of the issues which the extension of the best interests rule would create and would refer to the FCA's response to the IOSCO paper on this point. Rather than seeking to apply what is effectively a retail standard obligation to wholesale business, might it be possible to reformulate the test along the lines of whether it results in any material disadvantage to a wholesale client?

Question 44: Do you agree with our proposed requirements on reporting to clients on their holdings of client assets? If not, please provide reasons.

3.99 The FOA does not necessarily consider the amendments to be unreasonable but notes that the effect of the speed proposal, if it is adopted, is likely to be that clients will want much more frequent updates on the client assets which a firm is holding for them and it may be that the firm's actual costs in responding to such queries are significant (e.g. because it has to dedicate

someone to the role of responding or upgrade its IT systems to facilitate this). Such costs could obviously be shared among clients where there is more than one which requests such frequent information but it may still be relatively expensive, at least at the outset. In addition, the timeframes proposed by the FCA do not allow for the levels of system development or the procurement that may be necessary to support such changes. Ad hoc or infrequent reporting of client positions (on their demand) is operationally difficult to implement due to the cyclical nature of reconciliation and review processes which are integral to client statement production. The FOA would ask the FCA to consider proposing a greater frequency of reporting to clients as a replacement to clients requesting statements. The FOA would make a suggestion of reporting being increased to being monthly (as an alternative). If the FCA disagrees with this suggestion, the FOA would ask that the number of business days within which statements need to be produced following a request is increased from 5 to 10 (to allow the appropriate reconciliations and reviews to take place prior to a statement being sent).

3.100 Where client money is rehypothecated in a number of CCPs, each CCP will not necessarily have a uniform approach to rehypothecation. Security interests will generally be created under local law and some markets will require the clearing member to take title over securities before providing them to the market. If firms are required to track the nature of the onward provision of collateral to the various markets they support, client margin statements could become very complicated and confusing for clients.

3.101 The FOA would ask the FCA to clarify what it means by the definition in CASS 9.1.1(2)(b) of a "*firm which only arranges safeguarding and administration of assets*" and why the remainder of the chapter does not apply to such firms? Additionally, the FOA would ask the FCA to clarify the definition of client for the purposes of reporting and disclosure documents to confirm whether it does, or does not, include counterparties with which a firm trades but has no custodial relationship.

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.

3.102 The FOA assumes that the proposed new CASS 9.5.1 is not intended to apply to firms when dealing with professional clients and eligible counterparties as it is not referred to in the draft CASS 9.5.3 but believes it would be helpful to clarify this. While not wishing to suggest that the FCA should extend the scope of CASS 9.5.1, the FOA wonders what the rationale is for making CASS 9.5.2 on custody assets that are not designated investments wide enough to cover all clients, including eligible counterparties and thereby treating them differently from other client assets.

3.103 While the FOA understands the rationale for expanding the requirement to cover all assets and client types, members would note that this proposal would need to be supported by significant system developments to introduce reporting into some business lines where it was not previously required. The FOA would strongly urge that a transition period of a minimum of 12 months be considered. This requirement may be particularly onerous in this respect for commodities businesses.

3.104 The FOA would repeat here the need to clarify the definition of client – see the response to Question 44 above.

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

3.105 The FOA does not support the idea of a client assets disclosure document for non-retail clients and questions whether consolidating disclosure information into a single document provides sufficient additional protection to clients to justify the costs of performing the exercise.

3.106 The FOA would ask the FCA not to underestimate the amount of work that will be involved for firms in putting these disclosure documents in place, not least because they cannot easily be

designed on an industry wide basis as they need to refer to the relevant terms of the relevant client agreement. Larger firms providing multiple services are likely to have at least one set of arrangements in place with each client. This means that they will either be providing several disclosure documents or what could be a relatively complicated matrix to each client. Given the amount of work this could involve, the FOA would ask the FCA to consider applying a transitional period of as long as possible for firms in relation to the arrangements they already have in place. Given the complexity of the task, if the proposal is adopted, the requirement should not be introduced at a time when client documentation is undergoing unprecedented change to introduce a number of new laws and regulations.

3.107 The FOA also notes that its members may not have client agreements in place with eligible counterparties and would ask the FCA to confirm what is expected in such cases. While the FOA agrees that it would make sense for firms to review their disclosure documents on an annual basis, it does not believe that eligible counterparties or professional clients will necessarily wish to receive them.

3.108 If the proposal is adopted, the FOA believes the FCA is more likely to achieve some form of consistency across the market if it were to define the key provisions which it thinks should be included. The FOA notes that paragraph 6.17 of the Consultation contains a helpful list but this might be useful in the rule itself as well. Finally, the rules should make clear that the summary document should not have contractual effect.

3.109 The FOA would repeat here the need to clarify the definition of client – see the response to Question 44 above.

Question 47: Do you agree with our proposal to bring 'non-written' mandates into the scope of CASS 8? If not, please provide reasons.

3.110 The FOA does not have any comments on the proposed amendments to CASS 8.

Question 48: Do you agree that our proposed changes will ensure that CASS is compatible with the EMIR RTS? If not, please provide reasons.

3.111 As mentioned in paragraph 1.2 above, the FOA has already submitted its comments on the proposed changes to CASS described in chapter 8 of CP13/5, namely in the Third Response (see Appendix 4).

3.112 As a supplement, the FOA supports the proposed changes but would request that the wording is amended. The FOA would note that it should be made clearer that the indirect clearing rules should only apply to porting of a balance at a CCP, and should not require a clearing member to return any and all balances to the clients of their direct clients, if the direct client defaulted to the clearing member. The FOA would propose the following clarificatory wording be included: "*indirect clearing in relation to an Individual Segregation Account at an EU CCP."*

Question 49: Do you agree with the approach of replacing the existing client assets sourcebook with a new sourcebook? If not, please provide reasons.

3.113 The FOA agrees that, if the FCA proceeds to make more than a few of the proposed amendments, it would make sense to reorganise the CASS sourcebook so that the provisions are numbered in a more user friendly way. However, the FOA does not believe it is necessary to create a new sourcebook and, in fact, it might be better not to do so given the number of client agreements and terms of business that make reference to CASS or the FCA's Client Assets Rules.

Question 50: What are your views on the benefits and costs of the proposals? Please provide explanations and qualitative evidence to support your response where appropriate.

3.114 While the proposals in the Consultation will impose some discrete costs on firms, the FOA's members are having difficulty in determining the likely overall costs of implementing the

proposals in the Consultation in a realistic way as they link so closely into work that many of them are already undertaking in preparation for further EMIR obligations. For example, it is difficult to determine the cost of having to provide extra information to clients when it might be possible to include that in re-documentation projects being carried on for EMIR purposes but it depends on the exact nature of the information to be provided and the time at which it will be required and possible to do so. Although, some members of the FOA consider that the costliest parts of the proposals will be the repapering of bank acknowledgement letters.

APPENDIX 1

LIST OF FOA MEMBERS

FOA Members

FINANCIAL INSTITUTIONS
ABN AMRO Clearing Bank N.V.
ADMISI
AMT Futures Limited
Banco Santander
Bank of America Merrill Lynch
Banca IMI S.p.A.
Barclays Capital
Berkeley Futures
BGC International
BNP Paribas Commodity Futures
Bank of New York Mellon SA/NV
Citadel Derivatives Group (Europe)
Citigroup
City Index
CMC Group Plc
Commerzbank AG
Crédit Agricole CIB
Credit Suisse Securities (Europe)
Deutsche Bank AG
ETX Capital
FOREX.COM UK
FXCM Securities
GFI Securities
GFT Global Markets UK Ltd
G.H. Financials Limited
Goldman Sachs International
HSBC Bank Plc
ICAP Securities Limited
IG Group Holdings Plc
International FC Stone Group
InvestecWIN
Jefferies Bache Limited
JP Morgan Securities
Liquid Capital Markets
London Capital Group
Macquarie Bank
Mako Global Derivatives
Marex Spectron
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Monument Securities
Morgan Stanley & Co International
Newedge Group (UK Branch)
Nomura International Plc
Rabobank International
RBC Europe Limited
Scotiabank Europe
S E B Futures
Schneider Trading Associates
S G London
Standard Bank Plc
Standard Chartered Bank
Starmark Trading
State Street GMBH London Branch
The Kyte Group
The RBS
UBS Limited
Valbury Capital Ltd
Wells Fargo Securities

EXCHANGE/CLEARING HOUSES
APX Group
CME Group, Inc.
Dalian Commodity Exchange
European Energy Exchange AG
ICE Futures Europe
Johannesburg Stock Exchange
LCH.Clearnet Group
LMAX Limited
MCX Stock Exchange
MEFF RV
Nasdaq OMX
Nord Pool Spot AS
NYSE Liffe
Shanghai Futures Exchange
Singapore Exchange
Singapore Mercantile Exchange
The London Metal Exchange
Tradeweb
Turquoise Global Holdings
UnaVista Ltd

SPECIALIST COMMODITY HOUSES
Amalgamated Metal Trading
BASF Metals Forwards Ltd
BOCI Global Commodities
Cargill Plc
ED & F Man Capital Markets
Glencore Commodities
Gunvor SA
Hunter Wise Commodities LLC
Koch Metals Trading Ltd
Metdist Trading Limited
Mercuria Energy Trading
Mitsui Bussan Commodities
Natixis Commodity Markets
Noble Clean Fuels
Phibro GMBH
J.P. Morgan Metals
Sucden Financial
Toyota Tsusho Metals
Traderight Ltd
Triland Metals
Vitol SA

ENERGY COMPANIES
BP International IST
Centrica Energy
ChevronTexaco
ConocoPhillips Limited
E.ON Energy Trading SE
EDF Energy
EDF Trading Ltd
GDF Suez Branch Energy International
Petroineos Refining and Trading
Phillips 66 TS Limited
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading
Shell International

PROFESSIONAL SERVICE COMPANIES
Accenture
Ashurst LLP
ATEO Ltd
Baker & McKenzie
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Bovill Limited
Cadwalader, Wickersham & Taft LLP
Clifford Chance
Clyde & Co
CMS Cameron McKenna
Deloitte
Dentons UKMEA LLP
DRS LLP
Ernst & Young LLP
FfastFill
Fidessa Plc
Freshfields Bruckhaus Deringer
Herbert Smith Freehills LLP
Holman Fenwick Willan LLP
ION Trading Group
JLT Risk Solutions Ltd
K&L Gates LLP
Katten Muchin Rosenman UK LLP
Linklaters LLP
Kinetic Partners LLP
KPMG
McDermott Will & Emery LLP
Macfarlanes LLP
Mpac Consultancy LLP
Norton Rose Fulbright LLP
Omgeo Ltd
Options Industry Council
Orrick, Herrington & Sutcliffe LLP
PA Consulting Group
Pughview Ltd
R3D Systems Ltd
Reed Smith LLP
Rostron Parry
Shearman & Sterling (London) LLP
Sidley Austin LLP
Simmons & Simmons
SJ Berwin & Company
SmartStream Techologies
Speechly Bircham LLP
SunGard Futures Systems
Swiss FOA
Trading Technologies
Traiana Inc
Travers Smith LLP
Trayport

Futures and Options Association
2nd Floor, 36-38 Botolph Lane, London EC3R 8DE
Tel: +44 (0)20 7929 0081 Fax: +44 (0)20 7621 022
www.foa.co.uk

APPENDIX 2

FIRST RESPONSE

The Futures and Options Association
Comments on the FSA Handbook Client Assets Sourcebook

29 June 2012

1 Introduction

1.1 The Futures and Options Association (**FOA**) has set out in this paper some suggestions:

(a) as to how the FSA's Client Assets Sourcebook (**CASS**) should be amended in order to bring it into compliance with the Regulation on OTC derivatives, central counterparties and trade repositories (**EMIR**); and

(b) for improving CASS for other purposes, including addressing the Supreme Court judgment[1] in relation to Lehman Brothers International (Europe) client money issues and various practical problems experienced in trying to comply with CASS.

1.2 In putting forward these proposals, the FOA has drawn heavily on the views of its members and on extensive legal input provided by the international law firm Norton Rose.

2 Amendments to bring CASS into compliance with EMIR

General

2.1 As a general comment, the FOA believes that whatever amendments are made to CASS to reflect EMIR, it is important to avoid the potential for even greater confusion than already exists in some quarters as to when clients benefit from client money protection and what that protection actually provides. In particular, EMIR describes the two types of account which central counterparties (**CCPs**) are required to offer as "individual client segregation" and "omnibus client segregation" accounts (and CCPs may provide variations between these two types of segregation such as a version of the US LSOC account). However, the industry traditionally refers to client money accounts as "segregated accounts" so there is potential for misunderstanding if terms are not used clearly and consistently in the CASS rules. Another example is differing usages of the terms "net" and "gross".

2.2 Given that EMIR recognises that different levels of segregation will provide different levels of protection and requires clearing members to inform their clients about the costs and risks of each, the FOA believes that central counterparties and firms are required or should still be permitted to offer net omnibus accounts alongside the new segregated accounts. It is likely to be more difficult to port collateral relating to such accounts and this must be explained to clients clearly so that they can make an informed choice but the FOA believes there may be ways to assist the CCPs to facilitate this. In particular, it is exploring the possibility of purchasing insurance to cover any shortfall in an account that prevents it from being ported and will discuss this with the FSA in due course.

2.3 It will be important to ensure that clients do not think that any of the account types held at CCP level will mean they necessarily have client money protection as set out in CASS because whether that is the case will depend on various factors including the identity of the clearing member and whether the collateral is provided on a title transfer basis. At the CCP level, accounts of each type may or may not be client transaction accounts and some of each type are likely not to be.

2.4 In addition, it would be useful to clarify that a CCP does not hold cash as client money. It should also be made clear that client transaction accounts are accounts in the same sense as described in Article 39(9) EMIR, where accounts cannot be combined or set-off in the CCP's

[1] In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 - judgment handed down 29 February 2012

books and records rather than that this cannot occur in the physical accounts where the CCP may have deposited the cash.

Account models and pooling

2.5 The FOA is grateful to have had an opportunity to understand some of the options being considered by the FSA, particularly in the context of which accounts should be pooled with which other accounts on a pooling event and how far shortfalls are shared. Having discussed the practicalities of these ideas with its members, it considers that the most advanced models, under which the clearing member is required to hold different accounts reflecting each of the accounts held by each CCP, is likely to involve significant operational difficulties for all sizes of firm. This would be exacerbated by the fact that cash will need to be moved in and out of such accounts on a frequent and timely basis to meet the CCPs' margin calls (which are likely to be called more frequently as the process moves to being measured on a real time risk basis). These operational issues will result in significantly increased costs and provide no clear benefit in terms of enhanced protection for clients. The FOA believes one of the slightly simpler models whereby the relevant client money accounts are combined but given a privileged status would be preferable.

2.6 CASS 7A.2.4, which sets out the pooling arrangements for client money accounts on a primary pooling event, conflicts with Articles 48(5) and (6) EMIR which require CCPs to commit to porting assets and positions and, if this is not done within a pre-defined period, to return the proceeds of risk managing such positions and assets to the client. The FOA believes the simplest way to resolve this is to exclude client transaction accounts held at CCPs from the pooling requirement.

2.7 As set out in CASS 7A.3.8, on the failure of a bank which is holding a client bank account, money in each general client bank account and client transaction account is pooled. The failure of the bank in question may or may not affect the CCP which holds client transaction accounts for clients of the firm and such a pooling would interfere with the operation of those clearing arrangements. The FOA would suggest that client transaction accounts held with a CCP are also omitted from the pooling mechanism in this rule.

2.8 In the current version of CASS, it is unclear whether the default of a CCP constitutes a secondary pooling event (as suggested in CASS 7A.3.1) or not (as suggested by the fact it is not included in CASS 7A.3.16). The FOA is concerned that the rules are currently drafted in such a way that there is uncertainty over such a fundamental issue. If all client transaction accounts are to be omitted from pooling, it may be that this is no longer relevant to CASS, in which case it may be appropriate to address this point in the proposed framework for recovery and resolution for banks and investment firms. It should cover both UK and overseas CCPs. The question of what should be the consequences of a default of a CCP is also a wider question which must involve a consideration of Part VII Companies Act 1989 (**Part VII**) and the rules which some CCPs have in place for such an eventuality.

Miscellaneous

2.9 Firms which are clearing members clearing on behalf of their clients will transfer cash collateral that constitutes client money in their hands to a CCP in accordance with CASS 7.5. This permits the transfer of initial and variation margin but not any excess. This contradicts the requirement in Article 39(6) EMIR for clearing members to transfer to the CCP collateral they have received from their clients that have chosen individual client segregation in excess of that required by the CCP. CASS 7.5.3 will therefore need to be amended. It will also be important to determine the nature of any such excess amount for the purposes of the client money regime. If the CCP holds it in the same account as that client's required margin, we assume it will form part of the client transaction account which will be excluded from pooling, whereas if it should not be excluded from pooling, the CCP may need to hold it in a separate account, which the FSA will have to designate as some form of client money account.

2.10 Where a client has chosen an omnibus client segregation account, any such excess may remain with the clearing member, in which case we assume it will form part of the firm's normal client money accounts and be included in the pooling events as such.

2.11 CASS 7.8.2 applies to clearing members that have transferred client money to third parties in accordance with CASS 7.5 so the FOA would suggest including some sign-posting between the two sections, as well as tidying up the terms used in each so that they are the same. The CCP will not know whether a particular account is a client transaction account so it should be made clear that the clearing member is responsible for telling the CCP. This will be particularly important given the Lehmans judgment that identifiable cash in non-client money accounts can form part of the client money pool. A risk of a defaulting clearing member's insolvency practitioner trying to recover assets that had been ported would jeopardise the porting concept but this may have to be addressed in Part VII.

2.12 Many firms use the exemption for title transfer collateral arrangements in CASS 7.2.3(1) to facilitate the operation of margin arrangements with exchanges and CCPs. It would be helpful if the FSA could make the case for continued use of it for such purposes in relation to retail clients in its forthcoming European negotiations in relation to the MiFID Review.

2.13 CCPs will need information about their clearing members' clients in order to be able to port their positions and collateral or return their collateral to them directly. We envisage that most CCPs will require their clearing members to provide such information in their Rules but including this obligation in CASS also would be useful. It will also be important for successful porting that the CCP, clearing member and client agree on the amounts of positions and collateral so the clearing member may need to act as an intermediary and notify the CCP of any discrepancies between its and the CCP's figures. Such provisions could be included in CASS 7.6.

2.14 A clearing member which is holding client money, which it has transferred to a CCP, will need to ensure that its client money obligations cease on the porting of the client's positions and collateral to a new clearing member or the return of its cash from the CCP direct to the client. Perhaps this could be added to the list in CASS 7.2.15.

2.15 FOA members have found that CCPs tend not to respond to requests for CASS 7.8.2 acknowledgements and wonder whether it is worth retaining this rule in relation to CCPs given that they will be the subject of harmonised and more intrusive regulation and that the FSA and other regulators must, having authorised the CCPs, be satisfied with their arrangements for holding client cash. In addition, part of the purpose of the acknowledgements will be lost if client transaction accounts are no longer to be pooled as discussed above. In any event, with the introduction of the requirements for both cleared and non-cleared derivatives in EMIR, it may not be practicable to provide that a firm must cease to use a client transaction account with a particular CCP, intermediate broker or OTC counterparty in the event it fails to provide an acknowledgement under CASS 7.8.2 because the firm or its client will be under an obligation either to clear the derivative or to collateralise it on a bilateral basis.

3 Changes necessary to address the Lehman judgment

3.1 The FOA is curious whether the FSA considers that the interpretation of CASS provided by the Lehman judgment is the correct position to be taken as a matter of policy, particularly in relation to the potential scope of the client money pool. However, it assumes that the FSA will make the necessary amendments to CASS in order to codify the Lehman judgment where appropriate given the various references to the need to adopt the interpretation that best achieves the MiFID objective of protecting client assets. The FOA is also conscious that there will be further directions hearings and cases in relation to both Lehman and MF Global and assumes the FSA will review CASS in response to each of these in due course.

3.2 The FOA does not believe the Lehman judgment does or should prejudice the use of the alternative approach to client money, the continuation of which it supports, as this approach is fundamental to the operation of many investment firms. Mandating a change to a "normal approach" business model would require the establishment and monitoring of a huge number of additional accounts to be monitored on a daily basis, thereby increasing operational risk.

3.3 The client money entitlement set out in CASS 7 Annex 1 would benefit from clarification in respect of both going and gone concern scenarios. Firstly, there are no references to Annex 1 in either CASS 7.6 (on reconciliations) or CASS 7A.2 (on the primary pooling event). Secondly, it would be useful to confirm that the individual client balance and the client equity balance are contractual entitlements as the judgment concludes. It would also be useful to confirm that an entitlement to cash in the client money pool is not dependent on the client's contract making reference to the fact the firm held it as client money, although it is important that clients are satisfied that their agreements do not say anything to suggest the contrary.

3.4 CASS 7.7.2 should be amended to clarify the fact that the trust arises upon receipt of the client money by the firm.

3.5 The meaning of client money account in CASS 7A.2.4(1) should be clarified.

3.6 However, the points above do not deal with the most practical issue in the Lehman case, which is the time it has taken to recover client money. The FOA believes it would be appropriate for the CASS Rules to include an express authority for the insolvency practitioners to make interim distributions. It might also be useful, in light of the Lehman judgment, to explicitly enable them to distribute the cash in the segregated client money pool either to those claimants who have a clear claim to such cash or to all claimants on a pro-rata basis, before starting to identify client money in the house accounts or trace into third party accounts. This would even better achieve the MiFID objectives.

3.7 The FOA is also conscious that the Lehman and MF Global cases have thrown up some interesting but fundamental questions which have not yet been answered. These include questions around clients who either should have had client money protection but agreed it should be disapplied or clients who legitimately chose not to have client money protection but in respect of whom the firm segregated cash in any event. Another such issue is the extent to which the insolvency practitioners will be permitted or required to trace into firms' house accounts or the principles on which they will do so.

4 General implementation issues experienced by FOA members

4.1 The following ideas for amendments are derived from the experiences of FOA members in trying to operate under CASS. Many of them are a question of clarifying a rule, often by expressing the FSA's expectations as to how firms should comply or setting out explicitly and on the face of the rules where an alternative method of compliance is acceptable. The FOA appreciates that the FSA has given guidance on some of the areas of clarification but it can be difficult for firms to follow such guidance where it is not all in one place.

Scope

4.2 The FOA finds that the format used in CASS 7.1.7B to D can cause confusion as to the scope of the professional client opt out. We would therefore suggest some amendments to the headings.

4.3 The FOA believes the carve-out for credit institutions and approved banks in CASS 7.1.8 to CASS 7.1.11A is unnecessarily complicated and would appreciate clarification from the FSA as to its intended scope and the policy intention behind it. CASS 7.1.11 makes clear that the FSA does not regard the carve-out as absolute but does not set out the circumstances in which the FSA considers that the carve-out does not apply. The FOA believes that different banks may interpret the carve-out in different ways, particularly in relation to whether cash margin can be held as a deposit, which will become even more relevant with the introduction of EMIR. Auditors also appear to take different views on the matter and it is common for them to make observations about a firm's use of the banking carve-out and, in some cases, to record this as an exception, in their audit reports. Arguably, the lack of certainty relating to the banking carve-out gives rise to competitive inequality as incoming EEA banks are subject to home member state regulation in this respect and FOA members have noticed that banking supervisors elsewhere in the EEA tend to view the banking carve-out as absolute.

4.4 It would also be helpful if the FSA could clarify the status of the guidance at CASS 7.1.10, which is a legacy provision from the pre-N2 SFA/ IMRO rules. If CASS 7.1.8 is intended to be a MiFID copy-out provision, the presence of the guidance appears to be super-equivalent and it is unclear to what extent it is intended, as a matter of policy, to circumscribe use of the banking carve-out. If the FSA intends to set minimum standards that go beyond those in MiFID, it would be helpful, in particular, to have more clarity on how firms should interpret the reference to "at any time" in relation to the reconciliation of client entitlements in pooled client accounts and "within a reasonable period of time" in relation to client entitlements in nostro accounts.

4.5 CASS 7.2.8B allows firms not to treat cash as client money in respect of a delivery versus payment transaction for the purpose of settling a transaction in relation to units in a regulated collective investment scheme in certain circumstances. This has the consequence of money belonging or due to clients being held in the firm's bank accounts and the FOA therefore considers that the FSA should consider an amendment to this rule.

Allocated but unclaimed client money and client money waivers

4.6 The FOA considers CASS 7.2.19 to be a useful rule but would note that few firms have, in practice, entered into a written agreement in which the client has consented to the firm releasing its client money balances after six years of account dormancy. FOA members would find it useful if the FSA was prepared to consider and grant releases even where this condition is not satisfied, or to have some guidance acknowledging that it might be legitimate for a firm to discharge its fiduciary duty without this condition having been satisfied. The process for reliance on this rule and any modified version of it as suggested above, and the permitted use of unclaimed balances, should also be made clearer.

4.7 There is no similar guidance in CASS 5, which certain FOA members would find useful.

4.8 The FOA also notes that the guidance on obtaining client money waivers in the context of transfers of business is related to CASS 7.2.19 and suggests that there either be a clear link from the latter to the former or that the waivers be incorporated in CASS.

Diversification

4.9 The diversification rule at CASS 7.4.9A is a cause of significant concern for many FOA members, particularly the larger banks, in stressed market conditions and in relation to overseas markets where there is a limited choice of banks. It causes particular difficulty where to continue to comply with the 20% limit would mean effectively breaching principle 10 on protection of client assets. The FOA would like to see some form of recognition from the FSA, ideally in the form of a safe harbour, that a breach of the limits is acceptable where the clients' assets would otherwise be put at risk. Clearly, any such breaches should be fully documented with reasons for supervisory purposes.

4.10 Many FOA member banks attract clients, in part at least, on the basis of their creditworthiness and find that some clients would prefer to opt out of the client money rules by using the title transfer carve out than to have their cash deposited with riskier banks outside the group. The FOA considers that a firm should be able to disapply the diversification rule in CASS 7.4.9A if a client wishes it to do so, at least where the client is an eligible counterparty. The FOA recognises that it may be necessary to limit this to designated client bank accounts or designated client fund accounts that hold only the cash of the client in question.

4.11 The "at any point in time" wording in CASS 7.4.9A is also problematic because there can be occasions (particularly intraday) where the limit is exceeded in circumstances over which the firm has little control. The FSA has previously explained to the FOA its policy in deciding whether such breaches warrant a supervisory response which is helpful, particularly as it suggests that the FSA will in general monitor compliance against the end of business day position while recognising that all breaches will be assessed against a series of factors. The FOA believes it is important that this policy is set out in the rules.

Buffers

4.12 The FOA would appreciate guidance on whether and in what circumstances the FSA supports the use of buffers. While they are expressly permitted by CASS 7.4.21, some FOA members have heard the FSA and auditors suggest that the need to use buffers indicates inadequacies in systems and controls. However, the FOA understands from earlier dialogues with the FSA that buffers can be used to deal with operational shortfalls, particularly in volatile markets, and that this kind of cautious approach is particularly appropriate in the current climate. Members do not believe the judgments in the Lehman case provide sufficient clarity on this point.

Notification and acknowledgement of trust

4.13 Several FOA members have experienced both the FSA and auditors expressing a view on the format and content of acknowledgments given in accordance with CASS 7.8.1. Some of these requirements have also been reflected in speeches given by the FSA's CASS Specialist Supervision Team. These include that they must use the same form of words as CASS 7.8.1(1)(a), that they must be on the letterhead of the firm and be signed on behalf of the bank on each page (and that the full legal names of each entity must be used as well as the full name and job description of the signatory) and that the account number and name to which the letter relates must be set out in full. The FOA generally believes that the FSA's expectations should be set out in the rules so that they reflect the full extent of the requirements but the reality in this case is that it is impossible to get certain banks to comply with all the requirements and, where the deviation is minor, it makes little practical difference to the protection afforded to the assets. It would therefore be preferable if guidance concerning the detailed requirements for acknowledgements was centrally located but clearly described as best practice rather than mandatory.

4.14 In particular, several members have experienced difficulty in obtaining acknowledgements from overseas banks, not least because they are not necessarily familiar with the FSA Rules or do not recognise the concept of the trust to which the letters refer. As CASS 7.8.1(2) refers to UK client bank accounts, the FOA would be grateful if the FSA could confirm that a firm is permitted to use a non-UK client bank where the bank has not provided the acknowledgment within 20 business days without having to double segregate cash. This is particularly important in respect of jurisdictions where members have little choice as to which banks to use.

4.15 Please see also the comments on CASS 7.8.2 in relation to EMIR in paragraph 2 above.

CFTC Part 30 exemption

4.16 The FOA would be grateful for confirmation of the scope of the CFTC Part 30 exemption in CASS 7.4.32 and 7.4.33. It is assumed that an eligible contract participant can only opt out of CASS 7 to the extent set out in CASS 7.1.7B to CASS 7.1.7F. However, if this is the case, the exemption would appear to be an empty exemption for firms that carry on MiFID business.

Improved calculations

4.17 The FOA suggests that firms should be permitted to undertake the client money reconciliations in CASS Annex 1 (1) and (2) on each business day but using the aggregate balance on the client bank accounts and the client money requirement as at the close of business on the previous day on which the firm was open for business rather than the previous business day. This is because many firms execute transactions on markets outside the UK on non-UK business days and any resulting changes in the amounts that need to be segregated are not dealt with as quickly as they might be if the firm has to look back to the previous business day. This suggestion would ensure that firms' client money calculations are as up to date as possible. The FOA would like this possibility to be reflected in CASS Annex 1 because some member firms' auditors have interpreted the letter of these rules rather strictly.

4.18 In addition, as the client money calculation is always at least 24 hours behind at the date of a pooling event regardless of which approach is used, the FSA might consider the possibility of asking HM Treasury to require the insolvency practitioners to roll forward the calculation by one day to better reflect the amounts of cash that should and should not be in the client money pool.

Use of safe custody assets

4.19 Some FOA members think it would be useful for the FSA to provide further guidance on its expectations in relation to the rehypothecation by a firm of client assets in excess of the levels agreed in accordance with CASS 6.4, in particular, the FSA could consider a similar cure period mechanism to that in the U.S. regime, whereby if the safe custody assets could be recalled by the firm within a set period, the firm will not be deemed to be in breach of the rules in CASS 6.4. Alternatively, the FSA could consider a structure whereby the firm is able to ringfence an amount of client money equivalent to the excess in the interim, and that such ringfencing would not be deemed to be in breach of the trust.

Controlling client money

4.20 The FOA would find it useful if the FSA would confirm its interpretation of the circumstances in which a firm controls but does not hold client money and falls within the scope of CASS 8. It is understood that it applies where the firm has a power of attorney or similar authority over a client's account held with a third party but there may be other circumstances also.

Guidance on the Client Money and Assets Return (CMAR)

4.21 The guidance notes on the CMAR set out in SUP 16 Annex 29A make reference to firms including the results of the penultimate internal reconciliation for field 21, and the internal reconciliation carried out on the reporting period end date for fields 14 to 20. There are different interpretations within the industry on which day's reconciliation results should be used so more clarification on the reconciliation dates for fields 14 to 21 would be appreciated, ideally with worked examples.

4.22 For field 17 on unpresented cheques, the FSA has acknowledged that there is a mixed approach across the industry with some firms only counting stale cheques (those more than 6 months old) and other firms counting uncleared cheques (after the usual T+3 exemption). It would be helpful if the FSA could again consider whether a consistent approach across the industry would be preferable.

4.23 The guidance notes for field 26 can be interpreted to require different information. The first paragraph makes reference to firms identifying the number of unreconciled custody assets and allocating each item to one of the specified time bands, whereas the second paragraph makes reference to a firm calculating the number of calendar days between the date on which an internal reconciliation should have been carried out, but was not, and the reporting date. Once again, clarification would be appreciated.

General

4.24 The FOA respects the responsibility which the FSA has put on the auditors in assisting with improved compliance with CASS. However, there are a number of examples where firms have encountered difficulties with the way in which some auditors have been interpreting the CASS Rules. In particular, there have been instances where auditors have highlighted failures to comply with guidance in CASS which, when subsequently discussed between the firm and the FSA, the FSA has accepted as an acceptable alternative means of achieving the desired outcome. The FOA believes that it would be helpful if the FSA could hold a seminar on the CASS Rules for auditors with a view to ensuring that there is a common approach to interpretation of the Rules.

4.25 Many members would find it easier to ensure they are aware of and compliant with the FSA's most recent expectations on client asset protection if all such information was in a single location rather than spread out across the FSA's website, various speeches and emails to the FOA. Members have asked about the possibility of the FSA producing a document equivalent to the Transaction Reporting User Pack or Market Watch for client assets related issues. At the same time, at member request, the FOA is working on an industry standard document which members will be able to provide to their clients to help explain the operation of the FSA's client

money rules. It is thought it may also be possible to incorporate the risk disclosures relating to different levels of segregation that will be needed under Article 39.7 EMIR.

4.26 Some FOA members would find it useful if the FSA issued further guidance on its view as to how a firm can demonstrate that it has acted in accordance with the client's best interest rule in its application of the CASS Rules. Whilst there is some guidance on this at CASS 6.4.2 and CASS 7.2.7 further guidance on the FSA's view on how this can be met in practice would bring greater clarity to this area.

APPENDIX 3

SECOND RESPONSE

CP12/22: Client assets regime: EMIR, multiple pools and the wider review Parts II & III

A response by the Futures and Options Association

NOVEMBER 2012

CP12/22: Client assets regime: EMIR, multiple pools and the wider review – Parts II & III

1 Introduction

1.1 This response is submitted on behalf of the Futures and Options Association (**FOA**), which is the principal European industry association for 160 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).

1.2 The FOA is pleased to have the opportunity to respond to Parts II and III of the Consultation Paper 12/22 - Client assets regime: EMIR, multiple pools and the wider review (the **Consultation**). The FOA welcomes the FSA's willingness to consider fundamental changes to the client money and assets regime and the assurance to undertake an open-minded review of the regime in 2013. Indeed, while the FOA has supported the various incremental changes the FSA has introduced to the client assets regime over the course of the last four years, the FOA has been looking forward to a more wholesale review, which is aligned with necessary changes to insolvency law and the need to simplify compliance and implementation. The FSA will recall that the FOA has previously offered its members' suggestions as to various improvements that could be made to the FSA's Client Assets Rules (**CASS**) and a copy of the paper submitted on [ ] (the **Previous Response**) is attached at Appendix 2 to this response.

1.3 The FOA has put together this response following consultation and discussion with its members and with the significant assistance of Norton Rose LLP. The FOA would welcome the opportunity to discuss its members' comments with the FSA in more detail if this would be helpful.

1.4 The FOA would like to stress the importance for both the FSA and the industry to consider such fundamental changes carefully and would encourage the FSA to engage with it and its member firms, as well as other industry participants, during the period before trial determination so as to ensure that any practical and operational issues can be factored into the FSA's thinking from an early stage and new rules are finalised. In particular, the level of detail provided in relation to the wider review proposals is not yet sufficiently developed to enable FOA members to fully understand and calibrates the impact that such changes might have on the way they carry on their business.

2 General

2.1 In general terms, the FOA notes the FSA's expectation that the establishment of client money sub-pools will, as is set out in paragraph 3.10 of the Consultation, localise any client money shortfalls to a particular sub-pool and so allow distribution of client money from those sub-pools where no contentious issues have arisen, thereby facilitating a faster distribution of some client money.

2.2 On the other hand, the FOA believes that those perceived benefits could be more than outweighed – potentially significantly – by:

(a) despite best efforts by the firms, a major increase in operational complexity (e.g. multiple reconciliations, diversification obligations, record-keeping requirements and notification of requirements of changes leading to increased operational risk and cost) and, for many, a complete reengineering of firms' IT systems;

(b) the enhanced risk of legal challenge by customers in the event of a default seeking to assert that they were put into the wrong pool (particularly where the pool in question

becomes the subject of a shortfall) and the possibility that the recent judgement in the Lehman Brothers International (Europe) case[1] could be argued to apply to client's expectations regarding segregation in a particular sub-pool adding further to the legal uncertainty.

(c) potential exacerbation in operational complexity where, for example, individual client pools reflect multiple tiers of risks or where clients are invested across several pools with differentiated risk profiles or, in the case of difficult or fundamentally differentiated jurisdictions as regards the treatment of client money, where it may be necessary to establish an overarching geographical sub-pools to cover dealings in such a jurisdiction;

(d) the potential reduction in available margin offsets for customers because of the creation of multiple client money sub-pools – a benefit which may become even more important to customers if, for example, margin calls are significantly increased in order to respond to current pressures for them to be counter cyclical.

2.3 If the FSA does facilitate establishment of sub-pools, the FOA would have serious reservations about mandating their use for any purpose, whether for EMIR[2] purposes or to split the general pool.. The process changes demanded by implementation of the EMIR articles related to segregation and portability, facilitated by Part I of the Consultation Paper, represent a major undertaking for member firms throughout 2013. These changes will impact virtually every step of the trade cycle, and will require significant technology development and process change. The addition of concurrent changes to the pool structure will create further complexity, and there is a high risk of change management and house-keeping issues, which are the greatest enemies of effective segregation and client protection. Despite these significant concerns, the FOA has considered and answered all the FSA's questions about sub-pools in Part II of the Consultation, though they should be read subject to this overarching concern. The FOA has also considered the proposals in Part III. This assumes that these proposals are related to both the client money and custody regimes, although its responses focus slightly more on the former.

2.4 The FOA would also like to draw a distinction between 2 different approaches to sub-pooling:

(a) EMIR-related Sub-pools: This proposal envisages under-pinning net omnibus accounts at CCPs with dedicated client money pools. FOA members are concerned that attempting to implement and maintain sub-pools at this level will generate counter-productive cash management (and other operational challenges), as well as generating complexity for clients in changing account structures, and management of excess margin. In addition, porting would not be facilitated without giving CCP's a clear view of client's positions and margin at a Beneficial Owner level, and establishing arrangements to give CCP's access to a Clearing members bank accounts in the event of default.

(b) Business-level Sub-pools: This proposal envisages separation of more complex business from less complex business, or separation of different business types (eg retail vs non-retail, margined vs non-margined). FOA members can see the benefit of this approach to segregation and client protection in terms of the broader objectives of increasing speed and scale of return to assets to clients within less complex pools. However, members remain concerned that this is an added level of complexity in the immediate term, which may conflict with efforts to deliver the segregation and portability measures specified by EMIR.

2.5 The reason why sub-pools should not be mandated or clients incentivised to use them is because:

(a) this would deny end user choice, which is contrary to the intention and spirit of EMIR;

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[1] In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 - judgment handed down 29 February 2012

[2] Regulation EU 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

(b) end users should not be compelled to use high cost segregation options, bearing in mind that they are already facing significant increases in direct and indirect 'pass on' costs;

(c) the operational complexity of setting up and administrating sub-pools has not yet been trialled or tested (see concerns set out above), and the FSA has accepted that operating multiple pools of client money will be costly for firms (which is ultimately a cost for clients);

(d) the cost-benefit analysis compatibility statement included in Annex 1 to the CCP is unreliable insofar as, for example, firms have been unable to assess the establishment or on-going costs with any degree of accuracy at this early stage.

2.6 The FOA believes that some of the problems outlined above and the objective of portability can be met at less cost and operational complexity by requiring CCPs to offer gross margin omnibus accounts. An additional benefit of this solution is that it has a high degree of commonality with the solutions being implemented in the US; a consistent segregation and processing model will be less complex to implement and maintain for clients, brokers and CCPs.

However, the FOA believes that the establishment of such accounts should:

(a) Not be mandated or customers be incentivised to use this (or other forms of segregation) consistent with the overall objectives of EMIR to accommodate customer choice in the matter of segregation;

(b) Not undermine the availability of net margined omnibus accounts;

(c) Not impede firms from recovering from their customers the full costs of offering any particular level of segregation, although the potential high cost of the more secure forms of segregation may only be economically viable if they are subsidised by the business lines within an institution - and this could make their provision prohibitive for specialist firms.

2.7 More generally, the FOA appreciates that the FSA is conscious that amending the CASS regime can only improve client asset protection up to a point without making changes to insolvency law. However, it would reiterate the importance of this second layer of reform because the FSA's objectives could be fundamentally undermined without revision of insolvency law. The FOA believes this is true in respect of both the FSA's proposals on sub-pools and the ideas mentioned in relation to the wider review. The FOA understands that the FSA and HM Treasury are working very closely together, as well as with the industry, to achieve the most effective improvements to the regime as a whole. The FOA would appreciate the FSA adopting a transparent and consultative approach to such work.

2.8 The FOA considers it is also important for both the FSA and HM Treasury to bear in mind both the European and wider international context when undertaking their work in relation to client assets. It is understood that, while the UK insolvency and client assets regimes take into account certain aspects of European law and international practice, they are fairly bespoke to the UK. The FOA believes it can only be helpful in the longer term to take into account the practices of other jurisdictions and regulatory developments at those levels. It is essential that clients and potential clients in other jurisdictions regard changes introduced to the UK's client money and assets regime as (a) addressing previously identified deficiencies and weaknesses in the rules; and (b) enhancing the level of protection to the point where the UK has one of the strongest regimes for protecting client assets and money, which is at least comparable (even if different) to that provided in the US and in other major well-regulated jurisdictions.

2.9 On a more cosmetic point, the FOA believes that, should they be introduced, multiple client money pools should not be referred to with the terminology of "sub-pools" as this implies that they are sub-parts of the general client money pool when, in fact, they operate at the same, if not a higher, level.

2.10 While the FOA recognises that diversification is not the subject of a specific question in the CP, it does have concerns over its approach to multiple client money pools and these are set out in the paragraphs below.

2.11 Superimposing diversification upon client money pools would not only require an even greater number of additional client money bank accounts to be established to hold money in excess of the margin requirement but would additionally require firms to create separate bank accounts to support the multiple currencies necessary to manage margin payments in relation to overseas markets. As clients will receive detailed risk disclosures around the nature of a sub-pool, the rules already contain a mechanism for a client to give informed consent to opting out of diversification. Any clients that want an individual or small group sub-pool should be provided the flexibility to choose whether to have diversified client money bank credit risk, which is fluid and difficult to monitor, or whether to be able to decide upon and monitor the bank which holds their client money.

2.12 Some members have experienced difficulties in negotiating terms with external placement banks. The fact that a firm must insist that client money should be held on overnight deposit to be capable of immediate withdrawal, together with the requirement that the relationship between the bank and the firm be disclosed to the firm's clients, makes accepting such deposits unattractive to many banks. Many external placement banks only have appetite for USD and other major currencies. Were the external placement banks to be asked to provide multiple accounts containing small deposits, the FOA envisages that the terms upon which such bank accounts are offered would become even less attractive. In particular, supporting markets which require non-G10 currencies may become impossible for firms.

2.13 The FOA is also concerned about the impact of operational timings on the allocation of risk as between sub-pool participants and general client money pool participants. As currently drafted, CASS 7.10.9 does not create an appropriate allocation of risk as between clients whose money is held in the general client money pool and those clients that have agreed to have money held in a client money sub-pool. If remittances are permitted to pass through the general client money account before being transferred to a bank account that relates to a relevant sub-pool, it is likely that a disproportionate intraday risk is carried by the general client money pool. By way of example, if at the beginning of the day, a firm makes its margin calls from its general client money accounts and defaults before receiving margin money from a client which has subscribed to a particular client money sub-pool, the general client money pool has funded the sub-pool clients' margin requirements.

3 Part II of the Consultation

Question 3: Do you agree that we should introduce multiple client money pools to facilitate porting of cleared positions?

3.1 The FOA understands the FSA's reasons for considering the introduction of sub-pools to facilitate porting of positions in net omnibus client accounts and agrees that they have the potential to be beneficial in this context. However, the members believe that these benefits would be more than outweighed by the significant risks that they entail and that the FSA should consider alternative options to achieve its objectives.

3.2 The FOA believes it is important to acknowledge that the creation of sub-pools will create further complexity in CASS, which has already been seen to be capable of different interpretations by the industry as demonstrated by the Lehman Brothers litigation. Even if CASS can be clarified to the extent that there is a common understanding of its application in all circumstances, sub-pools would increase both operational risk on a day-to-day basis and legal risk in the event of another failure. In terms of operational risk, to facilitate porting, a firm would have to set up at least one sub-pool per omnibus client account they hold per CCP. The reality is that there will be many of these because the larger the CCP omnibus accounts and the correlated sub-pools, the less chance that they will be capable of porting, regardless of whether the CCP has access to any excess collateral at clearing firm level. This is not least because the clients might not all agree to

port to the same clearing member. Each sub-pool will take time and resources to set up, both from an operational, legal and on-boarding perspective. Each account may have different currencies, each of which will require different accounts, and multiple settlement instructions and internal transfers will be needed to support them, including to make at least daily variation and initial margin calls to CCPs. In order to ensure that their funds were protected within the correct sub-pool, clients would need to manage separate margin calls by each CCP, with different sets of payment instructions for each margin call. The risk of error will increase with complexity. In terms of legal risk, this heightened complexity is likely to exacerbate problems in the distribution of client assets upon the failure of a firm. Despite the FSA's proposed safeguards, it will be difficult for retail clients to understand these arrangements and any error or unclarity in the firm's records or operations will make it even more difficult to ascertain clients' entitlements. Even if a firm were in perfect compliance, it would take longer for the insolvency practitioners to work through the records to check this and would give clients greater scope for arguing that they were entitled to a share in a different pool or to a different amount. None of this would be likely to make either insolvency practitioners (given their strict liability) or CCPs more confident to port nor able to do so sufficiently quickly. This would therefore significantly undermine the likelihood of achieving the FSA's objectives, not only in facilitating porting but also in relation to the timely and full return of client assets. Overall, this would not necessarily result in a better outcome for either clients or creditors of a firm.

3.3 In particular, the basis of calculation of the "client money entitlement", as explored in the Lehman Brothers International (Europe) (LBIE) litigation, is likely to be problematic in the context of sub-pools. This is because clients could extend the point that their claim refers to the amount of cash that should have been segregated (rather than the amount of their cash that was actually in the client money pool) to argue that they are entitled to cash in each of or all of the general pool and sub-pools. The FOA realises that this is the reason for the warning in the disclosure document but the reality on a firm's failure is that clients have nothing to lose by claiming against all available pools. This is similar to their arguments about mis-categorisation referred to in answer to question 12. The FSA's objectives for sub-pools, both in an EMIR and a wider context, assume that any particular sub-pool can be resolved ahead of others and the general pool but these types of practical issues would undermine that assumption. Again, this would undermine the FSA's objectives generally but would also be particularly unhelpful in the EMIR context. This is because CCPs operate on the basis of short liquidation horizons (where the decision to transfer client business or liquidate client positions needs to be taken in a matter of days) and claims are likely to result in a sufficient delay and prevent porting. To avoid this outcome, a possible solution is for the rules to be amended so that the contents of the client money pool should be taken, at least in this context, as fixed at the last point of reconciliation before insolvency as being a cut off in ascertaining what money is within the given client money pool.

3.4 Further, some members have reservations about whether the creation of multiple sub-pools could undermine the protections afforded to general client money pool participants. It is critical that clients that do not opt for participation in a sub-pool retain a high level of protection and that a firm's overall arrangements remain fair. It would not be helpful for firms to have either no general client money pool or a very small general client pool together with a significant number of sub-pools because there is some safety in being part of a large general client money pool in terms of the assets available to cover losses or shortfalls. Were a firm to establish a system under which the general client money pool was small, the benefits of insulating separate groups from the consequences of client money shortfalls would be overridden by the considerable operational risk and cost that such an arrangement would present. The FOA would also hope that firms would be discouraged from creating or incentivising hierarchical participation in sub-pools on the basis of the creditworthiness of fellow participants. Such arrangements would concentrate the consequences among particular classes of client in a manner that may be perceived to be unfair.

3.5 The FOA believes that there are potentially alternative options if the FSA feels that something needs to be done to facilitate porting of positions in omnibus client accounts. However, the FOA would note that, while it understands the FSA's policy aim, any extra measures are not required by EMIR and that clients should have the choice of an omnibus client account as contemplated by EMIR (ie. without these additional arrangements). The FOA perceives there are concerns that clients may choose lower levels of protection on the grounds of cost savings but the members believe clients should be given credit for understanding and taking into account the wider

differences. They also believe that there is increasingly little scope for members to profit from differentials in margining and that they will have to compete on offering and commission rates. In any event, FOA members believe that the additional complexity involved in setting up and operating sub-pools would make them as, if not more, expensive than individual client accounts, which would give a confusing message to clients as they do not offer such great protection. The FOA would not advocate this because, if the FSA considers that client cash is safer held by a CCP than a clearing firm, this could be mandated, as is the case with individual client accounts. However, on the basis that this is too simplistic an assumption and there are good reasons for clearing firms to hold excess collateral, the FOA believes that the FSA should instead be encouraging CCPs to offer gross margining such that they would hold sufficient margin to port all positions within an omnibus client account. The FOA believes that more than one of the London CCPs is intending to do this. As indicated above, this should be as an alternative to net margining as some clients are content with the existing arrangements.

3.6 In any event, if the FSA were to introduce the concept of sub-pools, the FOA feels strongly that clearing firms should not be required to offer this option for the reasons articulated in paragraphs 3.2 to 3.4 above.

3.7 Notwithstanding the FOA's negative views on sub-pools, the FOA has nevertheless given FSA's remaining questions some thought and is keen to share its thinking. However, in light of the current complex and fluid status of applicable law and regulation applicable to porting client transactions, the FSA's proposed rules may require further calibration when EMIR regulatory technical standards are finalised, more interpretive guidance is provided by the European Securities and Markets Association (ESMA), HM Treasury have concluded their update of relevant insolvency laws and the FSA has published its final Handbook text on Part I of the Consultation. Additionally, the FOA would like to note that many clearing house omnibus and individual client segregation models are currently under development while they prepare for the implementation of Title IV of EMIR.

3.8 If multiple client money pools were to be introduced for EMIR purposes, on either a voluntary or mandatory basis, the draft Handbook text would need further detailed development. For example, as currently drafted, it is not clear how the cash held in the EMIR sub-pool would be shared between the clients whose contracts and collateral were recorded in the relevant client transaction account or whether, if the sub-pool were to contain sufficient cash, the CCP would be permitted to transfer each client's contracts and collateral to a different back-up clearing member. The FOA believes that there would need to be some coordination between the CCP and the firm as to how the sub-pool should be identified in the firm's books and records and what the CCP would be permitted to do with the cash held in the event of the firm's default.

3.9 The FOA notes that the sub-pool terms and disclosure document would need to identify that the purpose of the sub-pool is to facilitate porting of client transactions and that the sub-pool terms must identify the relevant CCP and client transaction account.

3.10 Finally, the FOA would emphasise two cost points namely:

(a) Where omnibus accounts are split into smaller units, netting benefits are reduced significantly or, in some cases, may be lost altogether depending upon the nature of the client money pool. As stated earlier, the importance of netting may become substantially more valuable for customers if margin calls are increased significantly in order to meet the need for them to be counter cyclical.

(b) One consequence of a firm maintaining a number of accounts at a central counterparty is that default fund contributions will increase in the case of markets which derive the default fund contribution from the sum of margin maintained by a clearing member.

Question 4: Do you agree that we should make the option of multiple client money pools available to other types of investment businesses?

3.11 Again, the FOA can appreciate why the FSA has suggested the extension of the use of sub-pools and, indeed, members have experienced some client demand for an enhanced form of protection

for their cash in the event of a firm's failure, but the FOA does not believe the wider introduction of sub-pools would result in a net benefit for the reasons in paragraphs 3.2 to 3.4 above.

3.12 The FOA is concerned at the prospect that multiple client money pools could be extended to cover all types of investment business before they have even been tested in terms of whether or not they meet the expectations of the FSA and the extent to which those expectations could be undermined by a significant exacerbation in operational and legal risk. Clearly, if the benefit is found to outweigh the cost of potential increase in risk then it should be facilitated to cover other forms of investment business and, indeed, be available for clients who wish for an enhanced form of protection for their cash in the event of a firm's failure.

3.13 The FOA would therefore expect there to be a further consultation before any introduction of sub-pools for wider purposes and would want to check then that the significant operational risk inherent in operating a number of sub-pools is fully factored into the FSA's deliberations as to whether to introduce the proposed rules. In the meantime, however, the FOA considers that the FSA has suggested sensible measures in the form of notifications to the regulator and disclosure to clients. However, the members have some comments on the sub-pool terms and disclosure documents, as detailed below. While the FOA believes that applying the same requirements in relation to segregation, reconciliations and record keeping makes sense, the FOA would again ask the FSA to allow the diversification requirement in CASS to be waived in respect of any sub-pool where the client has so agreed. The FOA's concerns and the practical difficulties with diversification are set out in its Previous Response.

Question 5: Do you think the sub-pool terms should include any further information?

3.14 If sub-pools were to be introduced, the FOA considers that more guidance from the FSA would be needed about the level of detail that will be required. There are concerns that the level of information proposed will be equivalent to that which should be retained in the CASS Resolution Pack. For example, the FOA assumes that it would be permissible to identify the beneficiaries by class (eg. all retail clients with spread betting accounts or all professional clients trading on the London Metal Exchange whose cash is held by the firm as client money, in each case, from time to time) and not by individual identity as, depending on the type of business carried on, the specific members of a sub-pool may change on a fairly frequent basis.

3.15 As disclosure of the identities of fellow members of a client money sub-pool would be inconsistent with client confidentiality, it would be helpful if any proposed rules confirmed that the sub-pool terms were confidential to the firm and regulatory bodies. It is envisaged that in many instances it would be difficult to produce appropriately clear terms which, were they to be shared with beneficiaries, would not disclose, directly or by inference, the identities of other beneficiaries in the sub-pool.

3.16 It would also be difficult to specify the locations where the cash relating to the sub-pool is held as these are likely to change on a frequent basis given firms' ongoing obligations in relation to due diligence of banks and diversification.

Question 6: Should firms be required to identify client money accounts in the sub-pool terms by account number or by name or both?

3.17 If sub-pools were to be introduced, the FOA believes that firms should be permitted to use either account name or number for these purposes as different firms' identification systems work in different ways.

Question 7: Do you think we should provide template sub-pool terms that can be completed by firms establishing new pools?

3.18 If sub-pools were to be introduced, the members think it would be useful for the FSA to engage with the industry and publish a template of core sub-pool terms or, at least, an example of the level of detail that firms should set out in their sub-pool terms. However, the members also think that it is important that any such template is sufficiently flexible to enable different firms to produce sub-pool terms that are appropriate to their particular sub-pools (possibly in an annex to

the standardised terms). Additionally, firms should not be criticised for using different formats or providing additional terms provided they contain the required information and are sufficiently clear.

3.19 Again, the FOA would reiterate its concerns about the level of detail to be provided and, if such terms are to be shared, the extent to which clients will understand and benefit from them. The FOA believes that firms would appreciate further consultation on any proposed format. As such it is important that the industry works with the FSA to develop appropriate sub-pool terms.

Question 8: Do you agree with the content of the sub-pool disclosure document? Do you think it should contain any further information?

3.20 If sub-pools were to be introduced, the FOA believes that, broadly speaking, the items proposed to be included in the disclosure document are the right ones, subject to the concern about confidentiality in relation to question 5. It may be difficult to define not only the beneficiaries of a sub-pool, but also the business lines to which it relates, sufficiently generically. The FOA believes that any disclosure document should also be useful and understandable by clients, rather than being drafted for the benefit of insolvency practitioners. Members believe that retail clients are likely to seriously struggle with these arrangements. However, the FOA questions whether, in addition to emphasising that a client who is not a beneficiary of a particular pool would have no claim or interest in it, should be extended to include the assurance that neither would any such client owe any liability to a particular pool unless it is a beneficiary of it.

3.21 In practice it may be difficult to define the content of a disclosure document, for example, consistently defining the business lines and the risks associated with the sub-pool are open to interpretation by each member firm, which clients may find misleading and at odds with the purpose of ensuring clients are fully aware of the risks they face in placing money in a sub-pool. The FOA thinks that it would make sense for the FSA or one of the industry bodies to produce a standard form of wording for items (5), (7) and (8) (although the draft Handbook rule almost provides this in relation to (8)) as these should be similar for most types of sub-pools. This wording could form the basis of the provisions which the firm could then tailor to each individual situation.

3.22 The FOA's deeper concern regarding disclosure documents is about the process of providing them to the client (and the risk of an undue burden being placed on available resources or on costs). The FOA would want guidance that there is flexibility in the way in which the acknowledgement and the consent referred to in draft CASS 7.10.18 could be provided (eg. that they can be in separate documents) and by what media the disclosure document, acknowledgement and consent must be communicated, alongside confirmation that wet signatures are not required. Such flexibility would enable the firm to manage the process in a way which is appropriate to the firm. However, as such process would be subject to audit, it is important that the FSA's expectations are clear on the face of CASS.

Additionally, firms should not be required to produce real time disclosures insofar as, particularly in times of market stress, this could increase systemic instability where, for example, firms are obligated to notify their client's real time when they stop using particular client money banks or cease providing access to certain markets.

3.23 In relation to proposed CASS 7.10.19(1), the risk disclosure document should only be required to disclose material risks and potential consequences for the beneficiaries as opposed to all risks. If reference is made to "principal" risks, this will bring the language in the section in to line with proposed rule 7.10.13. It would not be helpful if esoteric risks are subject to disclosure as this may result in the disclosures being overly long and difficult for clients to understand.

3.24 The same practical questions should also be addressed in relation to any amendments made to the disclosure document.

3.25 The FOA notes, as set out in paragraph 3.26 of the Consultation, that firms will be required to notify the FSA not less than 3 months before implementing 'amendments' to sub-pool terms. The FOA assumes that this is intended to cover only material amendments mirroring the comparable

obligation that appears in paragraph 3.32 of the Consultation with regard to notification of 'material amendments' to clients.

Question 9: Should we provide a template that can be completed by firms?

3.26 Please see our response to question 7 above.

Question 10: Do you agree that clients should be given one-way notification of any material amendments to a sub-pool three months before the proposed amendment?

3.27 The FOA agrees that, if sub-pools were to be introduced, clients should be given one-way notice of material amendments and that clients should be deemed to have accepted the proposal if the client does not notify the firm otherwise.

3.28 The FOA agrees that clients should be given sufficient notice of a material amendment to enable them to terminate their client relationship with respect to that pool. The general consensus is that 3 months is not unreasonable in respect of retail clients, but it may be too long in relation to wholesale clients who may be driving the amendments and where business models and needs change more rapidly or more frequently.

3.29 The FOA believes, however, that it should be made clearer which amendments require notification. The draft Handbook text refers to amendments to the disclosure document but not the sub-pool terms, which may be because the latter is not a client facing document.

Question 11: Do you agree that the surpluses from the sub-pools and the general pool, if there are any, should be used to cover any shortfalls in other pools in the manner proposed?

3.30 The FOA believes that this proposal would require further consideration if the FSA were to introduce sub-pools because this raises questions of priority and also ties in with the assumption that it will be possible to resolve sub-pools in advance of the general pool. While some members agree that this approach would ensure that, if there was a surplus on any account, that surplus would be used for the benefit of the firms' clients as a whole, others question whether a surplus in one sub-pool should be shared proportionately with any other sub-pools which have suffered a shortfall and the general pool, rather than it all reverting to the general pool. Overall, the timing implications could make any such allocation very difficult for an insolvency practitioner to manage efficiently

3.31 The way this question is phrased, namely, that surpluses from the sub-pools will be used to cover any shortfalls in other pools does not quite accord with the statement in paragraph 3.33 of the Consultation that sub-pool surpluses should be contributed to the general client money pool.

Question 12: Do you agree that these benefits would result from the segregation of retail and non-retail client money?

3.32 The FOA agrees that wholesale clients are likely to have a higher risk appetite than retail clients and are therefore likely to invest in more volatile products where client money holdings vary materially from day-to-day, creating risk. However, this analysis is too simplistic to apply to the market as a whole. There are many firms with business lines which are as risky as the same or equivalent services provided to wholesale clients, but in which retail clients wish to participate (on an informed basis). Perhaps it is more to the point that it is less that retail clients do not have an appetite for risk, but rather that, for perfectly good public policy reasons, they are inhibited from engaging in high risk transactions, which is not the case with wholesale clients.

3.33 The FOA agrees that the division of retail and non-retail client money may allow a more rapid distribution from the retail pool if fewer or no contentious issues have arisen in relation to that pool. However, the FOA thinks the chances of there being no such issues is slim as they do not just arise from the complexity or risk level of a business but also from arguments about what cash had been transferred to a firm and on what basis, which can get quite complicated in the days leading up to a failure. To add to the reasons why sub-pools are likely to increase litigation, set out in paragraph 3.3 above, a retail / non-retail split would almost certainly give rise to

disagreements as to whether clients were categorised appropriately, with clients using any arguments available to try to better position themselves. This would be exacerbated if the definition of a retail client were not consistent with evolving definitions of retail, under consideration in the proposed revised Markets in Financial Instruments Directive and proposed Markets in Financial Instruments Regulation. The FSA would also have to confirm how firms should deal with elective professional clients and eligible counterparties, as well as with professional clients that a firm has agreed to treat as retail clients.

3.34 Even if the FOA were to agree with the sub-pools proposal, it supports the right of customers to elect for their preferred level of protection and does not therefore believe that the FSA should mandate the segregation of client money or incentivise its placement into particular pools. The FOA questions why retail and non-retail clients should be treated differently. Most clients are afforded client money protection and are not opted out. It is therefore unclear what additional benefits would be served by creating different pools. For many firms the number of non-retail clients may be very small compared to their retail clients and the increased administration costs and effort, plus the increased risks would be disproportionate to any perceived benefits. The fact that non-retail clients may invest in more volatile investments has no impact on their cash, which will have the same volatility regardless of client type. The volatility lies in the underlying investments only.

3.35 As suggested by the FOA's concerns, it agrees that the additional operational and administrative burden of creating and maintaining sub-pools could deter firms from offering them if the FSA were to introduce them. However, it believes that if clients were to perceive the protections to be sufficiently enhanced, they would put pressure on firms to provide multiple client money pools. It is worth considering that the clients most likely to do this will not be unsophisticated retail clients, and therefore any segregation of pools should be carefully considered to ensure that this is the population benefiting from enhanced levels of protection. If the FSA permits sub-pooling, and does not specify clear scenarios for it to be applied, it is highly likely that Beneficial Owners operating under a single investment advisor, accessing markets through multiple brokers, may find themselves operating under different segregation and protection models. This is ultimately unhelpful for the end client, and may lead to commercial advantage becoming a key driver for segregation and protection solutions..

Question 13: Do you agree that these benefits would result from the segregation of business into margined and non-margined business?

3.36 Members agree that margined business does involve more frequent and generally larger transfers of cash into and out of the client money account and that it has the potential to give rise to greater complexities in calculating client money entitlements than other types of business. It is therefore potentially riskier and liable to involve a greater number of contentious issues than other lines of business.

3.37 Again, however, the FOA does not believe that the operation of multiple client money pools should be either introduced or mandated. Even if it were, members are not convinced that it should be mandated on this basis, which will only be relevant to firms that carry on both types of business. Several members already have a form of segregation between their exchange traded business and other margined business because they are operating the normal approach for the former and the alternative approach for the latter. Such firms would be keen to avoid a change in these arrangements given the amount of work that has gone into setting them up and making them work.

3.38 In addition, a division between margin and non-margined business may interfere with the operation of cross-margining arrangements e.g. a prime brokerage client which has a cross margining arrangement which covers cash equities contracts and margined equity derivatives.

Question 14: Do you think we should mandate the division of client money on this basis? If not, why not?

3.39 As emphasised in response to questions 3 and 4, the FOA has serious reservations about the introduction of multiple sub-pools and, as discussed in response to questions 12 and 13, the FOA

does not believe that the FSA should mandate the separation of client money. This applies to both the suggested splits between retail and non-retail clients and between margined and non-margined business, each of which is too much of a one size fits all approach and does not reflect organisational structures of members' businesses' and clients' demands.

Question 15: If we were to mandate the division of client money into sub-pools (for example, a pool for retail client money and a pool for non-retail client money) do you agree that we should also allow firms to create further sub-pools within each? If not, why not?

3.40 As noted above, the FOA members do not support either the introduction of multiple sub-pools or the mandating of them. However, if they were to be introduced and mandated along either of the lines proposed, while the FOA does not think this should preclude firms from developing sub-pools within such pools, it does think that the FSA should carefully consider whether there is a way of imposing some sensible limits on the number of sub-pools that a firm could create so as to limit the extent of the increased risk they entail. Careful thought would also be required as to the allocation of loss surpluses between such sub-pools and the general pool.

Question 16: Do you think that any mandating of certain client money pools should be dependent on complexity, size of client money holding and / or type of firm? (For example, should we mandate segregation only for investment banks or large brokers?)

3.41 Again, the FOA would reiterate that it has serious concerns about the introduction of multiple sub-pools and does not support the mandating of any particular sub-pools. However, if they were to be introduced and mandated, there are mixed views among the members on this question. Some members strongly disagree with any softening of the regime to accommodate small brokers on the basis that client asset protection should prevail over such concerns, while other members think it would be appropriate to carve out certain firms, such as those whose size means they would struggle with the operational and administrative requirements relating to establishing and maintaining different pools and / or whose business is sufficiently simple that it would be disproportionate.

3.42 To the extent that there is a proportional approach, it should be based on both the size and complexity of the firm as a large firm may have a simple business model and vice versa. Nonetheless, if segregation were to be mandated and the requirement were to be waived in respect of certain types of firm, that should not prevent the firms that benefit from the carve-out operating sub-pools if they wish to do so.

Question 17: Do you think there is a way of dividing client money into more than one pool that delivers greater net benefits for firms and clients?

3.43 This question assumes that splitting client money into different pools is beneficial to improving protection for clients. However, the FOA believes that the more fundamental questions are whether this assumption is correct and whether there are alternative ways to achieve the desired objectives. Even if the other possibilities are also not perfect, the relative merits and drawbacks of the various options should be considered before the FSA introduces such a fundamental change in the regime.

Question 18: Should we incentivise the use of sub-pools by requiring firms to notify their clients of the risks associated with the general client money pool and the sub-pool options available?

3.44 If multiple sub-pools were to be introduced, members believe that there is an important balance to be struck between, on the one hand, providing clients with the full facts to enable them to make an informed decision and, on the other hand, not undermining the protections that exist in relation to the general pool (ie the current level of client money protection) and the basis on which financial services business has been done and, for the most part, may continue to be done in the future. Members believe that there is a risk that such notices could give the impression, not only to clients but more generally as well, that cash is not properly protected if it is held in a general client money pool. The FOA believes that it is right to help clients understand the options available in the market and the varying risks associated with them, but that firms should provide

such information in a thoughtful way so as not to confuse or impair choice. It may be most appropriate for the FSA to work with industry participants to provide a basic form of wording for this. Further and as already stated, this kind of incentivisation (other than the context of key information disclosure) would potentially distort or undermine the objectives of customer choice established in EMIR.

3.45 Again, the FOA would suggest that there is perhaps a more fundamental question about whether the risk warnings that firms are currently required to provide to their clients are sufficiently robust to enable clients to properly understand the risks of client money pooling or whether this, combined with better education on how client money works, might be a simpler alternative to multiple sub-pools.

Question 19: Do you agree that the existing concept of designated client bank accounts and their use in a secondary pooling event should remain unchanged?

3.46 Members believe that the designated client bank / fund accounts should remain unchanged as their purpose is to protect clients that have requested them from the insolvency of a particular bank or banks. As far as the FOA can see they do not duplicate or overlap with the purpose of sub-pools, whose effect is on a primary pooling event. In fact, the members query whether it is possible for an account to be both a sub-pool and a designated client bank account.

4 Part III

Question 20: Do you agree it is important to have speedy return of client assets following a firm's insolvency? Please explain your answer.

4.1 The FOA agrees that it is important that client assets are returned to clients as promptly as possible. This is important for both retail and wholesale clients as explained below and gives a wider message of confidence in our markets both in the UK and worldwide. The timely return of retail and wholesale clients' assets is central to achieving and retaining public trust in addition to the points we raise in detail below. In the FOA's view, the simpler the structures that are designed to achieve this and the more clarity about how they work up front, the better.

Question 21: Does the status quo strike the right balance between speed and accuracy? Please explain your answer.

4.2 While the FOA agrees that both speed and accuracy are important, it believes that the importance of achieving accuracy in the sense of ensuring that all client money claimants and creditors receive their "fair" share has proved to only be possible at the cost of speed. In this sense, it does appear that the current regime is weighted in favour of accuracy. While FOA members do not believe that any client or creditor would want to think that their rights were being subordinated to the interests of returning cash to themselves and others faster, the reasons for the delays do not seem to be primarily caused by a desire for greater accuracy, though it is clear that this is an integral part of it. In other words, the delay in returning cash to clients and creditors in the LBIE and MF Global defaults resulted from the lack of clear records kept by LBIE and the desire of the administrators to seek court approval for their actions, respectively. While these were important steps to be taken to ensure accuracy, the former would not need to have taken so much time and effort if LBIE had kept better records and the latter might not have been as necessary if the administrators were not so fearful of being challenged. Certainly any rule changes would need to be harmonised with existing insolvency law to have any significant effect on speed of recovery.

4.3 Many members believe that there is little benefit in further tinkering with CASS. In many cases the event of a firm's insolvency will often identify serious failings in systems and controls, such that client money has not been properly segregated or the requisite reconciliations have not been undertaken, or shortfalls and discrepancies have not been corrected. The current changes that have been introduced to the CASS regime including the CASS Resolution Pack (**CASS RP**), reintroduction of the Client Money Asset Return, the creation of the CF10a client asset oversight controlled function, together with the proposals in Part 1 of CP12/22 for the porting of margin money and the Single Customer View, should all have an impact on the speed of distribution.

There is a real danger that the creation of multiple sub-pools will not have the desired effect and may even have the opposite result of slowing the process down, which is why the FOA has serious reservations about its introduction.

Question 22: Given the potential trade off between costs and speed, how fast do you think client assets should be returned to retail clients following an insolvency and, as a percentage, what loss should a retail client be prepared to incur to have client assets back in that time period?

4.4 While some FOA members have closer links to retail clients than others, all FOA members understand the importance of considering any proposed improvements to the client assets regime from their perspective. The FOA believes that clients expect to receive the full amount of their assets within a reasonable time frame and are prepared to wait a little longer to receive a full and fair return in an investment context than for a deposit. That said, FOA members do not believe clients are prepared to wait too long as, in many cases, they are relying on their investments to cover various day to day expenditure and to meet liabilities. While this applies equally to cash and securities, there may be a distinction between a client's risk position and the return of its cash in the sense that the client will want to know that its risk has been terminated and that it is no longer incurring further losses and would likely find it useful to know this amount even if it will not receive its assets for some time. One way in which this could be improved may be the provision of more frequent statements showing a client's positions and assets so that clients know what to expect.

4.5 The FOA notes that the period within which the Financial Services Compensation Scheme (**FSCS**) aims to resolve claims for investment business is significantly longer (within three or six months of determination of a claimant's eligibility) than in relation to deposits (within seven working days of the institution failing, or within twenty working days for more complex claims). It would be a positive result if the time for investment business could be reduced and the FOA would like to think that the work undertaken by firms to comply with new rules and enhanced FSA monitoring of their client money arrangements would help to lower that differential. There is also a difference between the maximum compensation per person per firm for investments (100% of the first £50,000) and deposits (100% of the first £85,000). However, consumers can manage this by ensuring they diversify their investment providers. The client assets regime and the FSCS are separate regimes but the FOA wonders whether there is any way in which the latter could be used to improve the former for retail clients, for example by ensuring that they are paid a particular percentage of their likely claims in advance of receiving them from the insolvency practitioner and the clients' rights against the insolvency estate being assigned to the FSCS.

4.6 Even if this were not possible, the costs of the insolvency practitioner and administration need to be covered and the need to apportion them proportionately will normally delay the final distribution until such costs are determined. It may be worth considering making a provision for the costs out of the FSCS directly for those clients eligible to claim, rather than taking it from the client and the client then having to make a claim on the FSCS. This may assist in speed of distribution for retail clients.

Question 23: Given the potential trade-off between costs and speed, how fast do you think client assets should be returned to wholesale clients following an insolvency and, as a percentage, what loss should a wholesale client be prepared to incur to have client assets back in that time period?

4.7 The regime should be designed so that client assets can be returned to wholesale clients as quickly as possible, albeit this will be subject to the level of protection chosen by clients. Most types of wholesale client have cash flow requirements in the same way as retail clients and their requirements are arguably more important since if businesses cannot pay one another or their staff, then the crisis spreads through the economy rapidly. Wholesale clients clearly occupy a broad spectrum and no doubt there are many that have sufficient reserves to cover a delay in the period of return, but it would be impossible to create a regime based on such distinctions. However, as with retail clients, it is important for a wholesale client to know that its risk has been terminated, even if the client then has to wait a short period for the return of its assets.

4.8 The FOA does not think that there can be an ideal figure attached to this. If the state of the client's administration is poor then the losses may be considerably higher then might be expected from a firm that was in generally good order but has been brought down due to the failure of a group company. It is equally important for the reputation of the UK market that wholesale assets are returned as speedily as possible, particularly where they are related to underlying retail funds.

4.9 Liquidity has always been crucial to financial business but it has been more explicitly recognised by regulators in the wake of the financial crisis. It will become even more fundamental for such entities and other companies trading OTC derivatives with the introduction of EMIR. This is why the EMIR mechanisms for porting or returning client assets are so fundamental, with the likelihood of porting dependent on speed and, in the absence of porting, the client needing its balance returned as quickly as possible.

Question 24: Should retail clients and wholesale clients be treated differently in respect of client asset protection and distribution? Please explain your answer.

4.10 At present, the client asset regime offers the same protection and affords the same risks to all clients, whether retail or wholesale, with the only "differential" being the greater scope for wholesale clients to "opt out" of the regime through the use of the title transfer exclusion which is considered justifiable on the basis that they have sufficient knowledge to understand the consequences. The FOA does not feel, or perceive on the part of others, any particular desire to develop the regime such that retail and wholesale clients that benefit from client asset protections are treated differently to a greater degree than at present, subject to a possible reconsideration of whether the level of disclosure provided to retail clients is sufficiently robust and the possibility of any improvements that can be made to the FSCS arrangements.

4.11 The FOA would, nonetheless, reiterate the difficulties that a retail / wholesale client distinction could cause in practice if there were a greater differential in treatment, with clients attempting to have their categorisation changed in the lead up to a firm's likely failure and others disputing their categorisation after the event. Any such distinctions, especially if based on unclear definitions, may only serve to further increase the number of post-default disputes and extend the insolvency process.

Question 25: Are there any other impediments that impact on the speed of return of client assets not identified above?

4.12 The FOA believes that there is a complex web of inter-related factors that can impact on the speed of return of client assets but agrees that these can be summarised as follows (accepting that they are not all relevant in every case and that some of the work undertaken by the FSA over the last few years is designed to improve some of them).

(a) The lack of compliance with the client assets regime exercised by the failed firm, including the availability and accuracy of records. Weaknesses in this area represent the greatest risk to a full and speedy return of client assets; more complexity increases the risk of error.

(b) The complexity of the business of the failed firm

(c) The likelihood of disputes arising in the wake of a firm's failure - in particular, any lack of clarity in the client money rules is likely to be fully explored between claimants in such circumstances

(d) The desire of insolvency practitioners to seek directions from the court in respect of the steps they propose to take, which is understood to result from their personal liability

(e) Some of the conclusions of the LBIE insolvency including the use of the point of last reconciliation as a means of ascertaining client money entitlements because while administrators are obliged to trace client money through proprietary accounts, the return of client assets is likely to remain slow (as explained in paragraph 3.4 above)

(f) Clients opting for lower levels of protection

4.13 The FOA believes that many of these factors relate to uncertainties and misunderstandings about the operation of the client asset regime and its interaction with insolvency law, both by the failed firm and those dealing with it - including its clients. Members therefore think that developing the client assets regime to include multiple client money pools and differential arrangements for retail and wholesale clients would not speed up the return of client assets unless serious work was undertaken to develop insolvency law in line with such changes and ensure that the new regime as a whole is properly understood.

4.14 The FOA believes the key statement is *'We therefore recognise that without changes to the wider framework that supports the client assets regime to enable prompt decisions and actions to be taken, any changes we introduce may only marginally speed up the return of client assets.'* There should be no further cost to the industry, and therefore to clients, by further changes to the CASS regime until such other reviews have been completed. Without such reviews and amendments to other legislation, any benefits from amendments to CASS will be minimal.

Question 26: Are there any other potential measures (not identified above) that you think should be considered to increase the speed of return of client assets?

4.15 The FOA members consider that it might also be useful to consider the use of bar dates in setting a deadline, before which those with a claim to client assets must lodge it with the insolvency practitioner. The FOA appreciates that such deadlines were set in relation to both the LBIE and MF Global administrations, but wonders whether they could be made shorter or whether, if the FSA introduced sub-pools, shorter dates could potentially be applied to wholesale client money pools on the basis that such clients should have the resources to enable them to respond quicker.

4.16 Members also wonder whether it is worth considering the treatment of cash received from affiliates and whether treating it as client money slows down the return to everyone else. The FOA appreciates that an affiliate of a firm might itself be holding cash on behalf of its client and does not dispute that such cash should be protected for the benefit of the client, but wonders whether there could at least be global consistency in relation to the treatment of proprietary cash of affiliates to avoid confusion.

4.17 The FOA also has some thoughts on some of the possibilities mentioned by the FSA.

(a) Regular statements: many FOA members are in a position to provide clients with statements at a higher frequency and to a greater level of detail than required by the FSA rules and will do so at the request of a client. However, they note that this may not be so easy for all sizes of firm and that more frequent statements for clients would increase costs and administration, with a commensurate impact for clients. The FOA would also note that, while some clients do demand such additional information, there are likely to be many that do not want it and so any such requirement should not be mandated and should remain at the discretion of the client. Additionally clients will increasingly be able to review their accounts online and through mobile applications.

(b) The FOA would find it helpful if the FSA could communicate its views on the implications / impact (if any) on the use of the banking exemption. The FOA would also ask the FSA to provide more clarity on their initial thoughts with regards to "exclusions" for title transfer arrangements in the client assets regime.

(c) Lock in / cooling-off periods: the FOA assumes that this potential proposal would take the form of some new rules to establish limits on the extent to which clients can request a change in their client money status, particularly in terms of how quickly they can expect a firm to be able to achieve this in the run up to a potential failure and how it needs to be evidenced to be valid. The FOA believes that this could be helpful in minimising the extent of disputes arising in the wake of a default and would be particularly important if sub-pools were introduced. However, the FOA would appreciate more guidance on how

the FSA would see them operating so that it can determine how practical they would be to implement.

(d) (i) Term deposits: Some members do not support the use of term deposits on risk grounds. If a firm enters into agreements with its external placement banks that its money will be held on term deposit, that firm will earn interest at a more favourable rate. However, this benefit is outweighed by the fact that such money will not be immediately available to clients in the event that the firm in question fails.

(ii) However, other members, whilst recognising that term deposits give rise to potential issues with the timeliness of return of cash to an insolvency practitioner, have experienced issues with some banks' appetite to hold large amounts of cash on terms which allow immediate access. This goes beyond the rate of return offered on such accounts, and members have been requested by some banks to reduce amounts held with them. The reasons for this are clearly linked to the banks' own funding needs and the requirements placed on them under the FSA's liquidity regime when holding instant access deposits from financial institutions. In these cases, an ability to place some portion of client money on term or notice deposits with higher-rated, systemic banks is key to a members' ability to maintain diversification across a range of banks. If all funds were required to be on instant access, members would be faced with a dilemma of reducing diversification or adding banks of lower credit quality. Neither of these options is particularly attractive in the light of the responsibilities placed on them under CASS. A wider scope of institutions with which firms could deposit client money could also be useful in this context as members have found that central banks will not generally accept it

(iii) The FOA agrees that firms should not be using term deposits inappropriately, where this involves too high a proportion of total client money being placed on term or at notice and which could give rise to liquidity issues for the firm, or where funds are tied up for too long a period in search of yield. However, members need the ability to strike a balance between instant access for liquidity and term deposits to maintain safety. They also see some benefit in their use in reducing operational risk over bank holidays or short periods of stress in particular markets such as Hurricane Sandy. The FOA does not consider that, if a member has modelled historic client money balances and identified an appropriate limit (and having received separate risk committee approval for banks with which to place term money), the use of term deposits is inappropriate in and of itself and would not want them to be prohibited. While firms need to be able to use their judgement and experience, members would welcome guidance from the FSA on what they consider to be the maximum acceptable tenor and / or percentage of funds. Various members would be pleased to discuss the use of term deposits on a smaller group basis if that would be of interest to the FSA.

Question 27: Are there any other potential measures (not identified above) that you think should be considered to reduce the market impact of an insolvent firm that holds client assets?

4.18 The FOA would be interested to hear more about the FSA's thinking regarding the possibility of enabling an insolvency practitioner to sell a failed firm's business without having to constitute the client money pool and distribute client assets. The FOA believes that this could be an attractive option if it were possible to effect a transfer sufficiently quickly that clients would not suffer any loss or lack of certainty. However, the FOA is also uncertain how realistic it would be to obtain the pre-consent of all clients to such a transfer, given the difficulties that most firms have in transferring client assets on transfers of business while the firm is still solvent. The FOA wonders whether, if the FSA were to proceed with this idea, it might be possible to build such consents into legislation or the FSA rules to avoid such complications. The FOA assumes that any such transfer mechanism would need to be incorporated into the relevant insolvency law regime in any event.

Question 28: Are there any other potential measures (not identified above) that you think should be considered to achieve a greater return of client assets?

4.19 FOA members also have some thoughts on some of the FSA's proposals for attempting to achieve a greater return of client assets.

(a) Buffer: the FOA has previously asked the FSA for guidance on the use of buffers. It is understood that the buffer under consideration would be for the purpose of providing funds to cover the costs of distribution and, potentially, losses caused by the firm's failure. Given the perceived change in thinking on buffers at the FSA, it is equally, if not more, important to explain the FSA's expectations on firms. The FOA believes that a relaxation of the FSA's current position on buffers would have two additional benefits: it would help to cover shortfalls and benefit firms in the reduction of movements intraday into and out of the client money account. The FOA understands the FSA has previously been concerned that firms should not need to hold buffers if their controls are sufficiently robust but members perceive that both the purposes mentioned can be legitimate and note that buffers are considered useful in the capital and liquidity regimes so could also be effective in respect of client money. Members are interested to understand how the FSA would see them being calculated as different approaches suit different purposes but in any event, would not want the calculation to be prescribed.

(b) Alternative approach: the FOA also considers it is essential for the FSA to clarify its expectations in relation to the alternative approach. Several FOA members use the alternative approach in respect of at least some of their business lines and would face operational difficulties if it were no longer available. Again, the FOA would be keen to understand the FSA's thinking on these amendments so that the members who best understand the issues could have an opportunity to input their practical considerations.

(c) Prioritising some clients over others: before it could consider this properly, the FOA would want much more information on the basis of how the FSA would propose to prioritise one set of clients over another for the purpose of allocating a shortfall. However, the FOA does not currently see how such an allocation could be sufficiently fair and it assumes the FSA would have to make some value judgements about the industry. It certainly seems unlikely that clients would agree to being categorised as lower priority.

(d) Insurance: private sector mutual insurance is likely to be difficult and costly to obtain and maintain and there will be no certainty over whether, in the event of a systemic failure, the insurance contracts would be honoured.

(e) Segregation: The FOA would appreciate more detail around what prohibiting, limiting or increasing controls around the use of client money segregation actually means.

4.20 A further measure that may be worth considering is making provision for the costs out of the FSCS directly for those clients eligible to claim, rather than taking it from the client and the client then having to make a claim on the FSCS costs. This may assist in speed of distribution for retail clients.

APPENDIX 4

THIRD RESPONSE

D R A F T: 07/08/13

Review of the Client Assets Regime for Investment Business (CP13/5)

A response to Section 8 ("Indirect Client Clearing (EMIR)") of CP13/5

By the Futures and Options Association

AUGUST 2013

FOA Response to Section 8 of CP 13/5

1. Introduction

1.1 The FOA is the industry association for more than 160 firms and institutions which engage in derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector (see Appendix 1).

1.2 The FOA supports the policy objectives of the current Review of the FCA's client asset regime in CP 13/5 to improve the speed of return and achieve a greater return of assets to clients in the event of an insolvency of an investment firm and to reduce the market impact of that insolvency. It anticipates that these objectives, to the extent possible, will apply also to the approach taken in relation to indirect clients in the event of the default of the direct client.

1.3 The FOA believes that the FCA's proposals with regard to indirect client clearing should be subject to the same priority as expressed in paragraph 1.16 of the CP, namely, the importance of striking an appropriate "balance" between what constitutes an "accurate" recovery for clients and the speed with which distribution should be made following a firm's solvency.

1.4 The FOA is preparing to provide its members' views on the CP as a whole in due course but in the meantime, and given the shorter deadline for responses on this point, provides its comments on Q.48 below.

1.5 As a general point, the FOA notes that the industry still has some work to do in determining how indirect client clearing structures can operate and that some of this needs to be supported by changes in legislation. While it welcomes the FCA's efforts to ensure that the concept is built into the client money regime at this stage, it presumes that, to the extent the finalised proposals for amending Part VII Companies Act 1989 in order to safeguard the actions of a clearing member in relation to the management and porting of the positions and associated collateral of indirect clients may impact on the outcome of the proposed amendments to CASS, it will be the subject of further consultation in line with the assurance given in paragraph 1.31 of the CP.

2. Specific comments in response to Q.48 "*Do you agree that our proposed changes will ensure that CASS is compatible with the EMIR RTS? If not, please provide reasons.*"

2.1 The FOA believes that the proposed changes are compatible with the EMIR RTS, but would make one or two observations, largely for the purposes of clarity, particularly for end-users of the market, namely:

- express confirmation that indirect clearing is not mandated, but a voluntary service that firms may, at their discretion, decide to offer to any or all of the indirect clients of a direct client of the clearing member; and
- because there is some confusion over the scope of indirect clearing, it should be clarified that – as understood by the FOA – the scope of indirect clearing is limited to OTC contracts and does not include exchange-traded contracts.

2.2 The FOA believes that it might be useful to clarify, for the purposes of Rule 7.5.2 and the definition of "client transaction account", that "intermediate broker" includes a firm that is a clearing member of a central counterparty. This will make clear the basis on which a client holding its indirect client's cash as client money may transfer it to the clearing member.

2.3 The FOA questions whether it would be preferable not to link CASS 7.2.15CR, 7.2.15DR and CASS 7A.2.4AG(1A) (from the draft Client Asset Sourcebook (Indirect Clearing) Instrument 2013) and

7A.2.6BG(1A) (from the draft Client Assets Sourcebook (Amendment No 4) Instrument 2013) to the "EMIR Level 2 Regulation" directly given that the provisions on indirect client clearing in EMIR relate specifically to the clearing obligation as set out in Article 4 EMIR and would therefore not capture indirect clearing arrangements being used to clear contracts that are not subject to the clearing obligation. We assume that the authorities intend to encourage clearing outside the scope of the clearing obligation and that where this happens, the protections that are afforded to indirect clearing that is subject to the clearing obligation should be extended. The FOA recognises that the FCA is following the drafting approach taken in the amendments that were made to incorporate EMIR last year but the references to EMIR itself are not exclusive in the sense that they do not relate specifically to the scope of the clearing obligation.

2.4 In both CASS 7.2.15R and, to the extent cash is returned to the client's insolvency official, CASS 7A.2.4 or CASS 7A.2.4A (from the draft Client Asset Sourcebook (Indirect Clearing) Instrument 2013) or CASS 7A.2.6BG (1) and (1A) (from the draft Client Assets Sourcebook (Amendment No 4) Instrument 2013), the FOA believes it would be helpful to clarify that payments of client money made by a clearing member to a client for onward distribution to its indirect client would not result in that money ceasing to be client money until that secondary distribution has taken place.

2.5 Given the complexity of trying to incorporate indirect client clearing into CASS, the FOA also wonders whether the FCA might consider clarifying, possibly in a policy statement or a section of the FCA Rules (separate to the sections of CASS discussed above) the obligations of the clearing member, client and indirect client, including those relating to client money. It is considered that this might be useful to help develop a consistent understanding of how indirect clearing is intended to operate.

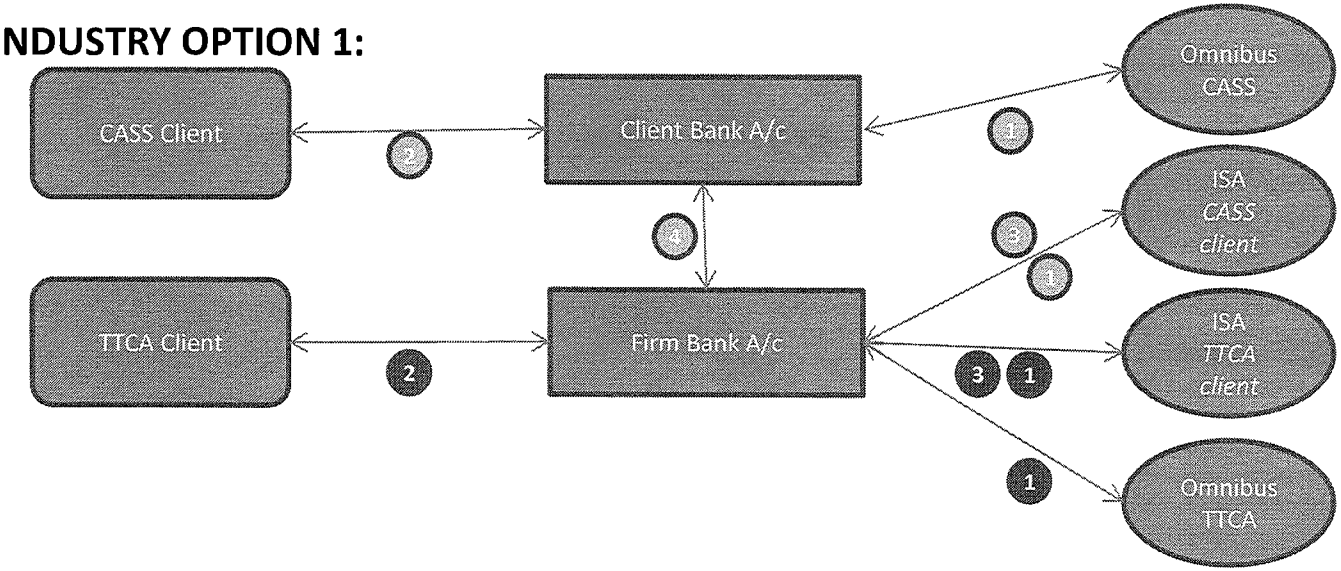
The FOA and its members would be pleased to discuss any of these issues further with the FCA.

APPENDIX 5

CASH FLOW MODELS

Option 1 – All ISA cash flow via firm bank accounts

INDUSTRY OPTION 1:



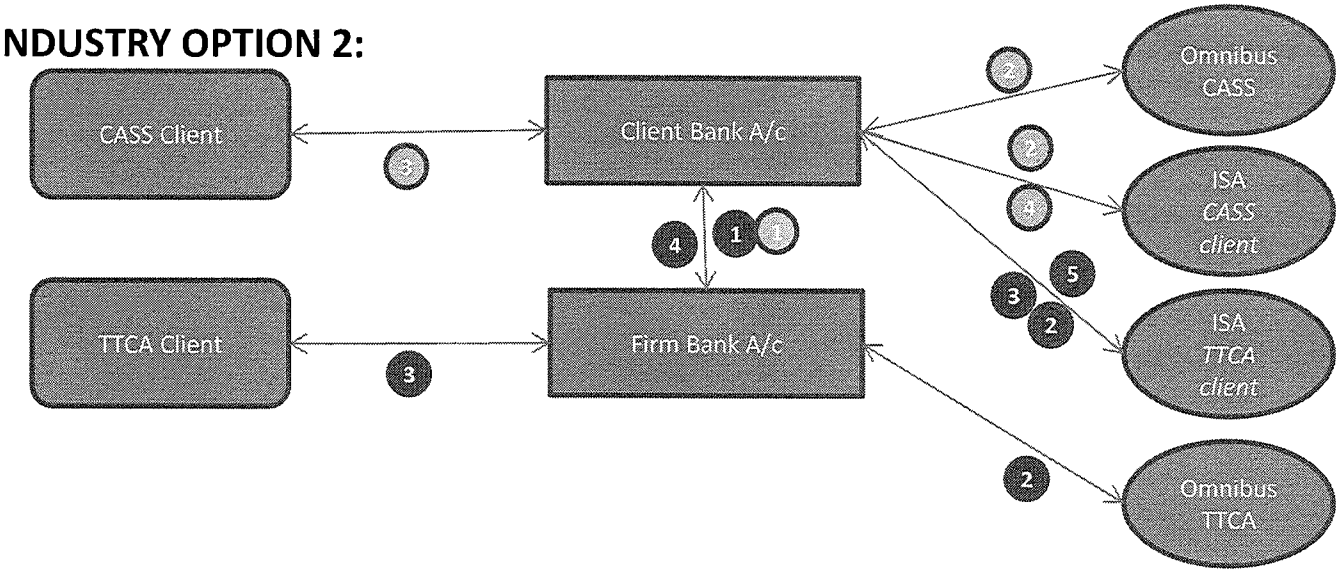
Step	Action
1	CCP debits clearing member for start of day margin requirement
2	Client meets margin requirement to Clearing Member
3	Firm onward posts excess
4	Firm removes margin requirement already funded to CCP, and any excess destined for CCP, from client bank a/c to Firm bank a/c
1	CCP debits clearing member for start of day margin requirement
2	Client meets margin requirement to Clearing Member
3	Firm onward posts excess

REQUIREMENTS

- Requires firm to have prompt mechanism to identify incoming credits to Include client from CCP and move to client bank a/c
- CASS rules must retain some flexibility for Mixed Remittances transiting via Firm bank a/cs
  - *Specific scenario of funds returning from CCP to clearing member on behalf of CASS ISA client*

Option 2 – All ISA cash flow via client bank accounts

INDUSTRY OPTION 2:



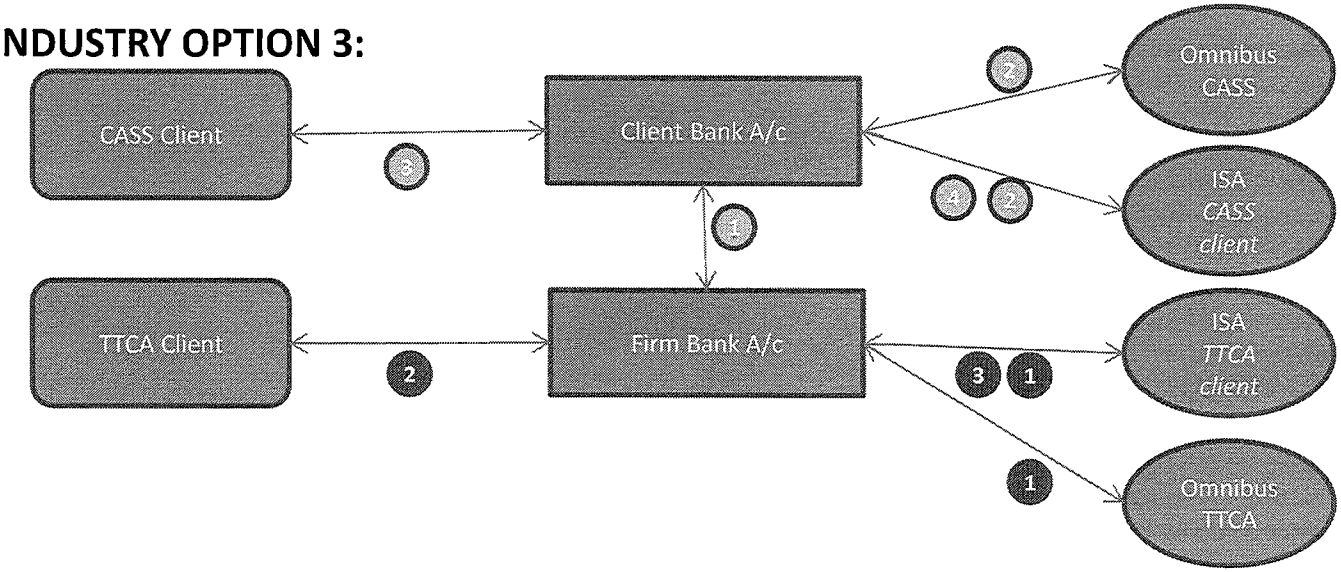
Step	Action
1	Firm pre-funds CASS and TTCA client ISA margin requirement at start of day
2	CCP debits clearing member for start of day margin requirement
3	Client meets margin requirement to Clearing Member
4	Firm onward posts excess
1	Firm pre-funds CASS and TTCA client ISA margin requirement at start of day
2	CCP debits clearing member for start of day margin requirement
3	Client meets margin requirement to Clearing Member
4	Firm identified TTCA ISA client excess and moves from Firm to Client bank account
5	Firm onward posts excess to TTCA ISA client account

REQUIREMENTS

- Requires firm to pre-fund ISA margin calls for both TTCA and CASS clients from Firm a/c to client bank a/c at start of day
- Elimination of requirement for acknowledgement letters on ISAs unless mandated as part of CCP authorisation process or Clearing Member is forced to double segregate

Option 3 – ISA cash flow via both client and firm bank accounts

INDUSTRY OPTION 3:



Step	Action
1	Firm pre-funds CASS client ISA margin requirement at start of day
2	CCP debits clearing member for start of day margin requirement
3	Client meets margin requirement to Clearing Member
4	Firm onward posts excess
1	CCP debits clearing member for start of day margin requirement
2	Client meets margin requirement to Clearing Member
3	Firm onward posts excess

REQUIREMENTS

- CCPs must be able to distinguish between types of ISA (CASS Include and TTCA)
- CCPs must be able to separate cash transactions between different types of ISA, and direct transaction flow to different bank accounts
- CCPs must provide acknowledgement letters (irrespective of legal arrangements for transfer of collateral) if that remains an FCA requirement and if requested by Clearing Members, or…
- Elimination of requirement for acknowledgement letters on ISAs unless mandated as part of CCP authorisation process, or CASS clients forced to treat ISA as TTCA if Acknowledgement Letter is not available
- Requires firm to pre-fund ISA margin calls for CASS clients from Firm a/c to client bank a/c at start of day