The Futures and Options Association

Proposals for the improvement of the FSA's Client Money Rules

Introduction

The Futures and Options Association (**FOA**) sets out in this paper some recommendations as to how the FSA's Client Money Rules (**Client Money Rules**), as set out in the Client Assets sourcebook of the FSA Rules (**CASS**), could be improved in light of the administration of Lehman Brothers International (Europe) (**LBIE**). These reflect discussions which the FOA has carried out with its members since 15 September 2008.

The FOA understands that the FSA is considering making certain amendments to the Client Money Rules and hopes that the FSA will take these recommendations into account. The FOA would be pleased to discuss these recommendations and any other proposals with the FSA in further detail.

The FOA is also conscious that the operation of the Client Money Rules has a complex relationship with insolvency law and believes it is important that any amendments that are made to one are reflected in the other. The FOA is also participating in the Investment Banking Advisory Panel review of the application of insolvency law to investment banks, and notes the similarity between several of the suggestions raised in HM Treasury's recent paper[1] and its own recommendations.

The FOA also notes the recent publication of the judgment in In *Re Global Trader Europe Limited*[2] and the conclusions which Sir Andrew Parke reached about the circumstances in which cash might not be held as client money both before and after a pooling event. The administrators of LBIE have sought directions from the court in relation to the judgement in the Global Trader case and to clarify the status and application of other aspects of the Client Money Rules that are ambiguous and where drafting changes would be appropriate. The court's deliberations may potentially also reveal instances of where the outcome of the court's interpretation of the Client Money Rules may lead to undesirable outcomes which can be addressed by amending the rules. As such, it would be helpful to continue to monitor the LBIE administration process to identify CASS rules that should be amended.

High level conclusions

The FOA believes that there are no structural problems with the Client Money Rules. However, the inability of the liquidators of LBIE to distribute the client money pool (for a number of reasons many which are not founded in problems with the Client Money Rules) has highlighted the fact that the Client Money Rules are one aspect of a system that has failed to return client money on a timely basis. Further, press and other commentary on the Lehman insolvency has made it clear that the Client Money Rules are not well understood by many clients.

The FOA is therefore making recommendations as to how to improve (i) perceptions surrounding the Client Money Rules, and (ii) to facilitate clients coming to a better level of understanding on the Client Money Rules and their practical application. The FOA has also considered matters of substance, such as where rule changes or new drafting may assist the creation of a client money regime under which clients may receive more effective or clearer protection and whereby the return of client assets may be achieved more quickly.

The FOA believes that clients do not understand the following points in particular:

- the perimeter of client money: i.e. when cash will (and will not) be held as client money, the treatment of cash transferred to a third party and whether it makes a difference if it is held outside the UK;
- what the Client Money Rules achieve and what exposures remain;
- how the Client Money Rules fit in with the contractual relationship they are entering into with a firm;

[1] "Developing effective resolution arrangements for investment banks" (May 2009 HM Treasury)
[2] Re Global Trader Europe Limited (in liquidation) [2009] EWHC 602 Chy

- what happens on a pooling event and the risk and potential causes of shortfalls; and
- how netting may affect their client money entitlement.

The FOA also believes that some parts of the judgment in In *Re Global Trader Europe Limited* may raise further issues in the minds of clients who might expect client money protection to apply to a wider set of circumstances.

The fact that the administrators of LBIE (advised by Linklaters LLP) have been unable to reach conclusions on the application of certain of the Client Money Rules with confidence without seeking directions from the High Court on their interpretation suggests that consideration of the outcomes they can produce and subsequent clarification would also be of benefit to firms and their advisers.

Recommendations

The FOA makes the following recommendations. The first half are aimed at making the client money regime clearer to clients and the second half pertain to more substantive shortcomings in the rules or the drafting of the rules.

Clarity on the client money regime

Clarify the scope of the statutory trust set out in section 139(1) of the Financial Services and Markets Act 2000 and explained in CASS 7.7. The majority of firms believe that this is a statutory trust over the firm's contractual right to the return of the cash against the bank with which the firm has deposited it, and there is some support for this view in In *Re Global Trader Europe Limited*. However, the wording of section 139(1) and CASS 7.7 are not as clear as they might be on this point which is fundamental to the client money regime.

Produce guidance on the application and effect of the Client Money Rules that firms can provide to their clients. The FOA supports the creation of industry guidance on the operation and interpretation of the Client Money Rules. It is felt that such guidance would carry more weight with clients (particularly overseas clients) if it were published, by the FSA. The FOA would also welcome the opportunity to discuss details of such guidance with the FSA.

Insert in the Client Money Rules further disclosure requirements.
These should include:
- the ability of firms to transfer client money to banks;
- information about the manner in which client money is held at exchanges and clearing houses;
- the impact of a firm transferring client money to an exchange or clearing house;
- the fact that the exchange or clearing house will not owe client money protection;
- the fact that some exchanges and clearing houses may not segregate proprietary and client money; and
- the risks associated with structures that segregate proprietary and client money.

The FOA notes that the HM Treasury Investment Bank Advisory Panel is contemplating the possibility of enhancing risk disclosures in contractual arrangements and supports measures that enhance client understanding of the Client Money Rules.

Holding client money

Provide some guidance on what is appropriate to firms carrying out due diligence on banks in accordance with CASS 7.4.7R and 7.4.8R. Certain members of the FOA would appreciate more practical guidance on how, and how much, due diligence firms are expected to undertake, especially on large, well-established banks. While the large size and the prominent status of a bank can no longer be considered to equate to low credit risk, it is sometimes difficult for individual FOA members to obtain up to date and detailed information from such banks. The FOA does, however, appreciate that such information is highly sensitive and will be of a non-public price sensitive nature.

Under CASS 7.1.12, a firm must treat affiliated companies as any other client of the firm for the purposes of the Client Money Rules. Consequently a firm must provide segregation to third party clients and the firm's affiliates, irrespective of whether the affiliates are acting in a proprietary capacity or on behalf of third parties. This results in commingling of client and the firm's affiliates' money in the segregated accounts and exposes third party clients to the risk of a group default. We recommend that this is addressed so that unambiguous segregation takes place between third party clients and the firm, including their affiliates where they are acting in a proprietary capacity.

Consider allowing firms to divide client money into different pools relating to different types of investments so that client money held in respect of riskier products such as OTC derivatives transactions could be separated from client money relating to simpler products such as cash equities traded on a delivery versus payment basis. On a primary or secondary pooling event, a firm's accounts containing client money relating to each type of investment would be pooled with each other, but not with accounts containing client money relating to different investment types so that the risk of shortfalls relating to more complex products (including those arising from a failure of an exchange or clearing house) need not be borne by clients who have invested in simpler products. This recommendation would have to work as a matter of insolvency law and after rights of set-off have been applied at the level of the firm. The FOA notes that a similar concept is mentioned in the HM Treasury paper. The FOA would like to note that under Commodity Futures Trading Commission rules, the client money pool for futures business is held separately from that pertaining to other investment types.

Return of client money

A new rule should be introduced to provide that the costs of distributing client money on a pooling event should be borne by the estate of the insolvent firm rather than being deducted from the client money pool. Alternatively, it should only be possible to use a maximum percentage of the client money pool to satisfy costs. Either of these options would enable a minimum amount of client money to be distributed more promptly on a pooling event because it would no longer be necessary to determine costs before any distributions could be paid to client money holders. The amount of any shortfalls would still need to be calculated before final distributions could be made. A new rule could also be introduced that would permit administrators to distribute a percentage of the client money pool while the entirety of the pool remains under investigation. Such a rule could be integrated with necessary changes to applicable insolvency laws which are currently under review by HM Treasury.