

THE GRASS IS ALWAYS GREENER ON THE OTHER SIDE

Britain's reformed investor protection regulations

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ABSTRACT

In March 2012, two brokerage firms declared bankruptcy in the UK. In both cases it quickly emerged that prior to their collapse the two brokerages concerned (Pritchard Stockbrokers and Worldspreads) attempted to cover their own losses using their clients' money.

Following the collapse of Lehman Brothers, the two cases had already represented a "live" test of the UK investor protection rules reformed in 2009. With regard to the problems identified based on the experience of these two cases, the UK financial regulator, the Financial Services Authority – and its successor the Financial Conduct Authority (FCA) – carried out a further reform of the relevant regulations in 2014.

Following wide-reaching consultations, with a view to protecting clients' money and assets, new rules gradually came into force in the United Kingdom in 2014 and 2015 which are now regarded as among the most stringent in Europe.

The goal of the present article is to briefly present the relevant UK regulations.

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1. THE GOAL AND SOURCE OF REGULATION

The goal of regulations on the protection of client money and assets is to ensure full protection of clients' investments in the event of bankruptcy of a financial enterprise, as well as to prevent client money and assets being unlawfully used by the company managing them for its own purposes. An additional important goal is to reduce the period of time needed to return clients' money: in the case of the bankruptcy of *Lehman Brothers International (Europe)*, as well as that of *MF Global*, investors only obtained all or part of their money back after a process lasting years. Also justifying the demand for rapid procedures is the fact that when more

complex companies with an international corporate structure become insolvent, it has happened on several occasions that banking regulators that freeze assets more efficiently have ensured compensation for losses more rapidly and to a greater extent for investors in their own countries than more slowly reacting regulators in other countries. The third goal is to ensure that when a bankruptcy occurs the problem can be prevented from spreading further.

The importance of the topic is indicated by the special attention which the FCA devotes to the relevant regulations, having examined the issue – most recently in 2013 – not only during regular supervision of companies but also during so-called thematic reviews of the sector. Moreover, since 2010 the FCA (and its predecessor) has maintained a separate supervisory unit (*Client Asset Unit*) specialising in this area to examine the issue with the involvement of expert specialists.

The regulator has already imposed several significant fines for violation of rules on investor protection, most recently in April 2015 when it penalised one of the most recognised trustee banks with a fine of GBP 126 million, an unusually high amount even by UK standards. In evaluating the amount, it is interesting to note that the fine was still high even though not a single client suffered losses in practice: they *could have suffered* losses, however, if the custodian bank had gone bankrupt in the preceding period. In the event of a breach of the rules pertaining to client assets, the regulator may – depending on the gravity of the given case – impose a penalty of between 0% and 4% of the stock of endangered client money and assets. (Based on the general rules, the eventual amount may decrease if the investment service provider cooperates with the regulator.)

The primary point of reference for traditional principles-based British regulation is Point 10 of the FCA's Principles for Businesses, which sets the principle of the requirement for adequate protection of client assets.

The detailed source in British regulation is the so-called CASS (Client Assets Sourcebook) section of the FCA Handbook, which details the relevant rules and guidelines over some 300 pages. (It is a peculiarity of British regulation that the Handbook contains both binding rules and non-binding guidelines.) In addition, a number of significant court rulings (particularly the aforementioned cases of Lehman Brothers International (Europe) and American brokerage MF Global) provide a further foothold in matters of detail.

2. THE SCOPE OF CASS

The scope of CASS extends to the approx. 1,500 financial service providers overseen by the FCA, except for those operating as branch establishments (for which the rules valid in the parent company's country apply).

CASS rules extend to practically all investment services, and so to both services defined by MiFID and to those falling outside its scope. Among the exceptions it is worth mentioning deposit-taking activity and coins or medals held for their non-ferrous metal value.

3. PERSON RESPONSIBLE FOR PROTECTION OF CLIENT ASSETS

One of the essential rules introduced following the bankruptcy of Lehman Brothers was the one obliging financial enterprises to appoint a manager who carries personal responsibility for both the protection of client assets and the efficiency of related controls. In British regulations, numerous significantly influential functions (“controlled functions”) are dependent on the approval of the banking supervisory authority; such as, for example, specific upper management levels, the role of compliance officer, persons responsible for the prevention of money laundering and various internal controls, as well as specified customer-facing front office roles.

At the smallest financial institutions it is not obligatory to appoint a separate person to this role, but in this case one of the firm’s directors must take responsibility for related tasks.

The appointed person is responsible for the content of regular supplies of data submitted to the FCA, and is also obligated to report any breach of the protection of clients’ money or assets whenever it occurs, even if only briefly.

4. PARTS OF CASS

The CASS rules differentiate between client money and client assets. By their nature, different rules apply to each; however, the underlying principles are similar.

- The CASS rules (for both money and assets) can essentially be divided into four parts:
- Identification and completeness
- Segregation: segregation of client assets
- Reconciliation (checks): regular comparison of internal and external records
- Legal protection

4.1 Identification and completeness

The CASS rules extend to a broad range of investment services falling both within and outside the scope of MiFID. If, therefore, a client holds some kind of asset with a financial service provider, or has placed money there in this context (for example, for the financing of a planned investment), then the investment service provider is obligated to provide the protection stipulated by CASS from the very beginning.

Among the few exceptions is money received through insurance brokerage activity (where the application of the rules is for the time being optional, not mandatory), as well as money held for its precious metal value (for example, the South African Krugerrand, the gold content of which is worth significantly more than its face value).

During its checks, the FCA devotes particular attention to ensuring that all client money and assets is comprehensively covered by CASS rules. A recurring error among investment service providers, and a cause of penalties, is the omission of certain accounts from the total for shorter or longer periods. One reason for the aforementioned fine of GBP 126 million was the lack of completeness, when in certain cases client money and assets remained on 13 accounts on which the financial service provider simultaneously also held its own money and assets.

4.2 Segregation

One of the most important features of the British regulations is that they prescribe strict, physical segregation with regard to money and assets received from clients.

With respect to the client's money, the essential general expectation is that clients should transfer money to a separate account which exclusively contains clients' money, so that it does not commingle even for a moment with the firm's own liquid assets. The related detailed rules stipulate that the financial enterprise is obligated to carry out the appropriate corrections, for example settling fees that burden the given bank account. It is further obligated to make provision for interest income generated on client accounts in its general terms and conditions, and to return the received interest to clients.

The regulations theoretically permit the client to pay money into the bank account used for the company's own liquid funds, but in this event it must comply with much stricter conditions and must verify the efficiency of controls to the auditor commissioned by the company. (In compliance with the European EMIR regulations, special rules apply to clearing houses.)

Clients' money may be placed exclusively on an account at the central bank or a commercial bank, or in a (money market) fund managing short-term bonds. Detailed rules govern the selection of the latter two, a process in which the service provider must proceed with due diligence, documenting the selection procedure and regular reviews in an appropriate manner. One important rule is that a maximum 20% of the assets of individual clients may be held at banks belonging to the same group, this proportion serving to limit individual clients' exposure in the event of the bank group's bankruptcy.

With respect to client assets, the most important rule is that assets must be registered with the custodian bank in the client's name, as far as this is possible and does not entail unwarranted costs.

In the wake of experiences of the liquidation of Lehman Brothers, a prohibition was introduced into CASS whereby it is forbidden to conclude a custody agreement in which the custodian bank has a general right to withhold a client's money if it has another claim against the financial enterprise or its corporate group.

While the regulations permit the money or assets of several clients to be held on the same account (omnibus account), the integrity of every client's own assets must be continuously guaranteed. In other words, for example, the investment service provider may not use a client's shares during another client's transaction, even if the latter has already bought the shares and these are in the process of being credited to them.

4.3 Reconciliation requirements

Besides physical segregation, financial enterprises are obligated to regularly check their records and reconcile these with internal and external data.

Internal reconciliation of records must be carried out on a daily basis according to FCA guidelines. The applied methodology must be reviewed by an independent auditor, whose report must be sent to the FCA. If a shortfall appears, the financial enterprise is obligated to redress the balance from its own resources at day's end and to investigate the cause of the shortfall.

In addition, internal documents must be compared with external documents – primarily bank account statements – on a regular basis, at least monthly. In the event of a shortfall, the procedure here is the same and the FCA must be informed of the shortfall.

With respect to client assets, financial enterprises have an obligation to submit regular reports. Enterprises managing larger client assets (amounts exceeding GBP 1 million or GBP 10 million) must submit a detailed report to the FCA monthly, and smaller enterprises twice yearly (Client Money and Asset Return – CMAR).

4.4 Legal protection

To protect clients' money, the financial enterprise is obligated to conclude an asset management contract defined under UK law (the institution of "trust law" known under common law, which has no real recognised equivalent in the legal systems of continental Europe). Very detailed rules apply to the relevant documentation.

Connected to these rules is the requirement for the custodian bank to sign a statement (acknowledgement letter) with predetermined content. In this it acknowledges that it holds the assets in its keeping as custodian bank, that the assets and money held on such accounts cannot be held together with other assets, that no other existing claim against the investment service provider may be enforced in respect of such assets, and that the name of the account refers unequivocally to its nature as a client account (e.g. it contains the word "client"). The acknowledgement letter must be obtained before any client money or assets are placed on the account held at the given financial institution (the 20-day grace period permitted under the previous regulations was abolished in 2015).

Acknowledgement letters must be reviewed annually and retained for five years after the closing of accounts.

5. "LIVING WILL" IN THE EVENT OF INSOLVENCY

Investment service providers are obligated to prepare a "living will" (CASS Resolution Pack) to cover potential insolvency, when officially appointed liquidators would begin to return money and assets to clients. CASS rules stipulate that financial service providers must draw up detailed documentation which they must regularly review so that the appointed administrator in the event of insolvency can proceed quickly and efficiently based on the documentation provided.

The content of the documentation is determined in detail in the regulations. To highlight the most important elements, the documentation must contain the names and account numbers of other institutions cooperating in the management of clients' money, the contracts concluded with them, and internal regulations pertaining to the protection of clients' money.

In short, UK regulations, in absorbing the lessons of various cases, have gradually become among the most stringent in Europe. Besides strict administrative rules, the difficulty of adhering to the regulations lies in the need, amid the complex operations of investment service providers, to ensure the complete and continuous segregation of client money and assets without error within numerous IT systems.

Here, too, the devil lies in the details, and these details can often prove costly indeed...

The British regulations, similarly to those on flight safety, have attained their current form, effective from July 2015, by drawing lessons from a variety of cases. The lessons learned by the British, together with certain elements of the new regulations, might prove instructive for other European countries as well.

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