RECOMMENDATIONS REGARDING THE PROTECTION OF CLIENT ASSETS
AN IOSCO CONSULTATION REPORT

A response by the Futures and Options Association (FOA)

MARCH 2013

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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 We understand and support IOSCO's underlying Principle that clients, when exercising their discretion to waive or modify their entitlement to have their client assets protected, should do so on the basis of understanding the implications of their decision and that that means that any such waiver, modification or opt out:

- should be the subject of a disclosure to clients; and
- the decision should be "affirmative and explicit" and not "deemed or implied".

1.3 The FOA believes, however, that there are a number of modifications that should be introduced to the IOSCO's proposed Principles to ensure that:

(a) the burden placed on firms is proportionate, reasonable and deliverable;

(b) a proper distinction is drawn between wholesale and retail customers to the extent that, while retail-driven fiduciary obligations are owed to the latter, that need not and should not be the case with the former who are well able to assess client asset risks for themselves (e.g. the right to re-hypothecate collateral should be permitted in the case of wholesale customers);

(c) clients retain responsibility for undertaking their own due diligence, where they are able and capable of doing so; and

(d) the client asset regime should not apply to a derivatives transaction itself (e.g. a contractually based instrument is not the same as a physically delivered security)

1.4 by way of enlargement to the points made in para 1.3(a) and (c), no intermediary will be able to have the capacity to assess the insolvency laws of other jurisdictions and all their applicable regulations to the individual and changing circumstances of clients to the degree anticipated in the IOSCO consultation report. Further, this advisory function is not appropriate to execution only intermediaries and those providing custody. At the end of the day, much of this information will largely be a matter for the customers themselves, particularly in the case of wholesale customers.

1.5 In developing its Principles and Recommendations, IOSCO should take into full account and, indeed, recognise that insolvency law is differentiated across many jurisdictions and will have an impact on the recommendations and processes for protecting client assets and that therefore they cannot operate on a wholly uniform basis. Further, all clients should be entitled to choose what level of protection they want in terms of their client assets ranging from net omnibus accounts through to individually segregated accounts (which is the position in the EU under EMIR).

1.6 The FOA notes that in a number of the IOSCO draft Principles there is a reference to firms undertaking due diligence responsibilities, many of which are interlinked and, to some extent, duplicative. The FOA believes that this is an obligation that perhaps could most cost effectively

be undertaken on a centralised basis recognising, of course, that it must meet the requisite standards and be kept up to date.

Such an approach would comprise:

- analysing and keeping up to date an assessment of the rules on client money/assets in foreign jurisdictions and how they compared with home state rules (as required under paragraphs 3.3, 4, 5.1, 5.2, 5.4, and 8.2 in the IOSCO consultation paper);

- a standardised disclosure requirement – comparable to that required under the EU's EMIR – of the consequences, advantages and disadvantages of different levels of segregation, including, as it is put in the IOSCO requirements, the impact/ consequences of any waiver, modification or "opting out" that may be permissible under the law of the home state regime as regards the degree of protection applicable to client assets/money (paras 6.2, 6.3 and 6.5).

2 Principle 1

2.1 The FOA supports this Principle, but is of the view that;

- the increasing complexity of client asset protection regimes, differentiation in independent legal systems and bankruptcy laws, the lack of ESMA supporting standards in key areas of the regime and the growing momentum towards individually segregated accounts (with all the accompanying administrative complexity) makes para 4, which adopts a snapshot approach of "at any time and without delay" is unduly burdensome and puts firms at legal risk. End of day information should be used in its place on the basis that this will accord with the principle of "as soon as reasonably practicable";

- in line with the ESMA technical standards in the EU, omnibus client accounts should continue to be wholly acceptable and that ownership should be established as between the intermediary and the client and not as between individual clients;

- the request to maintain "up-to-date" records should include the words "wherever reasonably possible" in order to take account of the fact that they will be subject to reconciliation and completion of other actions and responsibilities (complicated by the momentum towards individually segregated accounts), including investigating data which is perceived as incorrect or deficient in some way.

3 Principle 2

3.1 While the FOA understands the objectives behind this Principle, it does not seem necessary for client statements to show the nature of client asset protection applicable to a client. The decision made by the client will be already known to the client and will have been made on a fully informed basis as to the different levels of protection afforded by different tiers of protection. In addition, there are on-going disclosure obligations imposed upon the firms – all of which makes this a needless cost incurred by firms.

3.2 For the reasons stated in 3.1 above, the FOA believes that the obligation to provide a statement to each client on a regular basis is, again, a needless imposition of cost, but the FOA does agree that clients should be able obtain such statements on request and that this right can be made clear in the original customer agreement.

3.3 In this context, it is worthwhile bearing in mind that clients are required to give express, affirmative and explicit consent – which may not be "deemed or implied" – to any waiver, modification or opt-out to their entitlement to client asset protection and that this will have been made on a fully disclosed basis.

4 Principle 3

4.1 The FOA believes that this Principle should be rewritten to read "an intermediary should maintain appropriate arrangements designed to safeguard the clients assets and to minimise the risk of loss and misuse", particularly since differences in regulatory rules, and, particularly, in insolvency law, may reduce the ability of arrangements to safeguard clients' rights in client assets and to minimise the risk of loss and misuse to any absolute degree in any one jurisdiction.

4.2 This required analysis should be subject to an "all reasonable steps" measure and reasonable account should be taken of the continuous cost of consulting with law firms and accountancy firms on an on-going basis in the way suggested in para 2. Here again, while intermediaries recognise the importance of understanding how changes can materially change the status of a client asset and/or complicate the return of a client asset, a test based on any form of absolute knowledge would be unreasonable.

4.3 The FOA would repeat its observations that the requirement to "exercise all due skill, care and diligence" could impose an unreasonable expectation and obligation on regulated firms and that the test again should be modified to an "all reasonable steps" test.

4.4 The FOA believes that the general obligation to be imposed on intermediaries that they must advise the client of "any associated risks" is far to broad and, firstly, should be restricted to real and substantial risks that are relevant to the type of client or the way in which the asset has been protected – i.e. much greater recognition should be given to the considerable costs that would have to be incurred by intermediaries to provide that kind of information or to accept the legal risk that is associated with the broad-based and high cost levels of due diligence that have to be undertaken in order to deliver on this obligation.

4.5 The FOA agrees that it is essential that where client assets are placed with a third party, the intermediary should exercise "all due skill, care and diligence in the selection and appointment (where applicable) and periodic review of the third party and of the arrangements of safeguarding the client assets" and that consideration should be given to points raised in sub-paragraphs (a)2(d), but the FOA notes that diversification is not a requirement but it can complicate compliance with the obligations set out in the IOSCO paper.

4.6 With regard to para 3.5, the FOA would urge IOSCO to take into full account the fact that liens and other encumbrances on client assets are designed to protect an intermediary against the risk of client default and it creates a substantial and unreasonable level of conflict of interest to require an intermediary, where it is taking a step designed to reduce its credit risk, to subordinate in any way any such action on the basis, as implied, that it would not be in the "best interests of the client". This should surely be a matter that falls within the absolute discretion of an intermediary in terms of the management of its credit risk (on which considerable emphasis is in place by regulators in the current post-crisis environment).

5 Principle 4

5.1 The FOA agrees with this Principle and notes that, for the purpose of interpreting the obligation, the reference to "foreign jurisdiction" – as per note 1 to the consultation paper – is to be interpreted to mean a "jurisdiction outside of the EU" so that the home regime, in the context of the EU, is a reference to the EU regime as a whole and not that of individual EU member states (presumably in recognition of the significant role of ESMA in harmonising individual member state rules). However, there will still be cross-border differences between EU countries in this area, notwithstanding some degree of harmonisation of client asset rules, on the basis that ESMA's harmonising technical standards do not apply to all areas of client assets.

5.2 The obligation to ensure "compliance with applicable domestic requirements" should perhaps read, for the avoidance of doubt, "to achieve its compliance with applicable domestic requirements".

6 Principle 5

6.1 As indicated in para 1.4 above, the FOA believes that this is information that could be sent centrally by trade associations in the form of a standardised annex that could be provided to the clients of intermediaries in terms of:

(a) providing "adequate and appropriate information about the arrangements for client asset protection and the ways in which the intermediary holds or deposits different types of client assets and the attendant risks";

(b) informing clients of the material differences between a foreign jurisdiction in which client money/assets are held and the home state jurisdiction; and

(c) including any appropriate risk disclosure statements that will be necessary in order to enable clients to make informed decisions concerning their investments (as required in para 4).

6.2 The FOA notes that, as it would appear, Principle 3 requires a high level of understanding, particularly in relation to "all associated risks" and the impact of placing client money in a foreign jurisdiction, but that the disclosure obligation in Principle 5.4 rightly requires disclosure of only "material risks" of placing client assets in a particular jurisdiction. The FOA would caution IOSCO against imposing obligations on intermediaries which are excessive and can only be met by undertaking significant costs and accepting high levels of legal risk as regards the breadth of legal disclosure obligations. Proportionality in this area is essential. This is particularly the case with assuming disclosure and due diligence obligations in the context of wholesale customers which can be reasonably expected to be carried out by wholesale customers.

7 Principle 6

7.1 It is presumed that the requirement that the information set out in para 1 must be set out in a separate document does not apply to any document facilitating express client consent to a waiver, modification or opt out from the client asset protection regime as required under para 2. This seems to be the gist of paras 1,2 and 3.

7.2 While the FOA recognises that para 4 is, to some considerable extent, personalised to individual firms and clients, the FOA would reiterate its view that disclosure obligations, inevitably, have to be generic to a large degree. Personalising to a significant degree to the exact relationship between the client asset and the client's rights in the asset can only be undertaken through the obtaining and keeping up to date of legal opinions founded on the specific circumstances of the intermediary/client relationship. This, in the view of the FOA, would be wholly unreasonable. For example, if a particular client wants that level of detailed information, they should be prepared to pay separately for a legal opinion in the context of undertaking their own due diligence in this area. This is particularly the case, once again, with wholesale customers.

8 Principle 7

8.1 The FOA understands and recognises the importance of the regulators having adequate "tools" to effectively monitor compliance with their client asset protection regimes and that there will be circumstances where urgent action is necessary. However, intermediaries are facing a considerable and growing number of costly and burdensome additional requirements (a significant percentage of which will become yet another "pass-through cost" for end-users). It is important, therefore, that intermediaries do not face the situation of unnecessarily high regulatory costs e.g. subsidising the regulatory obligation to monitor compliance by incurring undue additional auditor costs and/or paying for specialist investigations which properly fall within the purview of the regulatory authorities or meeting excessive reporting obligations which are not in line with the purposes behind requiring a report. This observation is not intended to undermine the importance of having an effective client asset protection regime, but rather to ensure that the regime is cost efficient for end-users as well as intermediaries.

8.2 It should be noted that reports covering the ownership status of client assets are able to cover the “ownership status” as between the intermediary and its client, but not between the client and other third parties.

9 Principle 8

9.1 The FOA notes the obligation on regulators to be able to assess the impact of intermediaries placing or depositing client assets in foreign jurisdictions and believes that this should be a primary obligation placed upon the regulatory authorities and should be covered as appropriate in inter-regulatory MOU’s. The obligation on an intermediary to report information to its regulatory authority pursuant to para 2 should only be exercised where that information cannot be obtained directly from the relevant regulatory authority pursuant to para 3. The FOA believes that duplication in providing obligations should be avoided wherever possible.