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Custody and client money watch

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Forwards

Over the course of 2016 we would expect the Financial Conduct Authority (**FCA**) to continue to visit firms to ensure that they are complying with the FCA's Client Assets Sourcebook (**CASS**). The FCA will likely focus on ensuring that firms have fully implemented the various changes to CASS that came into force during the course of 2014/2015. We further expect to see FCA proposals on amendments to CASS 7A designed to speed up return of client money on a primary or secondary pooling event as well as the long-awaited final CASS rules for insurance intermediaries (**CASS 5**).

From 7 March 2016, the CASS operational oversight function (CF10a) will become the "other overall responsibility function (SMF 18)" for firms that will be subject to the FCA's senior management regime. Firms within scope should by now ensure that they have implemented the required changes.

From 12 July 2016, certain aspects of the EU Regulation on Reporting and Transparency of Securities Financing Transactions will become effective. See In-depth for further details.

On 3 January 2017, the new updated Markets in Financial Instruments Directive[1] and Regulation[2] (**MiFID II** and **MiFIR** respectively) are due to come into effect, although as at the time of writing, this may be delayed by at least a year until January 2018. In addition to continuing the existing MiFID client assets regime, MiFID II / MiFIR have introduced several new requirements in relation to client assets. Some of these requirements are in effect already reflected in the current version of CASS (for example, the requirement to establish and maintain a client assets oversight function) whilst others, such as the outright ban on title transfer collateral arrangements with retail clients, will be new.

In the first half of 2018, EU member states will be obliged to have transposed the Insurance Distribution Directive[3] (**IDD**) into local law. The IDD contains specific rules on the protection of customer monies which may require that amendments to CASS 5 be made.

Backwards

The FCA's overhaul of its client asset regime came into force in stages between 1 June 2014 and 1 June 2015. The changes to CASS over the course of 2014/2015 were extensive and included:

- new delivery versus payment rules;
- new rules in relation to the use of the banking exemption;
- requirements for written agreements in connection with title transfer collateral and custody arrangements and the new acknowledgement of trust letters;
- a requirement that agreements contain termination provisions in relation to title transfer collateral arrangements and that firms document requests from clients to terminate such arrangements;
- new rules on diversification of third parties holding client money, immediate segregation of client money under the normal approach and prudent segregation to prevent shortfalls on primary pooling events;
- confirmation that money arising out of safe custody assets and due to clients should be treated as client money;
- a requirement that firms record grounds for their selection and appointment of third party custodians;
- new requirements in relation to the use of the alternative approach to client money segregation; and
- confirmation that monies arising from or in connection with safe custody assets should be treated as client money.

Firms should by now have fully implemented these changes, which should have entailed updating internal systems and controls, putting in place new policies and procedures and amending client facing documentation.

Further details of the changes can be found here.

[1] Directive 2014/65/EU. The text of MiFID II can be found here.
[2] Regulation 600/2014/EU. The text of MiFIR can be found here.
[3] Directive 2016/97/EU. The text of the IDD can be found here.

In depth: Securities Financing Transactions Regulation

Securities Financing Transactions Regulation: what should you be doing now?

Background to the reforms

The EU Regulation on Reporting and Transparency of Securities Financing Transactions (**SFTR**) was published in the Official Journal of the EU on 23 December 2015 and entered into force on 12 January 2016.[1] The SFTR implements key recommendations from the Financial Stability Board (**FSB**) "shadow banking" agenda, and in particular the August 2013 *Policy Framework for Addressing Shadow Banking Risk in Securities Lending and Repos*.[2] In this framework, the FSB expressed concerns regarding lack of visibility over leverage levels and collateral movements in securities financing markets and consequently urged regulators to introduce a number of transparency initiatives to mitigate perceived systemic risk in these markets.

The SFTR takes forward the primary components of the FSB recommendations through the following new requirements:

- **Reporting obligations:** all counterparties to "Securities Financing Transactions" or "**SFTs**"[3] must report transaction details to trade repositories. These are similar to the European Market Infrastructure Regulation (**EMIR**)[4] requirements for derivatives reporting (although with no volume-based distinctions for non-financial counterparties). The reporting obligations are two-sided, although where financial counterparties contract with non-financial SMEs it will fall to the financial counterparty to report both sides of the transaction.[5]
- **Investor transparency**: managers of UCITS and AIFs must supplement existing pre-investment and periodic investor disclosures for each fund with detailed information on SFT and total return swap usage by the fund.[6]
- **Collateral re-use restrictions:** counterparties intending to re-use collateral (including under title transfer arrangements) must satisfy certain consent and disclosure conditions beforehand.[7]

The SFTR also includes a "marker" for EU authorities to carry out further work with a view to implementing the FSB recommendations for minimum haircuts on certain non-centrally cleared SFTs with non-bank counterparties. In December 2015, the FSB published its final proposals for minimum haircut floors on certain SFTs (ranging from 0.5% to 10% depending on the collateral quality); however, work on this area remains on-going by the FSB and Basel Committee.

The title of the SFTR is somewhat misleading in overall terms as its scope in fact extends substantially beyond securities financing markets (and as such goes beyond the scope of the FSB recommendations). Most notable are the collateral re-use restrictions, which will capture all collateral arrangements incorporating title transfer or re-use rights, whether or not undertaken in connection with securities financing. In addition, the reporting and investor disclosure requirements for "SFTs" in fact capture both securities and commodities financing transactions and margin lending, and the investor disclosure requirements also extend to all of the above, plus total return swaps. There is therefore significant overlap between the SFTR and requirements under MiFID and EMIR (although wording is included to avoid direct duplication).

The territorial scope of the SFTR has, like EMIR, the potential to extend beyond the EU (or EEA) as the requirements will apply in cases where a transaction is executed (or collateral received) through either an EU branch of a non-EU entity or an EU legal entity (including its third country branches). The investor transparency requirements, however, apply only to EU authorised fund managers and not to third country managers marketing funds into the EU.

The remainder of this article focuses principally on the collateral re-use restrictions and their impact when read together with current and future MiFID and FCA requirements. The re-use restrictions will be relevant to all financial institutions that take

[1] Regulation 2015/2365/EU. The text of the SFTR can be found here. The text of the SFTR has EEA-wide application, but will require EEA implementation.
[2] The text of the FSB's policy document can be found here.
[3] Repurchase and reverse repurchase transactions, securities or commodities lending or borrowing, buy-sell back or sell-buy back transactions and margin lending transactions.
[4] Regulation 648/2012/EU. The text of EMIR can be found here.
[5] Article 4, SFTR.
[6] Articles 13-14, SFTR.
[7] Article 15, SFTR.

collateral under either (i) security arrangements incorporating a right of use (outside of a default scenario) and/or (ii) title transfer collateral arrangements (**TTCA**).

Re-use and title transfer restrictions

The requirements

Article 15 of the SFTR sets out the following pre-conditions for counterparties seeking to re-use financial instruments received under a TTCA or a security financial collateral arrangement:

- express written agreement on the part of the collateral providing counterparty to enter into a TTCA or to grant consent to the right of use for the receiving counterparty;
- prior disclosure by the collateral taker to the collateral provider of the risks and consequences involved in executing the agreement (including in the event of default by the collateral taker);
- transfer of the financial instruments from the account of the collateral provider upon exercise of the right of use (or title transfer); and
- re-use must be undertaken in accordance with the terms of the written collateral agreement.

This requirement is not limited to collateral received under SFTs, but captures all collateral arrangements concluded by way of title transfer or incorporating a right of use, provided that the collateral constitutes (MiFID) financial instruments (i.e., in contrast with the reporting requirements, these restrictions do not apply to commodities). This will therefore capture not only SFTs, but also many prime brokerage and derivative transactions. Two-way disclosure is likely to be required for most collateral swaps or other transactions involving reciprocal exchanges of collateral.

Penalties for breach

Sanctions may be imposed at national level for breach of the requirements, including (in principle) fines of up to €15m or 10% of consolidated turnover. The wording of Article 15 confirms that it "shall not affect national law concerning the validity or effect of a transaction". Some commentators have speculated that the more express wording elsewhere in the SFTR confirming that breach of the reporting requirements will not adversely affect validity or enforceability of transactions casts doubt on whether the same legal position will apply to breaches of Article 15 (on which the "validity" wording is less definitive and may be affected by differing national law interpretations).

Combining the MiFID and SFTR restrictions

As the substantive scope of the collateral restrictions broadly overlaps with MiFID, their impact should be considered alongside the existing MiFID restrictions in this area, as well as the anticipated further reforms under MiFID II, which will place further constraints around the ability of MiFID firms to conclude TTCAs.

The FCA's recently reformed CASS rules already impose restrictions on UK firms in entering into TTCAs, including a requirement for an express written agreement and appropriate termination provisions, as well as restrictions on TTCAs with retail clients.[8] The prime brokerage rules in CASS 9 also impose further transparency obligations in relation to use of clients' safe custody assets. As the existing CASS requirements already partially achieve the outcomes prescribed by the SFTR, the incremental burden for UK firms (particularly prime brokers) should therefore be relatively limited (at least for TTCAs), although firms will nonetheless need to review their existing arrangements to ensure compliance with both sets of restrictions, as the scope of the SFTR restrictions is potentially wider.

The TTCA restrictions to be introduced under MiFID II have the potential for more commercial significance, as well as increased compliance burden associated with TTCA arrangements. As well as introducing an outright ban on TTCAs with retail clients, the European Securities and Market Authority's (**ESMA**) technical advice to the European Commission on MiFID II Level 2 measures also specifies a list of circumstances in which TTCAs are presumed to be inappropriate even for wholesale clients, and requires reasoned justification by firms for any continued use of TTCAs, as well as additional client disclosures. If these requirements are carried through into the final MiFID II implementing measures, this will likely jeopardise the continued widespread use by firms of TTCAs, and require firms to implement additional compliance procedures for remaining TTCA business.

Assuming that the substance of the ESMA technical advice on TTCAs is indeed taken forward, this will mean that, from 2017-18 onwards (depending on forecast delays), TTCAs will be prohibited for retail clients in all circumstances, and for wholesale clients they will need to be justifiable against the MiFID II criteria and comply with both the MiFID II and SFTR documentation requirements.

[8] CASS 6.1.6R-6.1.8EG. The text of CASS 6 can be found here.

What you should be doing now?	
If you currently take collateral through an EU legal entity or branch on a title transfer basis or under security arrangements subject to a right of use	
You should review your agreements to ensure that:	Date effective:
• you are in full compliance with the provisions applicable to TTCAs under the reformed CASS 6 rules;	Now
• you have informed your counterparty of all risks to its collateral, as required under Article 15 SFTR; • the agreement provides for the counterparty's express consent to the right of re-use (or, in the case of TTCAs, express agreement to the provision of collateral on a title transfer basis); • the arrangements are structured such that the collateral assets will be transferred from the account of the borrower (subject to exceptions for third country arrangements);	12 July 2016
• no TTCAs will remain in place with retail clients; and • (subject to confirming the final form MiFID II requirements) ensure that TTCAs with wholesale counterparties remain "appropriate" by reference to the MiFID II criteria and comply with the enhanced disclosure and record-keeping requirements.	3 January 2017[1]
If you enter into SFTs	
You should:	Date effective:
• ascertain which of your market-based securities or commodities financing transactions executed through an EU branch or legal entity qualify as SFTs; and • implement arrangements for reporting and record-keeping of entry into and modification of SFTs (either directly or by delegation to a counterparty or other third party – noting that for financial counterparties that contract with SME non-financial counterparties, you will be obliged automatically to report for both sides).	12-21 months (phased by counterparty status) from publication of regulatory technical standards on reporting
If you are an EU-authorised manager of a UCITS or AIF	
You should:	Date effective:
• review and be in a position to identify your usage of SFTs and total return swaps; • prepare to disclose SFT usage details in future annual and (if applicable) semi-annual investor reports); and • prepare to disclose SFT usage details in the prospectus or other pre-investment disclosure document(s).	12 July 2017

[1] On 27 November 2015, the European Parliament announced its willingness to consider a one-year delay to the implementation of MiFID II, subject to certain conditions.

In brief: The current CASS rules on TTCAs

Background

CASS applies, broadly, to firms that hold assets for or on behalf of clients in the course of carrying on certain regulated activities. This summary focuses on the custody rules (and related CASS provisions in CASS 3 and 9), which apply in connection with custody activities, fund depositary activity, or where a firm otherwise holds clients' assets in connection with MiFID or other designated investment business.

As part of the wider policy objectives of the CASS rules in ensuring adequate protection for clients' assets, the rules impose various restrictions on firms that enter into TTCAs and security arrangements incorporating rights for the firm to use the client's assets. These can be found in the Custody Rules (CASS 6), the Collateral Rules (CASS 3) and the Prime Brokerage Rules (CASS 9). A number of new requirements were introduced into CASS 6 during 2015, which increase the protection for clients in connection with TTCAs - and the associated compliance burden for firms. The current rules on title transfer and re-use (taking into account the recent changes) are briefly summarised below.

This briefing does not specifically address the obligations of firms under the Client Money Rules in CASS 7. It is worth noting, however, that similar restrictions on TTCAs to those discussed below were introduced into CASS 7 in parallel with the recent equivalent changes to the custody rules.

CASS 6: Custody Rules

CASS 6.1, which deals with the scope and application of the Custody Rules, clarifies that the rules cease to apply where a client transfers full ownership of a safe custody asset to a firm for the purpose of securing or otherwise covering present or future, actual, contingent or prospective obligations (this is subject to certain limitations where retail clients are concerned). Accordingly, the majority of CASS 6 does not apply to TTCAs (although the Collateral Rules may apply).

Following recent changes made to the rules on 1 June 2015, however, the above provisions on TTCAs are now accompanied by a series of new obligations on firms that enter into TTCAs. This includes:

- the requirement for a formal written agreement, covering the client's agreement to the transfer of full ownership of the relevant assets, as well as the terms on which the title transfer may be reversed and the assets returned to the firm (which reactivates the custody rules);
- an obligation to introduce procedures around client requests for termination of TTCAs (although this stops short of requiring that firms grant the client an absolute right to terminate); and
- a five year record-keeping obligation (counted from the date of termination).

Firms should also be aware that MiFID II will introduce further restrictions regarding TTCAs, including an outright ban on TTCAs with retail clients, and new restrictions potentially limiting wholesale arrangements to "appropriate" cases.

CASS 3: Collateral Rules

The Collateral Rules apply where a firm receives or holds assets to secure the obligation of a client regarding its designated investment business, and has rights to re-use the assets. CASS 3.2 clarifies that the Custody Rules continue to apply until the point at which the right of use is exercised; from that point onwards, however, the firm's primary obligation is sure that it maintains adequate records to enable it to meet any future obligations including the return of equivalent assets to the client.

No material changes have been made to CASS 3 as part of the recent reforms, although new guidance is introduced reminding firms to be mindful of the obligation to act in the client's best interests in the context of their collateral arrangements.

CASS 9: Prime Brokerage Rules

CASS 9 applies to firms providing prime brokerage services to clients, where the broker acts as principal and has the right to use the client's safe custody assets. This is subject to a series of operational, governance and transparency requirements, including (in particular), disclosure to clients of the risks associated with the use of client assets by the broker for its own account. No material changes have been made to CASS 9 as part of the recent reforms.

Custody in the pre-dematerialised world

Modern custody relationships are generally characterised under English law as trusts under which the custodian takes legal title to the security and the client retains a beneficial interest, thereby making the "safe" custody assets unavailable to the creditors of the custodian. But this was not always the case.

In the age of bearer securities, before computerisation and dematerialisation, the relationship between custodian and client was generally characterised as one of bailor and bailee.[1] A custodian's interest, as bailee, is a mere possessory one – bailment is predicated on the delivery of possession of physical control over the security or assets.[2] The analysis is the same for other assets, such as bullion.[3]

As bailee, the custodian has physical possession of the securities certificates in question but those certificates remain owned by the client. In other words, title to the securities, legal or otherwise, is not passed to the custodian. As such creditors would have no claim against those securities upon the custodian's insolvency.

Similarly, where a bailee sells the securities without the bailor's consent, the bailor would have an action in conversion against the third party purchaser, notwithstanding the fact that the third party was a bona fide purchaser for value without notice of the bailor's ownership of the securities. This is in contrast to the position under trust law where in the same situation, the purchaser would get good title leaving the beneficial owner of the securities with an action against the trustee for breach of trust but with no rights against the third party purchaser.

[1] Where bearer bonds were deposited with a certain Mr Halley "for safe custody" he was found by the court to be "an ordinary bailee". *In re Hallet's Estate. Knatchbull v. Hallett* [1878 H. 147] (1879) 13 Ch.D. 696 at 708, per Jessell MR.

[2] See, for example, *Swiss Bank Corporation v Lloyds Bank Ltd and others* [1980] 2 All ER 419 at 430, per Buckley LJ. Although note that whilst traditionally there could be no bailment of intangible property the common law is now "receptive to bailments of non-material things." N.E. Palmer, Bailment, 3rd ed., London Sweet & Maxwell, 2009, p 1528ff.

[3] See, for example, *Dollfus Mieg v Bank of England* [1949] Ch 369, [1949] 1 All ER 946.

Enforcement update

The FCA has not issued any final notices in relation to breaches of CASS since the April 2015 fine against Bank of New York Mellon. The FCA reported that it had five CASS investigations open as of March 2015 – we would expect further clarity from the FCA in its next annual report due to be published in March 2016.

On 14 April 2015, the FCA fined the Bank of New York Mellon London branch and the Bank of New York Mellon International Limited (collectively, **BNYM**) £126 million for CASS failings (reduced by 30% from £180 million for early settlement).

In essence, the FCA found that BNYM had:

- failed to maintain its records and accounts in a way that ensures their accuracy;
- failed to conduct entity-specific external reconciliations;
- failed to have in place an entity-specific process in place for identifying external reconciliation discrepancies and therefore could not promptly correct any such discrepancies;
- used clients' assets without the necessary consent;
- deposited clients' assets into omnibus client accounts with third parties but could not separately identify their clients' assets from those of the third party;
- failed to implement CASS-specific governance arrangements;
- as a result of other failings, was unable to maintain satisfactory CASS resolution packs;
- submitted incomplete and inaccurate CMARs; and
- failed to put in place adequate CASS-specific training.

The FCA found that BNYM's CASS failings were driven in large part by the use of global custody platforms which did not record which entity within the BNYM group clients had contracted.

A copy of the FCA's Final Notice can be found here.

A copy of our summary of the case can be found here.

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